PLAINTIFF'S EXHIBIT 4220
Comes v. Microsoft

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For The Fiscal Year Ended June 30, 1999

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

For the Transition Period from ____________ to ____________

Commission File Number 0-14278

MICROSOFT CORPORATION

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Washington (State of incorporation)	91-1144442 (I.R.S. ID)

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One Microsoft Way, Redmond, Washington 98052-6399

(425) 882-8080

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock

2 3/4% Convertible Exchangeable Principal-Protected Preferred Stock

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [_]

The aggregate market value of common stock held by non-affiliates of the registrant as of September 10, 1999 was $375,039,342,820.

The number of shares outstanding of the registrant's common stock as of September 10, 1999 was 5,141,508,124.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 1999 Annual Report to Shareholders are incorporated by reference into Parts I, II, and IV. Portions of the definitive Proxy Statement dated September 10, 1999 to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held November 10, 1999 are incorporated by reference into Part III.

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MICROSOFT CORPORATION

FORM 10-K

For The Fiscal Year Ended June 30, 1999

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PART I

Item 1. Business

General

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for intelligent devices, personal computers (PCs) and servers; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN(TM) network of Internet products and services; e-commerce platforms; and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells PC input devices; trains and certifies system integrators; and researches and develops advanced technologies for future software products.

Microsoft's business strategy emphasizes the development of a broad line of software products for information technology (IT) professionals, knowledge workers, developers, and consumers, marketed through multiple channels of distribution. The Company is divided into three main areas: the Business Divisions, the Sales and Support Group, and the Operations Group.

The Business Divisions act in parallel, each with responsibility for the product planning and marketing strategies for their respective customer segments. These customer segments are the Windows(R) Platforms segment, the Business Productivity Applications and Developer segment, and the Consumer, Commerce, and Other segment.

The Windows Platforms segment contains three groups. The Business and Enterprise Group develops and markets PC and server operating systems required by large organizations and IT professionals. The Consumer Windows Group oversees and develops operating systems designed primarily for stand-alone PCs used in homes and small businesses. The Streaming Media Division develops a digital media platform for streaming music, video, and synchronized multimedia over the Internet.

The Business Productivity Applications and Developer segment has two primary groups organized around providing software and solutions for knowledge workers and software developers. The Business Productivity Group creates and markets primarily desktop and server applications. The Developer Group builds architecture and software tools for developers.

The Consumer, Commerce, and Other segment includes the Consumer and Commerce Group and the Home and Retail Division. The Consumer and Commerce Group provides services to consumers over the Internet and provides software solutions and services for businesses to conduct commerce on the Internet. The Home and Retail Division creates and markets productivity programs, learning and entertainment products, and hardware peripherals. For financial reporting, revenue from Microsoft Press, consulting, and certification of system integrators is included in this segment.

See notes to financial statements for financial information regarding segment reporting.

Microsoft has a research lab dedicated to creating new technology and converting problems into tangible solutions that Microsoft developers can incorporate into products to meet customers' needs.

The Sales and Support Group is responsible for building long-term business relationships with original equipment manufacturers (OEMs), enterprises, small- and medium-sized businesses, application developers, educational institutions, and consumers. Enterprises are offered tailored license programs, enterprise-wide support, consulting services, and other specialized services. The group also manages the channels that serve customers by working with OEMs, distributors, and resellers. In addition to the OEM channel, Microsoft has

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three major geographic sales organizations: the South Pacific and Americas; Europe, Middle East, and Africa; and Asia. The Sales and Support group supports the Company's products with technical support for end users, developers, and IT departments in organizations.

The Operations Group is responsible for managing business operations and overall business planning. This includes the process of manufacturing and delivering finished goods and licenses; corporate functions such as finance, administration, human resources, and legal; and the publishing efforts of Microsoft Press.

Products

Windows Platforms

The Windows Platforms segment is responsible for the development of PC and server platforms, including the Microsoft(R) Windows and Windows NT(R) operating systems. The segment is also responsible for developing the Microsoft Internet Explorer browsing software and Microsoft Windows Media(TM) Technologies. PC operating systems perform a variety of functions, such as allocating computer memory, scheduling applications software execution, managing information and communication flow among the various PC components, and enabling end users to access files and information from a variety of sources. The Windows NT operating system for servers is an enterprise-wide platform for building and deploying distributed applications for networked PCs. The Windows Platforms segment also provides products for developing, running, and managing Internet and intranet applications and content.

Windows 98. The successor to Windows 95, Windows 98 is a personal computer operating system that provides a Web-oriented user interface, better system performance along with easier system diagnostics and maintenance. Windows 98 supports graphics, sound, and multimedia technologies and provides the ability to easily add and remove peripheral devices and support for Universal Serial Bus (USB). Windows 98 was released in June 1998.

Windows 95. The successor to the MS-DOS(R) operating system and Windows 3.x, Windows 95 was released in August 1995. Windows 95 is a fully integrated, multitasking 32-bit operating system, designed to be compatible with Intel microprocessor-based PCs, most hardware devices, and applications for Windows 3.x and MS-DOS.

Windows NT Workstation. A fully integrated, multitasking 32-bit PC operating system, Windows NT Workstation provides security, robustness, and portability. Windows NT Workstation is designed for mission- critical computing and provides the same features and applications programming interfaces (APIs) for Intel and Alpha AXP microprocessors. Microsoft Windows NT Workstation combines the Windows 98 operating system interface and usability features with the reliability and security of Windows NT for the business environment.

Windows NT Server. Windows NT Server is an operating system foundation for both server applications and file and print sharing, with network management

Results of Operations for 1997, 1998, and 1999

Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for intelligent devices, personal computers (PCs), and servers; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN network of Internet products and services; e-commerce platforms; and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells PC input devices; trains and certifies system integrators; and researches and develops advanced technologies for future software products.

Revenue

The Company's revenue growth rate was 32% in fiscal 1997, 28% in fiscal 1998, and 29% in fiscal 1999. Revenue growth rates reflected the continued adoption of Windows operating systems and Microsoft Office, particularly as Microsoft software is deployed across entire corporate, academic, and governmental organizations. Software license volume increases have been the principal factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and organizational license programs is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office and BackOffice, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. During each of the three years, an increased percentage of products and programs included elements that were billed but unearned and recognized ratably, such as Microsoft Windows, Microsoft Office, maintenance, and other subscription models. See accompanying notes to financial statements.

As noted above, the Company's business model continues to evolve from selling packaged products to licensing organizational licenses and subscriptions. The Company's products are generally delivered to customers through a multi-tiered channel of distributors and resellers, but the distribution model is also changing for selected retail products that are now being shipped straight to resellers and other selected products that are now being shipped straight to customers. Due to these changes in channel mechanics and the business model, the risk of returns of product from distributors and resellers has declined. Accordingly, the estimate for future product returns was reduced by $250 million in the fourth quarter of fiscal 1999.

The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and training and certification of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. These amounts had been previously netted in sales and marketing expenses, except for MSN access fees, which had been netted in research and development expenses. Direct costs of these activities are classified as cost of revenue. Prior financial statements and disclosures have been reclassified

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for consistent presentation. Revenue from these activities was $578 million, $778 million, and $1.06 billion in 1997, 1998, and 1999.

Microsoft also made two changes related to the ratable recognition of revenue for a portion of its revenue for certain products. A new accounting rule that interprets American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, requires companies to use the average sales price of each undelivered element of software arrangements. Prior authoritative guidance allowed a comparison of the total price differential between a licensed product sold through different channels of distribution to derive the value of undelivered elements offered to customers acquiring product from one channel but not the other. Upon adoption of this new rule in the fourth quarter of fiscal 1999, the percentages of the total arrangement treated as unearned decreased. This change in the timing of revenue recognition reduced the amount of Microsoft Windows and Microsoft Office sales treated as unearned and increased the amount of revenue recognized upon shipment. Additionally, as part of the Company's long range planning process and a review of product shipment cycles, it was determined that the life cycle of Windows should be extended from two years to three years. The net impact of these changes was to increase reported revenue $80 million in the fourth quarter of 1999.

Business Divisions. Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer, Commerce, and Other.

Windows Platforms revenue was $4.92 billion, $6.28 billion, and $8.50 billion in 1997, 1998, and 1999. Platform revenue is primarily licenses of PC operating systems and business and enterprise server systems with client/server, Internet, and intranet architectures.

The Company's principal PC operating systems are Windows 95, Windows 98, and Windows NT(R) Workstation. Windows 95 was released in August 1995, while its successor, Windows 98, became available at the end of fiscal 1998. Windows NT Workstation version 4.0 was released in fiscal 1997. Although the growth rate of new PC shipments slowed, PC operating systems contributed to revenue growth as shipments of new PCs preinstalled with such systems increased during the three-year period. Additionally, increased penetration of the higher value Windows NT Workstation led to growth in all three years.

Windows NT Server is a comprehensive business and enterprise server operating system, combining application, file and print, communication, and Web services. Windows NT Server version 4.0 was released in fiscal 1997. Revenue from Windows NT Server increased strongly during each of the three years due to greater corporate demand, particularly for intranet computing solutions.

Productivity Applications and Developer revenue was $5.62 billion, $7.04 billion, and $8.82 billion in 1997, 1998, and 1999. Products include primarily desktop applications, server applications, and software developer tools.

Microsoft Office integrated suites, including the Standard, Small Business, Professional, and Premium Editions, are the Company's principal desktop applications and a key driver of revenue growth. Microsoft Office 97 was released in fiscal 1997 and Microsoft Office 2000 was released at the end of fiscal 1999. The primary programs in Microsoft Office are the word processor Microsoft Word, Microsoft Excel spreadsheet, and Microsoft Outlook(R) messaging and collaboration client. Various versions of Office, which are available for the Windows and Macintosh operating systems, also include Microsoft Access database management program, Microsoft PowerPoint(R) presentation graphics program, Microsoft FrontPage(R) Web site creation and management program, or other programs. Revenue from stand-alone versions of Microsoft Excel, Word, and PowerPoint continued to decrease as the sales mix shifted to integrated product suites.

Server applications, based on Microsoft Windows NT Server, offer an enterprise-wide distributed client/server, Internet, and intranet environment. Products include Microsoft Exchange Server, Microsoft SQL Server, and other server applications in the Microsoft BackOffice family of products. Microsoft Exchange is an enterprise messaging and collaboration server while Microsoft SQL Server is a scalable

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database and data warehouse platform. Revenue from these products increased strongly over the three-year period, albeit with slowing growth rates in 1998 and 1999.

Independent software vendors, corporate developers, and solutions developers license tools such as the Microsoft Visual Studio(R) development system, which includes the Microsoft Visual Basic(R) development system, to develop software for the Windows operating systems and the Internet. Revenue from developer products increased moderately in 1997, was flat in 1998, and increased strongly in 1999.

Although revenue was not significant, preinstallations of Windows CE by OEMs on intelligent devices were strong in 1998 and 1999.

Consumer, Commerce, and Other revenue was $1.40 billion, $1.94 billion, and $2.43 billion in 1997, 1998, and 1999. This category of product revenue includes learning and entertainment software; PC input devices; training and certification fees; consulting; and the online services. The Company's Internet services include the MSN portal, MSN access, WebTV(R), and vertical properties such as MSN Hotmail Web-based email service, Expedia.com(TM) travel site, CarPoint car buying site, and MoneyCentral personal finance site.

Learning and entertainment revenue was relatively flat in all three years. Mouse, gaming device, and keyboard sales increased in 1997 and 1998, but were steady in 1999. Training and certification fees from system integrators, along with consulting services to large enterprise customers and technology solution providers, increased strongly in all three years. Revenue from MSN Internet access fees and WebTV services increased due to higher subscriber levels. Advertising revenue, although relatively small in amount, increased exceptionally well in 1999 for the online portal and vertical properties.

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

OEM channel revenue was $3.49 billion in 1997, $4.72 billion in 1998, and $6.40 billion in 1999. The primary source of OEM revenue is the licensing of desktop operating systems, and OEM revenue is highly dependent on PC shipment volume. Growth was also enhanced by increased penetration of higher-value Windows NT Workstation licenses.

Revenue in the South Pacific and Americas Region was $4.39 billion, $5.57 billion, and $7.25 billion in 1997, 1998, and 1999. Revenue in the Europe, Middle East, and Africa Region was $2.77 billion, $3.50 billion, and $4.33 billion for the three years. Growth rates have been lower in Europe than in other geographic areas due to higher existing market shares and a faster shift to licensing programs. Asia Region revenue was $1.29 billion in 1997, $1.48 billion in 1998, and $1.78 billion in 1999. After strong growth in prior years, revenue was relatively flat in Japan and Southeast Asia in 1998 and the first half of fiscal 1999 due to economic issues and weak currencies.

The Company's operating results are affected by foreign exchange rates.

Approximately 32%, 32%, and 29% of the Company's revenue was collected in foreign currencies during 1997, 1998, and 1999. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

Operating Expenses

Microsoft encourages broad-based employee ownership of Microsoft stock through an employee stock option (ESO) program in which most employees are eligible to participate. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30

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days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of $217 million was recorded in the fourth quarter for fiscal 1999 compensation expense, calculated under the provisions of Accounting Principles Board Opinion 25 (APB 25). Charges related to ESO compensation were reflected in 1999 operating expenses as follows (in millions):

Cost of revenue	$ 44
Research and development	105
Sales and marketing	46
General and administrative	22
Total	$217

Cost of revenue. Cost of revenue as a percent of revenue was 18.2% in 1997, 16.1% in 1998, and 14.3% in 1999. The percentage decreases resulted primarily from the trend in mix shift to OEM and organizational licenses. The decrease was also due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks) and higher-margin Windows NT Server, other servers, and client access licenses in the BackOffice product family. Additionally, cost of revenue in 1999 was positively impacted by a reduction in estimates of obsolete inventory and other manufacturing costs of $67 million. As discussed above, the Company's business model continues to evolve toward licensing from sales of packaged products through distribution channels. Consequently, risks associated with manufacturing and holding physical product have declined.

Research and development. Microsoft continued to invest heavily in the future by funding research and development (R&D). Expense increases in 1997, 1998, and 1999 resulted primarily from development staff headcount growth in many areas, particularly Windows platforms, including PC operating systems, servers, and Internet and intranet technologies. R&D costs also increased for productivity applications, development tools, and online services.

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

Sales and marketing. The increase in the absolute dollar amount of sales and marketing expenses in the three-year period was due primarily to expanded product-specific marketing programs, such as Office 97 in 1997, Windows 98 in 1998, and Office 2000 in 1999. Sales and marketing costs as a percentage of revenue decreased primarily due to moderate headcount growth. Microsoft brand advertising expenses rose slightly in 1998, but declined in 1999.

General and administrative. Increases in general and administrative expenses were attributable to higher legal fees, litigation costs, and growth in the number of people and computer systems necessary to support overall increases in the scope of the Company's operations.

Other expenses. Other expenses include the recognition of Microsoft's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities.

Investment Income, Gain on Sale, and Income Taxes

Investment income increased primarily as a result of a larger investment portfolio generated by cash from operations in 1997, 1998, and 1999, coupled with realized gains from the sale of certain bond and equity securities in 1999.

In fiscal 1999, Microsoft sold its Softimage, Inc. subsidiary to Avid Technology, Inc. for a pretax gain of $160 million.

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The effective income tax rate was 35.0% in 1997. The effective income tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies. Excluding the impact of the gain on the sale of Softimage, Inc., the effective tax rate for fiscal 1999 was 35.0%.

Net Income

Net income as a percent of revenue increased in 1997, 1998, and 1999 due primarily to the lower relative cost of revenue and sales and marketing expenses, combined with greater investment income.

Financial Condition

The Company's cash and short-term investment portfolio totaled $17.24 billion at June 30, 1999. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, primarily strategic technology companies. The Company has made large-scale investments in access providers, including cable, telephony, and wireless communications companies. During 1999, the Company purchased $5.0 billion of AT&T convertible preferred securities and warrants, $600 million of Nextel Communications, Inc. common stock, $500 million of NTL, Inc. convertible preferred stock, $330 million of United Pan-Europe Communications common stock, and $200 million of Qwest Communications International Inc. common stock. In connection with AT&T's proposed merger with MediaOne Group, Inc., the Company agreed to acquire MediaOne's interest in Telewest Communications plc, a leading provider of cable television and residential and business cable telephony services in the United Kingdom, subject to certain regulatory approvals and other conditions. During 1997, Microsoft purchased $1.0 billion of Special Class A common stock and convertible preferred stock of Comcast Corporation. Microsoft also owns an interest in MCI WorldCom, Inc.

Microsoft and National Broadcasting Company (NBC) operate two MSNBC joint ventures: a 24-hour cable news and information channel, and an interactive online news service. Microsoft is paying $220 million over a five-year period that ends in 2001 for its interest in the cable venture and one-half of the operational funding of both joint ventures. Microsoft guarantees a portion of amount of compensation of directors.

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2.12 Committees. The Board of Directors, by resolution adopted by a majority of the full Board of Directors, may designate from among its members one or more committees, each of which:

a. Shall have two (2) or more members;

b. Shall be governed by the same rules regarding meetings, action without meetings, notice, and waiver of notice, and quorum and voting requirements as applied to the Board of Directors; and

c. To the extent provided in such resolution, shall have and may exercise all the authority of the Board of Directors, except no such committee shall have the authority to:

(1) Authorize or approve a distribution except according to a general formula or method prescribed by the Board of Directors;

(2) Approve or propose to shareholders action which the WBCA requires to be approved by shareholders;

(3) Fill vacancies on the Board of Directors or on any of its committees;

(4) Amend the Articles of Incorporation;

(5) Adopt, amend, or repeal the Bylaws;

(6) Approve a plan of merger not requiring shareholder approval; or

(7) Authorize or approve the issuance or sale or contract for sale of shares, or determine the designation and relative rights, preferences, and limitations on a class or series of shares, except that the Board of Directors may authorize a committee, or a senior executive officer of the Corporation, to do so within limits specifically prescribed by the Board of Directors.

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ARTICLE III

Special Measures Applying to Meetings of Shareholders, the Board of Directors and Committees of the Board

3.1 Action by Written Consent. Any action required or permitted to be taken at a meeting of the Board of Directors or a committee of the Board may be accomplished without a meeting if the action is taken by all the members of the Board or all the members of the committee, as the case may be. The action must be evidenced by one or more written consents describing the action to be taken, signed by all directors or all members of the committee, as the case may be, and delivered to the Corporation for inclusion in the minutes. Directors' consents may be signed either before or after the action taken.

Action taken by unanimous written consent is effective when the last director signs the consent, unless the consent specifies a later effective date.

3.2 Use of Communications Equipment. Meetings of the shareholders, the

Board of Directors and committees of the Board may be effectuated by means of a conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other during the meeting. Participation by such means shall constitute presence in person at such meeting.

3.3 Oral and Written Notice. Oral notice may be communicated in person or by telephone, wire or wireless equipment that does not transmit a facsimile of the notice. Oral notice is effective when communicated if communicated in a comprehensible manner.

Written notice may be transmitted by mail, private carrier, or personal delivery; telegraph or teletype; or telephone, wire, or wireless equipment that transmits a facsimile of the notice and provides the transmitter with an electronically generated receipt. Written notice is effective at the earliest of the following: (a) when received; (b) five (5) days after its deposit in the US. mail if mailed with first-class postage; (c) on the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee.

ARTICLE IV

Officers

4.1 Positions. The officers of the Corporation may consist of a Chairman, a President, one or more Vice Presidents (who may be designated as Vice Presidents, Senior Vice Presidents or Executive Vice Presidents), a Secretary and a Treasurer as appointed by the Board of Directors or the Chief Executive Officer. The Corporation may have such additional or assistant officers (sometimes referred to as "additional

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officers") as the Board of Directors, Chief Executive Officer or Chief Operating Officer may deem necessary for its business and may appoint from time to time. The Board of Directors shall also have the authority, but shall not be required, to designate officers as the Chief Executive Officer, the Chief Operating Officer the Chief Financial Officer or similar such titles. Any two or more offices may be held by the same person.

If a director/officer has not been designated as Chairman, or if the designated Chairman is not present, the Board of Directors shall elect a Chairman from amongst its members to serve as Chairman of the Board of Directors. The Chairman shall preside at all meetings of the Board of Directors, and shall have such other powers as the Board may determine.

4.2 Appointment and Term of Office. The officers of the Corporation shall be appointed annually by the Board of Directors at the first meeting of the Board of Directors held after each annual meeting of the shareholders. If officers are not appointed at such meeting, such appointment shall occur as soon as possible thereafter, or may be left vacant. Each officer shall hold office until a successor shall have been appointed and qualified or until said officer's earlier death, resignation, or removal.

4.3 Authority and Duties of the Chief Executive Officer. The Chief Executive Officer shall have general charge and supervision of the business of the Corporation, shall see that all orders, actions and resolutions of the Board of Directors are carried out, and shall have such other authority and shall perform such other duties as set forth in these bylaws or, to the extent consistent with the bylaws, such other authorities and duties as prescribed by the Board of Directors.

4.4 Authority and Duties of Other Officers. Each officer other than the Chief Executive Officer shall have the authority and shall perform the duties set forth in these bylaws or, to the extent consistent with the bylaws, the duties prescribed by the Board of Directors, by the Chief Executive Officer, or by an officer authorized by the Board of Directors to prescribe the duties of such officer. Any designation of duties by the Chief Executive Officer or other officer shall be subject to review by the Board of Directors but shall be in full force and effect in the absence of such review.

4.5 Compensation and Contract Rights. The Board of Directors shall have authority (a) to fix the compensation, whether in the form of salary, bonus, stock options or otherwise, of all officers and employees of the Corporation, either specifically or by formula applicable to particular classes of officers or employees, and (b) to authorize officers of the Corporation to fix the compensation of subordinate employees. The Board of Directors shall have authority to appoint a Compensation Committee and may delegate to such committee any or all of its authority relating to compensation. The appointment of an officer shall not of itself create contract rights.

4.6 Resignation or Removal. Any officer of the Corporation may resign at any time by giving written notice to the Board of Directors. Any such resignation is effective when the notice is delivered, unless the notice specifies a later date, and shall be without prejudice to the contract rights, if any, of such officer.

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The Board of Directors, by majority vote of the entire Board, may remove any officer or agent, with or without cause. An officer or assistant officer, if appointed by another officer, may also be removed by any officer authorized to appoint officers or assistant officers. The removal shall be without prejudice to the contract rights, if any, of the person so removed.

4.7 Vacancies. If any office becomes vacant by any reason, the directors may appoint a successor or successors who shall hold office for the unexpired term or leave such office vacant.

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ARTICLE V

Certificates of Shares and Their Transfer

5.1 Issuance; Certificates of Shares. No shares of the Corporation shall be issued unless authorized by the Board. Such authorization shall include the maximum number of shares to be issued, the consideration to be received, and a statement that the Board considers the consideration to be adequate. Shares may but need not be represented by certificates. Certificates for shares of the Corporation shall be in such form as is consistent with the provisions of the WBCA or the law of a predecessor corporation and after the effective date of these Bylaws shall state:

a. The name of the Corporation and that the Corporation is organized under the laws of the State of Washington;

b. The name of the person to whom issued; and

c. The number and class of shares and the designation of the series, if any, which such certificate represents.

The certificate shall be signed by original or facsimile signature of two officers of the Corporation, and the seal of the Corporation may be affixed thereto.

5.2 Transfer of Stock. Shares of stock represented by certificates may be transferred by delivery of the certificate accompanied by either an assignment in writing on the back of the certificate or by a written power of attorney to assign and transfer the same on the books of the Corporation, signed by the record holder of the certificate. The shares shall be transferable on the books of the Corporation upon surrender thereof so assigned or endorsed.

5.3 Rules and Regulations Concerning the Issue, Transfer and Registration of Shares. The Board of Directors shall have power and authority to make all such rules and regulations as the Board may deem proper or expedient concerning the issue, transfer and registration of shares of stock. In case of the loss, mutilation, or destruction of a certificate of stock, a duplicate certificate may be issued upon such terms as the Board shall authorize. The Board shall have power and authority to appoint from time to time one or more transfer agents and registrar of the shares of stock.

5.4 Shares without Certificates. The Board of Directors may authorize the issue of some or all of the shares without certificates. Within a reasonable time after the issue or transfer of shares without certificates, the corporation shall send the shareholder a written statement of the information required on certificates by the WBCA.

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ARTICLE VI

Books and Records

6.1 Books of Accounts, Minutes, and Share Register. Except as otherwise provided by law the Corporation:

a. Shall keep as permanent records minutes of all meetings of its shareholders and Board of Directors, a record of all actions taken by the Board of Directors without a meeting, and a record of all actions taken by a committee of the Board of Directors exercising the authority of the Board of Directors on behalf of the Corporation;

b. Shall maintain appropriate accounting records;

c. Or its agent shall maintain a record of its shareholders, in a form that permits preparation of a list of the names and addresses of all shareholders, in alphabetical order by class of shares showing the number and class of shares held by each; and

d. Shall keep a copy of the following records at its principal office:

(1) The Articles or Restated Articles of Incorporation and all amendments to them currently in effect;

(2) The Bylaws or Restated Bylaws and all amendments to them currently in effect;

(3) The minutes of all shareholders' meetings, and records of all actions taken by shareholders without a meeting, for the past three (3) years;

(4) Its financial statements for the past three (3) years, including balance sheets showing in reasonable detail the financial

condition of the Corporation as of the close of each fiscal year, and an income statement showing the results of its operations during each fiscal year prepared on the basis of generally accepted accounting principles or, if not, prepared on a basis explained therein;

(5) All written communications to shareholders generally within the past three (3) years;

(6) A list of the names and business addresses of its current directors and officers; and

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(7) Its most recent annual report delivered to the Secretary of State of Washington.

6.2 Copies of Resolutions. Any person dealing with the Corporation may rely upon a copy of any of the records of the proceedings, resolutions, or votes of the Board of Directors or shareholders, when certified by the Secretary, an assistant secretary, or other officer authorized by the Board.

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Notes:

Section 1.9 was amended in September 1998 to provide for electronic proxy voting.

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<SEQUENCE>4
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Exhibit 13.1

Quarterly Information
(In millions, except per share data) (Unaudited)

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	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
<S>	<C>	<C>	<C>	<C>	<C>
1997					
Revenue	$2,405	$2,808	$3,365	$3,358	$11,936
Gross profit	1,923	2,250	2,782	2,811	9,766
Net income	614	741	1,042	1,057	3,454
Basic earnings per share	0.13	0.15	0.22	0.22	0.72
Diluted earnings per share	0.12	0.14	0.20	0.20	0.66
Common stock price per share:					
High	17.33	21.54	25.88	33.74	33.74
Low	13.44	16.36	20.19	22.44	13.44
1998					
Revenue	$3,334	$3,792	$3,984	$4,152	$15,262
Gross profit	2,800	3,179	3,344	3,479	12,802
Net income	663	1,133	1,337	1,357	4,490

Basic earnings per share	0.14	0.24	0.27	0.27	0.92
Diluted earnings per share	0.13	0.21	0.25	0.25	0.84
Common stock price per share:					
High	37.69	36.66	45.47	54.28	54.28
Low	30.82	29.50	31.10	40.94	29.50
1999					
Revenue	$4,193	$5,195	$4,595	$5,764	$19,747
Gross profit	3,544	4,407	3,887	5,095	16,933
Net income	1,683	1,983	1,917	2,202	7,785
Basic earnings per share	0.34	0.40	0.38	0.43	1.54
Diluted earnings per share	0.31	0.36	0.35	0.40	1.42
Common stock price per share:					
High	59.81	72.00	94.63	95.63	95.63
Low	47.25	48.13	68.00	75.50	47.25

</TABLE>

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1999, there were 92,169 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

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Exhibit 13.2

Financial Highlights
(In millions, except earnings per share)

<TABLE>
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Year Ended June 30	1995	1996	1997	1998	1999
<S>	<C>	<C>	<C>	<C>	<C>
Revenue	$6,075	$ 9,050	$11,936	$15,262	$19,747
Net income	1,453	2,195	3,454	4,490	7,785
Diluted earnings per share (1)	0.29	0.43	0.66	0.84	1.42
Cash and short-term investments	$4,750	$ 6,940	$ 8,966	$13,927	$17,236
Total assets	7,210	10,093	14,387	22,357	37,156
Stockholders' equity	5,333	6,908	10,777	16,627	28,438

</TABLE>

(1) Diluted earnings per share have been restated to reflect a two-for-one stock split in March 1999.

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Exhibit 13.3

Management's Discussion and Analysis

MSNBC debt.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at June 30, 1999 was $28.44 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $275 million on June 30, 1999. Cash will also be used to fund ventures and other strategic opportunities.

In addition, cash will be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 710 million common shares while 1.79 billion shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $69 billion as of June 30, 1999. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable preferred stock. Net proceeds of $980 million were used to repurchase common shares. In

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December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of $79.875 and a cap of $102.24 per preferred share, equivalent to $19.97 and $25.56 per common share.

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

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

Issues and Uncertainties

While Microsoft management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

Rapid technological change and competition Rapid change, uncertainty due to new and emerging technologies, and fierce competition characterize the PC software industry. The pace of change continues to accelerate, including "open source" software, new computing devices, new microprocessor architectures, the Internet, and Web-based computing models.

Future initiatives The Company continues to expand its efforts to provide and support mission-critical systems to large enterprises. Microsoft is also developing a Windows Web-centric platform and simpler and new natural interfaces for PC users. Additionally, Microsoft is committed to providing technologies, operating systems, and online services for all types of computing devices, including PCs, televisions, and intelligent appliances. Future revenue from these initiatives may not duplicate historical revenue growth rates.

PC growth rates The underlying PC unit growth rate and percentage of new PCs acquired as replacement units directly impact the Company's software revenue growth. Additionally, inexpensive PCs and specialty devices create less demand for Microsoft software than traditional PCs. The PC shipment growth rate may continue to decrease, the replacement rate may continue to increase, and limited-use PC growth may increase, reducing future software revenue opportunity.

Product ship schedules Potential delays in new product releases, including seminal products such as Windows 2000, could dampen revenue growth rates and cause operational inefficiencies that impact manufacturing and distribution logistics and relationships with customers, OEMs, and independent software vendors.

Customer acceptance While the Company performs extensive usability and beta testing of new products, user acceptance and corporate penetration rates ultimately dictate the success of development and marketing efforts.

Prices Future product prices may decrease from historical levels, depending on competitive market and cost factors. European and Asian software prices vary by country and are generally higher than in the United States to cover localization costs and higher costs of distribution. Increased global license agreements, European monetary unification, or other factors could erode such price uplifts in the future.

Saturation Product upgrades, which enable users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices and margins than new products. Also, penetration of the Company's desktop applications into large organizations is becoming saturated. These factors are likely to depress future desktop applications revenue growth.

Organizational licenses Average revenue per unit from organizational license programs is lower than average revenue per unit from retail versions shipped through the finished goods channels. Unit sales under licensing programs may continue to increase.

Earnings process An increasingly higher percentage of the Company's revenue is subject to ratable recognition, which impacts the timing of revenue and earnings recognition. This policy may be required

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for additional products, depending on specific license terms and conditions. Also, maintenance and other subscription programs may continue to increase in popularity, particularly with organizations.

Channel mix Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenue was achieved through the OEM channel during 1998 and 1999.

Cost of revenue Decreases in cost of revenue as a percentage of revenue in 1998 and 1999 were due to general shifts from packaged products to OEM and organizational licenses, from lower-margin products to higher-margin products, and from disks to CD-ROMs. These shifts may not continue. Direct costs of product support; services such as consulting and training and certification of system integrators; and online operations comprise the majority of cost of revenue and are not likely to decrease. The trend of declining cost of revenue as a percentage of revenue is unlikely to continue in 2000.

Employee compensation Microsoft employees currently receive salaries, incentive bonuses, other benefits, and stock options. Fiscal 2000 salaries will be enhanced, with the mid-point salary range raised from the 50th to the 65th percentile of competitive positions. Additionally, new government regulations, poor stock price performance, or other factors could diminish the value of the option program to current and prospective employees and force the Company into more of a cash compensation model. Had the Company paid employees in cash the equivalent of the Black-Scholes value of options vested in 1997, 1998, and 1999, the incremental pretax expense would have been approximately $620 million, $850 million, and $1.10 billion.

Long-term R&D investment cycle Developing and localizing software is expensive, and the investment in product development often involves a long payback cycle. The Company plans to continue significant investments in software research and development, including online initiatives. Significant revenue from these product opportunities is not anticipated for a number of years. Total spending for R&D in 2000 will increase over spending in 1999.

Sales and marketing investments The Company's plans for 2000 include accelerated investments in its sales groups, customer satisfaction, and marketing activities.

International operations Much of the Company's operations are conducted outside of the United States, and a large percentage of sales, costs of manufacturing, and marketing is transacted in local currencies. As a result, the Company's international results of operations are subject to local economic environments and foreign exchange rate fluctuations.

Market risk The Company is exposed to foreign currency, interest rate, and equity price risks. A portion of these risks is hedged, but fluctuations could impact the Company's results of operations and financial position. The Company hedges the exposure of accounts receivable and a portion of anticipated revenue to foreign currency fluctuations, primarily with option contracts. The Company monitors its foreign currency exposures daily to ensure the overall effectiveness of its foreign currency hedge positions. Principal currencies hedged include the Japanese yen, British pound, German mark, French franc, and Canadian dollar. Fixed income securities are subject to interest rate risk. The portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. The Company routinely hedges its exposure to interest rate risk with options in the event of a catastrophic increase in interest rates. Many securities held in the Company's equity and other investments portfolio are subject to equity price risk. The Company hedges its equity price risk on certain highly volatile equity securities with options.

The Company used a value-at-risk (VAR) model to estimate and quantify its market risks. The VAR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. Assumptions applied to the VAR model at June 30, 1999 include the following: normal market conditions; Monte Carlo modeling with 10,000 simulated market price paths; a 97.5% confidence interval; and a 20-day estimated loss in fair value for each market risk category. Accordingly, 97.5% of the time the estimated 20-day loss in fair value would be nominal for foreign currency denominated investments and accounts receivable, and would not exceed $95 million for interest-sensitive investments or $1.38 billion for equity securities.

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Previously, the Company used a sensitivity analysis to estimate interest rate and equity price risk. A 10% increase in interest rates would have reduced the carrying value of interest-sensitive securities by $128 million and $101 million at June 30, 1998 and 1999. A 10% decrease in market values would have reduced the carrying value of the Company's equity securities by $300 million and $1.37

billion at June 30, 1998 and 1999.

Intellectual property rights Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenue to the Company. While this adversely affects U.S. revenue, revenue loss is even more significant outside of the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenue positively.

Litigation Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks.

Year 2000 The Year 2000 presents potential concerns for business and consumer computing. In addition to the well-known calculation problems with the use of 2-digit date formats as the year changes from 1999 to 2000, the Year 2000 is a special case leap year and in many organizations using older technology, dates were used for special programmatic functions. The problem exists for many kinds of software and hardware, including mainframes, mini computers, PCs, and embedded systems. The consequences of this issue may include systems failures and business process interruption.

Microsoft has tested more than 3000 versions/languages of its products. The vast majority of these tested products are Year 2000 compliant, as defined by Microsoft. There are a small number of older products that are identified as being non-compliant, and Microsoft will provide recommendations regarding these products. Not all versions of products or all products will be tested. All Year 2000 software updates, resources, and tools are available to customers at no charge from the Microsoft Year 2000 Portal Page or Microsoft Year 2000 Resource CD.

Current information needed to evaluate the impact of the Year 2000 on organizational and home computing environments is available at the Microsoft Year 2000 Portal Page (www.microsoft.com/year2000) and the Microsoft Year 2000 Resource CD, which is released on a quarterly basis. The Web site and Microsoft Year 2000 Resource CD detail specific Year 2000 information concerning Microsoft products and technologies for large organizations. The detailed information available on the Web site and Microsoft Year 2000 Resource CD is presented to assist information technology (IT) professionals in planning their transition to the Year 2000. The Microsoft Year 2000 Portal Page also contains information for small business and home PC users, including in-depth product information, answers to frequently asked questions, and links to other Year 2000 sites.

Variability of definitions of "compliance" with the Year 2000 and of different combinations of software, firmware, and hardware will likely lead to lawsuits against the Company. The outcome of such lawsuits and the impact on the Company are not estimable at this time.

The Year 2000 issue also affects the Company's internal systems, including IT and non-IT systems. Microsoft has assessed the readiness of its mission-critical systems for handling the Year 2000. Although testing and remediation of all systems have not been completed, management currently believes that all mission critical-systems will be compliant by the Year 2000 and that the cost to address the issues is not material. Nevertheless, Microsoft is creating contingency plans for certain internal systems.

Microsoft is addressing the effect this issue will have on its third-party supply chain and has undertaken steps to formulate a system of working with key third parties to understand their ability to continue providing services and products through the change to 2000. Microsoft is working directly with its key vendors, distributors, and resellers to avoid material business interruptions in 2000. Contingency plans are being developed where practicable for these key third parties.

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Resolving Year 2000 issues is a worldwide phenomenon that is absorbing a substantial portion of IT budgets and attention. Certain industry analysts believe the Year 2000 issue will accelerate the trend toward distributed PC-based systems from mainframe systems, while others believe a majority of IT resources will be devoted to fixing older mainframe software in lieu of large-scale transitions to systems based on software such as that developed by Microsoft. The impact of the Year 2000 on future Microsoft revenue is difficult to discern, but is a risk to be considered in evaluating the future growth of the Company.

Future growth rate The revenue growth rate in 2000 may not approach the level attained in prior years. As discussed previously, operating expenses are expected to increase in 2000. Because of the fixed nature of a significant portion of such expenses, coupled with the possibility of slower revenue growth, operating margins in 2000 may decrease from those in 1999.

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Exhibit 13.4

Microsoft Corporation

Financial Statements

Income Statements for the three years ended June 30, 1999

Cash Flows Statements for the three years ended June 30, 1999

Balance Sheets as of June 30, 1998 and 1999

Stockholders' Equity Statements for the three years ended June 30, 1999

Notes to Financial Statements

Independent Auditors' Report

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Income Statements
(In millions, except earnings per share)

<TABLE>
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Year Ended June 30	1997	1998	1999

<S> <C> <C> <C>

Revenue	$11,936	$15,262	$19,747
Operating expenses:			
Cost of revenue	2,170	2,460	2,814
Research and development	1,863	2,601	2,970
Acquired in-process technology	--	296	--
Sales and marketing	2,411	2,828	3,231
General and administrative	362	433	689
Other expenses	259	230	115
Total operating expenses	7,065	8,848	9,819
Operating income	4,871	6,414	9,928
Investment income	443	703	1,803
Gain on sale of Softimage, Inc.	--	--	160
Income before income taxes	5,314	7,117	11,891
Provision for income taxes	1,860	2,627	4,106
Net income	$ 3,454	$ 4,490	$ 7,785
Earnings per share (1):			
Basic	$ 0.72	$ 0.92	$ 1.54
Diluted	$ 0.66	$ 0.84	$ 1.42

</TABLE>

(1) Earnings per share have been restated to reflect a two-for-one stock split in March 1999.

See accompanying notes.
<PAGE>

Cash Flows Statements
(In millions)

<TABLE>
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Year Ended June 30	1997	1998	1999
<S>	<C>	<C>	<C>
Operations			
Net income	$ 3,454	$ 4,490	$ 7,785
Depreciation and amortization	557	1,024	1,010
Write-off of acquired in-process technology	--	296	--
Gain on sale of Softimage, Inc.	--	--	(160)
Unearned revenue	1,601	3,268	5,877
Recognition of unearned revenue from prior periods	(743)	(1,798)	(4,526)
Other current liabilities	321	208	966
Accounts receivable	(336)	(520)	(687)
Other current assets	(165)	(88)	(235)
Net cash from operations	4,689	6,880	10,030
Financing			
Common stock issued	744	959	1,350
Common stock repurchased	(3,101)	(2,468)	(2,950)
Put warrant proceeds	95	538	766
Preferred stock issued	980	--	--
Preferred stock dividends	(15)	(28)	(28)
Stock option income tax benefits	796	1,553	3,107
Net cash from (used for) financing	(501)	554	2,245
Investing			
Additions to property and equipment	(499)	(656)	(583)
Cash portion of WebTV purchase price	--	(190)	--
Cash proceeds from sale of Softimage, Inc.	--	--	79
Purchases of investments	(18,216)	(19,114)	(36,441)
Maturities of investments	1,874	1,890	4,674
Sales of investments	13,752	10,798	21,080
Net cash used for investing	(3,089)	(7,272)	(11,191)

Net change in cash and equivalents	1,099	162	1,084
Effect of exchange rates on cash and equivalents	6	(29)	52
Cash and equivalents, beginning of year	2,601	3,706	3,839
Cash and equivalents, end of year	3,706	3,839	4,975
Short-term investments	5,260	10,088	12,261
Cash and short-term investments	$ 8,966	$ 13,927	$ 17,236

</TABLE>

See accompanying notes.
<PAGE>

Balance Sheets
(In millions)

<TABLE>
<CAPTION>

June 30	1998	1999
<S>	<C>	<C>
Assets		
Current assets:		
Cash and short-term investments	$13,927	$17,236
Accounts receivable	1,460	2,245
Other	502	752
Total current assets	15,889	20,233
Property and equipment	1,505	1,611
Equity and other investments	4,703	14,372
Other assets	260	940
Total assets	$22,357	$37,156
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 759	$ 874
Accrued compensation	359	396
Income taxes payable	915	1,607
Unearned revenue	2,888	4,239
Other	809	1,602
Total current liabilities	5,730	8,718
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock--shares authorized 100; shares issued and outstanding 13	980	980
Common stock and paid-in capital--shares authorized 12,000; shares issued and outstanding 4,940 and 5,109	8,025	13,844
Retained earnings, including other comprehensive income of $666 and $1,787	7,622	13,614
Total stockholders' equity	16,627	28,438
Total liabilities and stockholders' equity	$22,357	$37,156

</TABLE>

See accompanying notes.
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Stockholders' Equity Statements
(In millions)

<TABLE>
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Year Ended June 30	1997	1998	1999
<S>	<C>	<C>	<C>
Convertible preferred stock			

Balance, beginning of year	--	$ 980	$ 980
Convertible preferred stock issued	$ 980	--	--
Balance, end of year	980	980	980
Common stock and paid-in capital			
Balance, beginning of year	2,924	4,509	8,025
Common stock issued	744	1,262	2,338
Common stock repurchased	(91)	(165)	(64)
Structured repurchases price differential	--	328	(328)
Proceeds from sale of put warrants	95	538	766
Reclassification of put warrant obligation	45	--	--
Stock option income tax benefits	792	1,553	3,107
Balance, end of year	4,509	8,025	13,844
Retained earnings			
Balance, beginning of year	3,984	5,288	7,622
Net income	3,454	4,490	7,785
Other comprehensive income:			
Net unrealized investment gains	280	627	1,052
Translation adjustments and other	5	(124)	69
Comprehensive income	3,739	4,993	8,906
Preferred stock dividends	(15)	(28)	(28)
Common stock repurchased	(3,010)	(2,631)	(2,886)
Reclassification of put warrant obligation	590	--	--
Balance, end of year	5,288	7,622	13,614
Total stockholders' equity	$10,777	$16,627	$28,438

</TABLE>

See accompanying notes.

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Notes to Financial Statements

Accounting Policies

Accounting principles. The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles.

Principles of consolidation. The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated. Investments in 50% owned joint ventures are accounted for using the equity method; the Company's share of joint ventures' activities is reflected in other expenses.

Estimates and assumptions. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates.

Foreign currencies. Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to other comprehensive income. Revenue and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

Revenue recognition. Revenue is recognized when earned. The Company's revenue recognition policies are in compliance with all applicable accounting regulations, including American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, With Respect to Certain Transactions. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from certain license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to and through distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. Revenue attributable to undelivered elements, including technical support and Internet browser technologies, is based on the average sales price of those elements and is recognized ratably on a straight-line basis over the product's life cycle. When the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for returns and bad debts.

Cost of revenue. Cost of revenue includes direct costs to produce and distribute product and direct costs to provide online services, consulting, product support, and training and certification of system integrators.

Research and development. Research and development costs are expensed as incurred. Statement of Financial Accounting Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.

Income taxes. Income tax expense includes U.S. and international income taxes, plus the provision for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are
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accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

Stock split. During March 1999, outstanding shares of common stock were split two-for-one. All share and per share amounts have been restated.

Financial instruments. The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and six years from the purchase date. All cash and short-term investments are classified as available for sale and are recorded at market using the specific identification method; unrealized gains and losses are reflected in other comprehensive income. Cost approximates market for all classifications of cash and short-term investments; realized and unrealized gains and losses were not material.

Equity and other investments include debt and equity instruments. Debt securities and publicly traded equity securities are classified as available for sale and are recorded at market using the specific identification method. Unrealized gains and losses are reflected in other comprehensive income. All other investments, excluding joint venture arrangements, are recorded at cost.

Derivative financial instruments are used to hedge certain investments, international revenue, accounts receivable, and interest rate risks, and are, therefore, held primarily for purposes other than trading. These instruments may involve elements of credit and market risk in excess of the amounts recognized in the financial statements. The Company monitors its positions and the credit quality of counter parties, consisting primarily of major financial institutions, and does not anticipate nonperformance by any counter party.

During June 1999, the Financial Accounting Standards Board (FASB) issued SFAS 137, Accounting for Derivative Instruments and Hedging Activities-Deferral of the Effective Date of FASB Statement 133. The Statement defers the effective date of SFAS 133 to fiscal 2001. Management is evaluating SFAS 133 and does not believe that adoption of the Statement will have a material impact on its financial statements.

Property and equipment. Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 15 years.

Reclassifications. The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also been made for consistent presentation.

Unearned Revenue

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

End users receive certain elements of the Company's products over a period of time. These elements include browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. Upon adoption of SOP 98-9 during the fourth quarter of fiscal 1999, the Company was required to change the methodology of attributing the fair value to undelivered elements. The percentages of undelivered elements in relation to the total arrangement decreased, reducing the amount of Windows and Office revenue treated as unearned, and increasing the amount of revenue recognized upon shipment. The percentage of revenue recognized ratably decreased from a range of 20% to 35% to a range of approximately 15% to 25% of Windows desktop operating systems. For desktop applications, the percentage decreased from approximately 20% to a range of approximately 10% to 20%. The ranges depend on the terms and conditions of the license and prices of the elements. The impact on fiscal 1999 was to increase reported revenue $170 million. In addition, the Company extended the life cycle of Windows from two to three years based upon
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management's review of product shipment cycles. The impact on fiscal 1999 was to decrease reported revenue $90 million. Product life cycles are currently estimated at 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organizational license agreements. At June 30, 1999, Windows platforms products unearned revenue was $2.17 billion and unearned revenue associated with productivity applications and developer products totaled $1.96 billion. Unearned revenue for other miscellaneous programs totaled $116 million at June 30, 1999.

Financial Risks

The Company's cash and short-term investment portfolio is diversified and consists primarily of investment grade securities. Investments are held with high-quality financial institutions, government and government agencies, and corporations, thereby reducing credit risk concentrations. Interest rate fluctuations impact the carrying value of the portfolio. The Company routinely hedges the portfolio's return with options in the event of a catastrophic increase in interest rates. At June 30, 1999, the notional amount of the options outstanding was $4.0 billion. The fair value and premiums paid for the options were not material. Much of the Company's equity security portfolio is highly volatile, so certain positions are hedged.

Finished goods sales to international customers in Europe, Japan, Canada, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. Certain international manufacturing and operational costs are disbursed in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Although foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses, the Company hedges a portion of accounts receivable balances denominated in local currencies, primarily with purchased options. At June 30, 1999, the notional amount of options outstanding was $662 million. The fair value and premiums paid for the options were not material.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a portion of planned international revenue with purchased options. The notional amount of the options outstanding at June 30, 1999 was $2.25 billion. The fair value and premiums paid for the options were not material.

At June 30, 1998 and 1999, approximately 40% and 50% of accounts receivable represented amounts due from 10 customers. One customer accounted for approximately 12%, 8%, and 11% of revenue in 1997, 1998, and 1999.

Microsoft lends certain fixed income and equity securities to enhance investment income. Adequate collateral and/or security interest is determined based upon the underlying security and the credit worthiness of the borrower.

<TABLE>
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Cash and Short-Term Investments

June 30	1998	1999
<S>	<C>	<C>
Cash and equivalents:		
Cash	$ 195	$ 635
Commercial paper	2,771	3,805
Certificates of deposit	419	522
Money market preferreds	454	13
Cash and equivalents	3,839	4,975
Short-term investments:		
Commercial paper	868	1,026
U.S. government and agency securities	3,511	3,592
Corporate notes and bonds	3,998	6,996
Municipal securities	1,361	247
Certificates of deposit	350	400
Short-term investments	10,088	12,261
Cash and short-term investments	$13,927	$17,236

</TABLE>
<PAGE>

<TABLE>
<CAPTION>
Property and Equipment

June 30	1998	1999
<S>	<C>	<C>
Land	$ 183	$ 158
Buildings	1,259	1,347
Computer equipment	1,182	1,433

Other	428	578
Property and equipment--at cost	3,052	3,516
Accumulated depreciation	(1,547)	(1,905)
Property and equipment--net	$ 1,505	$ 1,611

</TABLE>

During 1997, 1998, and 1999, depreciation expense, of which the majority related to computer equipment, was $353 million, $528 million, and $483 million; disposals were not material.

<TABLE>
<CAPTION>
Equity and Other Investments

June 30, 1999	Cost Basis	Net Unrealized Gains	Recorded Basis
<S>	<C>	<C>	<C>
Debt securities recorded at market, maturing:			
Within one year	$ 682	$ 8	$ 690
Between 10 and 15 years	533	(3)	530
Beyond 15 years (AT&T)	4,731	347	5,078
Debt securities recorded at market	5,946	352	6,298
Equity securities recorded at market:			
Comcast Corporation common stock	500	1,394	1,894
MCI Worldcom, Inc. common stock	14	1,088	1,102
Other	849	1,102	1,951
Unrealized hedge loss	--	(785)	(785)
Equity securities recorded at market	1,363	2,799	4,162
Equity securities and instruments recorded at cost:			
Nextel Communications, Inc. common stock	600	--	600
Comcast Corporation convertible preferred stock	555	--	555
NTL, Inc. convertible preferred stock	511	--	511
Other	2,179	--	2,179
Equity securities and instruments recorded at cost	3,845	--	3,845
Other investments	67	--	67
Equity and other investments	$11,221	$3,151	$14,372

</TABLE>

Debt securities include corporate and government notes and bonds and derivative securities. Debt securities maturing beyond 15 years are composed entirely of AT&T 5% convertible preferred debt with a contractual maturity of 30 years. The debt is convertible into AT&T common stock on or after December 1, 2000, or may be redeemed by AT&T upon satisfaction of certain conditions on or after June 1, 2002. Unrealized gains on equity securities recorded at market were $1.4 billion on June 30, 1998. Equity securities and instruments recorded at cost include primarily preferred stock, common stock, and warrants that are restricted or not publicly traded. At June 30, 1998 and 1999, the estimated fair value of these investments was $2.4 billion and $6.1 billion, based on publicly available market information or other estimates determined by management. The Company hedges the risk of significant market declines on certain highly volatile equity securities with options. The options are recorded at market, consistent with the underlying equity securities. At June 30, 1999, the notional amount of the options outstanding was $2.1 billion; the fair value was $1.0 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1997 and 1998 were not material; realized gains were $623 million and losses were not material in 1999.

Income Taxes

The provision for income taxes consisted of:

<TABLE>
<CAPTION>

Year Ended June 30	1997	1998	1999
<S>	<C>	<C>	<C>
Current taxes:			
U.S. and state	$1,710	$2,518	$4,027
International	412	526	281
Current taxes	2,122	3,044	4,308
Deferred taxes	(262)	(417)	(202)
Provision for income taxes	$1,860	$2,627	$4,106

</TABLE>
<PAGE>

U.S. and international components of income before income taxes were:

<TABLE>
<CAPTION>

Year Ended June 30	1997	1998	1999
<S>	<C>	<C>	<C>
U.S.	$3,775	$5,072	$10,649
International	1,539	2,045	1,242
Income before income taxes	$5,314	$7,117	$11,891

</TABLE>

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies. In 1999, the effective tax rate was 35.0%, excluding the impact of the gain on the sale of Softimage, Inc. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate were not significant.

Income taxes payable were:

<TABLE>
<CAPTION>

June 30	1998	1999
<S>	<C>	<C>
Deferred income tax assets:		
Revenue items	$ 713	$ 1,145
Expense items	613	648
Deferred income tax assets	1,326	1,793
Deferred income tax liabilities:		
Unrealized gain on investments	(479)	(1,046)
International earnings	(373)	(647)
Other	(26)	(16)
Deferred income tax liabilities	(878)	(1,709)
Current income tax liabilities	(1,363)	(1,691)

Income taxes payable	$ (915)	$(1,607)

</TABLE>

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. Tax Court. The IRS is examining the Company's U.S. income tax returns for 1992 through 1994. Management believes any related adjustments that might be required will not be material to the financial statements. Income taxes paid were $1.1 billion in 1997, $1.1 billion in 1998, and $874 million in 1999.

Convertible Preferred Stock

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred stockholders have preference over common stockholders in dividends and liquidation rights. In December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of $79.875 and a cap of $102.24 per preferred share, equivalent to $19.97 and $25.56 per common share. Net proceeds of $980 million were used to repurchase common shares.

Common Stock
Issued and outstanding. Shares of common stock outstanding were as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1997	1998	1999
<S>	<C>	<C>	<C>
Balance, beginning of year	4,776	4,816	4,940
Issued	188	202	213
Repurchased	(148)	(78)	(44)
Balance, end of year	4,816	4,940	5,109

</TABLE>

Repurchase program. The Company repurchases its common stock in the open market to provide shares for issuing to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 2000.
<PAGE>

During 1998, the Company executed two forward settlement structured repurchase agreements with an independent third party totaling 42 million shares of stock and paid cash for a portion of the purchase price. In 1999, the Company settled the agreements by returning 28 million shares of stock, based upon the stock price on the date of settlement. The timing and method of settlement were at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the date of the agreement was originally reflected in common stock and paid-in capital.

Put Warrants

To enhance its stock repurchase program, Microsoft sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 1999, 163 million warrants were outstanding with strike prices ranging from $59 to $65 per share. The put warrants expire between September 1999 and March 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

Employee Stock and Savings Plans

Employee stock purchase plan The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1997, 1998, and 1999, employees purchased 5.6 million, 4.4 million, and 2.7 million shares at average prices of $14.91, $27.21, and $52.59 per share. At June 30, 1999, 70.9 million shares were reserved for future issuance.

Savings plan The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may contribute up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were $28 million, $39 million, and $49 million in 1997, 1998, and 1999.

Stock option plans The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after 10 years. At June 30, 1999, options for 406 million shares were vested and 998 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

<TABLE>
<CAPTION>

		Price per Share	
	Shares	Range	Weighted Average
<S>	<C>	<C>	<C>
Balance, June 30, 1996	952	$ 0.28 - $14.74	$ 5.52
Granted	220	13.83 - 29.80	14.58
Exercised	(180)	0.28 - 14.74	3.32
Canceled	(36)	4.25 - 24.29	9.71
Balance, June 30, 1997	956	0.56 - 29.80	7.86
Granted	138	16.56 - 43.63	31.28
Exercised	(176)	0.56 - 31.24	4.64
Canceled	(25)	4.25 - 41.94	14.69
Balance, June 30, 1998	893	0.56 - 43.63	11.94
Granted	78	45.59 - 83.28	54.62
Exercised	(175)	0.56 - 53.63	6.29
Canceled	(30)	4.25 - 74.28	21.06
Balance, June 30, 1999	766	0.56 - 83.28	17.28

</TABLE>
<PAGE>

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1999 were as follows:

<TABLE>
<CAPTION>

Range of Exercise Prices	Outstanding Options Shares	Outstanding Options Remaining Life (Years)	Outstanding Options Weighted Average Price	Exercisable Options Shares	Exercisable Options Weighted Average Price
<S>	<C>	<C>	<C>	<C>	<C>
$0.56-$5.97	242	2.9	$ 4.31	230	$ 4.24
5.98-13.62	158	3.9	10.85	89	10.62
13.63-29.80	173	4.7	14.92	66	14.67
29.81-43.62	117	5.5	32.06	21	31.83
43.63-83.28	76	6.2	55.04	--	--

</TABLE>

The Company follows Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, to account for stock option and employee stock purchase plans. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of $217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.

An alternative method of accounting for stock options is SFAS 123, Accounting for Stock-Based Compensation. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards, pro forma income statements for 1997, 1998, and 1999 would have been as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1997 Reported	1997 Pro forma	1998 Reported	1998 Pro forma	1999 Reported	1999 Pro forma
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Revenue	$11,936	$11,936	$15,262	$15,262	$19,747	$19,747
Operating expenses:						
Cost of revenue	2,170	2,290	2,460	2,628	2,814	3,024
Research and development	1,863	2,168	2,601	3,023	2,970	3,504
Acquired in-process technology	--	--	296	296	--	--
Sales and marketing	2,411	2,539	2,828	3,003	3,231	3,448
General and administrative	362	424	433	520	689	822
Other expenses	259	259	230	230	115	115
Total operating expenses	7,065	7,680	8,848	9,700	9,819	10,913
Operating income	4,871	4,256	6,414	5,562	9,928	8,834
Investment income	443	443	703	703	1,803	1,803
Gain on sale of Softimage, Inc.	--	--	--	--	160	160
Income before income taxes	5,314	4,699	7,117	6,265	11,891	10,797
Provision for income taxes	1,860	1,646	2,627	2,325	4,106	3,723
Net income	3,454	3,053	4,490	3,940	7,785	7,074
Preferred stock dividends	15	15	28	28	28	28
Net income available for common shareholders	$ 3,439	$ 3,038	$ 4,462	$ 3,912	$ 7,757	$ 7,046
Diluted earnings per share	$ 0.66	$ 0.58	$ 0.84	$ 0.73	$ 1.42	$ 1.29

</TABLE>

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1997, 1998, and 1999, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by

SFAS 123, pro forma net income would have
<PAGE>

been $3,179 million, $4,019 million, and $7,109 million, and earnings per share would have been $0.61, $0.75, and $1.30 for 1997, 1998, and 1999.

The weighted average Black-Scholes value of options granted under the stock option plans during 1997, 1998, and 1999 was $5.86, $11.81, and $20.90. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1999 and 1998 and .30 in 1997, and risk-free interest rates of 6.5%, 5.7%, and 4.9% in 1997, 1998, and 1999.

Earnings Per Share

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

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

<TABLE>
<CAPTION>

Year Ended June 30	1997	1998	1999
<S>	<C>	<C>	<C>
Net income	$3,454	$4,490	$7,785
Preferred stock dividends	15	28	28
Net income available for common shareholders	$3,439	$4,462	$7,757
Weighted average outstanding shares of common stock	4,782	4,864	5,028
Dilutive effect of:			
Common stock under structured repurchases	--	6	13
Preferred stock	26	34	16
Employee stock options	436	458	425
Common stock and common stock equivalents	5,244	5,362	5,482
Earnings per share:			
Basic	$ 0.72	$ 0.92	$ 1.54
Diluted	$ 0.66	$ 0.84	$ 1.42

</TABLE>

Operational Transactions

In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. A director of the Company owned 10% of WebTV. Microsoft paid $425 million in stock and cash for WebTV. The Company recorded an in-process technologies write-off of $296 million in the first quarter of fiscal 1998.

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. and recorded a pretax gain of $160 million. As part of a transitional service agreement, Microsoft agreed to make certain development tools and management systems available to Avid for use in the Softimage business.

In November 1998, Microsoft acquired LinkExchange, Inc., a leading provider of online marketing services to Web site owners and small and medium-sized businesses. Microsoft paid $265 million in stock. During fiscal 1999, Microsoft also acquired several other entities primarily providing online technologies and services. The Company did not record significant in-process technology write-offs in connection with these transactions.

In July 1999, Ticketmaster Online CitySearch, Inc. agreed to purchase certain online properties of Sidewalk in exchange for stock and warrants at a price to be determined upon closing.

Commitments

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $92 million, $95 million, and $135 million in 1997, 1998, and 1999. Future minimum rental commitments under
<PAGE>

noncancelable leases, in millions of dollars, are: 2000, $133; 2001, $121; 2002, $97; 2003, $83; 2004, $75; and thereafter, $194.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 2000, $125 and 2001, $22. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed $275 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

Contingencies

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

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

On November 17, 1998, the court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims, because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The court ordered Microsoft to make certain changes in its products that include Sun's Java technology and to make certain changes in its Java software development tools. The court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On July 23, 1999 the court also granted Microsoft's motion to increase the bond on the preliminary injunction from $15 million to $35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the court issued tentative rulings on three of the motions. In the preliminary rulings, the court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++ (R) 6.0 development system, and the SDK for Java
<PAGE>

infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java Technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java Technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the court heard oral argument on the three tentative rulings. No final orders have been issued. At the hearing, the court also directed the parties to identify other pending summary judgment motions that the court should next consider. There are no other hearing or trial dates set.

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

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

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS(R) operating system and Windows in the late 80s and early 90s --essentially the same complaints that resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

The Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

Segment Information

<TABLE>
<CAPTION>

Year Ended June 30	Windows Platforms	Productivity Applications and Developer	Consumer, Commerce, and Other	Reconciling Amounts	Consolidated
<S>	<C>	<C>	<C>	<C>	<C>
1997					
Revenue	$5,213	$5,992	$ 1,129	$ (398)	$11,936
1998					
Revenue	$6,236	$7,458	$ 1,765	$ (197)	$15,262
Operating income	3,661	4,824	(1,050)	(1,021)	6,414
1999					
Revenue	$8,590	$8,686	$ 1,784	$ 687	$19,747
Operating income	6,007	5,568	(1,072)	(575)	9,928

</TABLE>

The Company's organizational structure and fundamental approach to business reflect the needs of its customers. As such, Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer, Commerce, and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and other Internet services. Assets of the segment groups are not relevant for management of the businesses nor for disclosure. In addition, it is not practicable to discern operating income for 1997 for the above segments due to previous internal reorganizations.

Segment information is presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The Company's financial reporting systems present various data for management to run the business, including profit and loss statements (P&Ls) prepared on a basis not consistent with generally accepted accounting principles. Reconciling items include certain elements of unearned revenue, the treatment of certain channel inventory amounts and estimates, and revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization, but do not reflect the charge for the ESO exercise price methodology previously employed by the Company.

Revenue attributable to U.S. operations includes shipments to customers in the United States, licensing to OEMs and certain multinational organizations, and exports of finished goods, primarily to Asia, Latin America, and Canada. Revenue from U.S operations totaled $7.8 billion, $10.1 billion, and $13.7 billion in 1997, 1998, and 1999. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled $4.1 billion, $5.2 billion, and $5.9 billion in 1997, 1998, and 1999.

Long-lived assets totaled $1.2 billion and $1.5 billion in the United States in 1998 and 1999 and $287 million and $154 million in other countries in 1998 and 1999.
<PAGE>

Independent Auditors' Report
- --

To the Board of Directors and Stockholders
of Microsoft Corporation:

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1998 and 1999, and the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1998 and 1999, and the results of their operations and their cash flows for each of the three years ended June 30, 1999 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP
Seattle, Washington
July 19, 1999

</TEXT>
</DOCUMENT>
<DOCUMENT>
<TYPE>EX-21
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Exhibit 21

Subsidiaries

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399

Microsoft FSC Corporation. (U.S. VIRGIN ISLANDS)
Microsoft Investments, Inc. (NEVADA)
Microsoft Ireland Operations Limited (IRELAND)
Microsoft Licensing, Inc. (NEVADA)
MSLI L.L.C. (NEVADA)
Microsoft Operations Pte Ltd. (SINGAPORE)
Microsoft Regional Sales Corporation (NEVADA-Singapore Branch)
Microsoft Puerto Rico, Inc. (Manufacturing) (DELAWARE)
The Microsoft Network L.L.C. (DELAWARE)
Microsoft Treasury, Inc (NEVADA)
GraceMac Corporation (NEVADA)
Microsoft de Argentina S.A.
Microsoft Pty. Limited (AUSTRALIA)
Microsoft Gesellschaft m.b.H. (AUSTRIA)
Microsoft N.V. (BELGIUM)
Microsoft Informatica Limitada (BRAZIL)
Microsoft Bulgaria EOOD
Microsoft Canada Co.
Microsoft Chile S.A.
Microsoft Colombia Inc. (DELAWARE)
Microsoft de Centroamerica S.A. (COSTA RICA)
Microsoft Hrvatska d.o.o. (CROATIA)
Microsoft s.r.o. (CZECH REPUBLIC)
Microsoft Danmark ApS (DENMARK)
Microsoft Dominicana, S.A. (DOMINICAN REPUBLIC)
Microsoft Del Ecuador S.A.
Microsoft El Salvador S.A. de C.V.
Microsoft Egypt L.L.C.
Microsoft Oy (FINLAND)
Microsoft France S.A.R.L.
Microsoft G.m.b.H. (GERMANY)
Microsoft Hellas S.A. (GREECE)
Microsoft de Guatemala, S.A.
Microsoft Hong Kong Limited
Microsoft Hungary Kft.
Microsoft Corporation (India) Private Limited
Microsoft India (R&D) Private Limited
PT. Microsoft Indonesia
Microsoft Israel Ltd.
Microsoft SRL (ITALY)
Microsoft Cote d'Ivoire (IVORY COAST)
Microsoft Company, Limited (JAPAN)
Microsoft Asia Ltd (NEVADA-JAPAN BRANCH)
Microsoft Product Development Ltd (NEVADA-JAPAN BRANCH)
East Africa Software Limited (KENYA)
Microsoft CH (KOREA)
Microsoft Kuwait Representative Office
SIA Microsoft Latvija
Microsoft Corporation Lebanon Representative Office
Microsoft (Malaysia) Sdn. Bhd.
Microsoft Mexico, S.A. de C.V.
Microsoft Indian Ocean Islands Limited (MAURITIUS)
<PAGE>

Microsoft Maroc S.A.R.L. (MOROCCO)

Microsoft B.V. (THE NETHERLANDS)
Microsoft Manufacturing B.V. (THE NETHERLANDS)
Microsoft International B.V. (THE NETHERLANDS)
Microsoft New Zealand Limited
Microsoft Norge AS (NORWAY)
Microsoft de Panama, S.A.
Microsoft (China) Company Limited (THE PEOPLE'S REPUBLIC OF CHINA)
Microsoft Peru, S.R.L.
Microsoft Philippines, Inc.
Microsoft sp. z.o.o. (POLAND)
MSFT-Software Para Microcomputadores, LDA (PORTUGAL)
Microsoft Caribbean, Inc. (DELAWARE)
Microsoft Romania SRL
Microsoft ZAO (RUSSIA)
Moscow Microsoft Ireland Operations Limited (Representative Office)(RUSSIA)
Microsoft Arabia Limited (SAUDI ARABIA, 60% owned)
Microsoft Singapore Pte Ltd.
Microsoft Slovakia s.r.o.
Microsoft d.o.o., Ljubljana (SLOVENIA)
Microsoft (S.A.) (Proprietary) Limited (SOUTH AFRICA)
Microsoft Iberica S.R.L. (SPAIN)
Microsoft Aktiebolag (SWEDEN)
Microsoft AG (SWITZERLAND)
Microsoft Taiwan Corporation
Microsoft (Thailand) Limited
Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (TURKEY)
Microsoft Corporation (UNITED ARAB EMIRATES)
Microsoft Limited (UNITED KINGDOM)
Microsoft Research Limited (UNITED KINGDOM)
Microsoft Uruguay, S.A.
Microsoft Venezuela, S.A.
The Resident Representative Office of MICROSOFT Corporation in Hanoi (VIETNAM)
Microsoft Corporation, Zimbabwe Liaison Office
WebTV Networks, Inc. (California)
DreamWorks Interactive L.L.C. (WASHINGTON, 50% owned)
MSBET L.L.C. (DELAWARE, 50% owned)
MSFDC L.L.C. (DELAWARE, 50% owned)
MSFDC International, Inc. (DELAWARE, 50% owned)
MSNBC Cable, L.L.C. (DELAWARE, 50% owned)
MSNBC Interactive News, L.L.C. (DELAWARE, 50% owned)
Ninemsn Pty. Limited (AUSTRALIA)
WebTV Networks K.K. (JAPAN)
Microsoft HomeAdvisor, LLC (NEVADA)
Transpoint L.L.C. (DELAWARE, 95% owned by MSFDC L.L.C.)
Wireless Knowledge L.L.C. (DELAWARE, 50% owned)
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Exhibit 23.

Independent Auditors' Consent

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981

Stock Option Plan), 33-44302, 33-51583, and 333-06298 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors), 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors), 333-16665 (Microsoft Corporation 1997 Employee Stock Purchase Plan), 333-61729 (Microsoft Corporation 1998 Special Stock Award Program), 333-75243 (Microsoft Corporation Savings Plus 401(k) Plan) and 33-06298 of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, 33-63471, 33-64870, 333-00857, 333-01177, 333-02759, 333-05961, 333-8081, 333-12441, 333-17143, 333-18055, 333-18195, 333-23621, 333-31803,333-37841, 333-41387, 333-43449, 333-45989, 333-52377, 333-61507, 333-65813, 333-69027, 333-75389, 333-79461 of Microsoft Corporation on Forms S-3, and 333-26411 of Microsoft Corporation on Form S-4 of our report dated July 19, 1999 appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 1999.

/s/ Deloitte & Touche LLP
Deloitte & Touche LLP
Seattle, Washington
September 28, 1999

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THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE ACCOMPANYING FINANCIAL STATEMENTS AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For The Fiscal Year Ended June 30, 2000

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

For the Transition Period from ______ to ______

Commission File Number 0-14278

MICROSOFT CORPORATION

Washington (State of incorporation)	91-1144442 (I.R.S. ID)

One Microsoft Way, Redmond, Washington 98052-6399

(425) 882-8080

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [_]

The aggregate market value of common stock held by non-affiliates of the registrant as of September 8, 2000 was $302,326,027,351.

The number of shares outstanding of the registrant's common stock as of

September 8, 2000 was 5,355,376,816.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2000 Annual Report to Shareholders are incorporated by reference into Parts I, II, and IV. Portions of the definitive Proxy Statement dated September 8, 2000 to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held November 9, 2000 are incorporated by reference into Part III.

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MICROSOFT CORPORATION

FORM 10-K

For The Fiscal Year Ended June 30, 2000

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Part I

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PART I

Item 1. Business

General

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for servers, personal computers (PCs), and intelligent devices; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN(TM) network of Internet products and services and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells hardware devices; provides consulting services; trains and certifies system integrators; and researches and develops advanced technologies for future software products.

Microsoft's business strategy emphasizes the development of a broad line of software products for information technology (IT) professionals, knowledge workers, developers, and consumers, marketed through multiple channels of distribution. The Company is divided into three main areas: the Business Divisions, the Sales, Marketing, and Support Group, and the Operations Group.

The Business Divisions work in close partnership in order to create powerful software services and solutions built around the Internet, Windows, and new devices. Each division is responsible for the product planning, development, strategy, and in some cases, marketing strategies for their respective customer segments. The product segments, based on these business divisions, are the Windows(R) Platforms segment, the Business Productivity Applications and Developer segment, and the Consumer and Other segment.

The Windows Platforms segment contains the Windows Division and the Windows Digital Media Division. The Windows Division develops PC and server platforms required to run applications and services and to deliver the connectivity, management services and infrastructure for all types of users. The Windows Division builds platforms for enterprise, dotcoms, small businesses, and consumers. The Windows Digital Media Division develops digital media technology and services for Windows platforms available across all types of devices, networks, and services.

The Productivity Applications and Developer segment has two primary divisions, the Business Productivity Group and the Developer Group. The Business Productivity Group creates desktop and server software applications and solutions for the knowledge workers and small businesses. The Developer Group builds architecture and development of our tools and related platform technologies for software developers.

The Consumer and Other segment includes the Consumer Group. The Consumer Group provides Internet services and creates and markets productivity programs, learning and entertainment products, and hardware peripherals for consumers. For financial reporting, revenue from Microsoft Press, consulting, and certification of system integrators is included in this segment.

See notes to financial statements for financial information regarding segment reporting.

Microsoft has a research lab dedicated to creating new technology and converting problems into tangible solutions that Microsoft developers can incorporate into products to meet customers' needs.

The Sales, Marketing, and Support Group is responsible for building long-term business relationships with original equipment manufacturers (OEMs), enterprises, small- and medium-sized businesses, application developers, educational institutions, and consumers. Enterprises are offered tailored license programs, enterprise-wide support, consulting services, and other specialized services. The group contains the Marketing Division, which is responsible for domestic execution of integrated marketing campaigns and similar worldwide initiatives;

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and developing expertise in public relations, advertising, customer loyalty, research, and events. The group also manages the channels that serve customers by working with OEMs, distributors, and resellers. In addition to the OEM channel, Microsoft has three major geographic sales organizations: the South Pacific and Americas; Europe, Middle East, and Africa; and Asia. The Sales, Marketing, and Support group supports the Company's products with technical support for end users, developers, and IT departments in organizations.

The Operations Group is responsible for managing business operations and overall business planning. This includes the process of manufacturing and delivering finished goods and licenses; corporate functions such as finance, administration, human resources, and legal.

Products

Windows Platforms

The Windows Platforms segment is responsible for the development of PC and server platforms, including the Microsoft Windows and Windows 2000 operating systems. The segment is also responsible for developing the Microsoft Internet Explorer browsing software and Microsoft Windows Media(TM) Technologies. PC operating systems perform a variety of functions, such as allocating computer memory, scheduling applications software execution, managing information and communication flow among the various PC components, and enabling end users to access files and information from a variety of sources. The Windows NT operating system for servers is an enterprise-wide platform for building and deploying distributed applications for networked PCs. The Windows Platforms segment also provides products for developing, running, and managing Internet and intranet applications and content.

Windows Millennium Edition. The latest version of the Windows operating system, Windows Millennium Edition (Me) operating system is designed specifically for home users to manage digital photos and music, work with video, create a home network, and communicate with other consumers. Windows Me was released in September 2000.

Windows 98. The successor to Windows 95, Windows 98 is a personal computer operating system that provides a Web-oriented user interface, better system performance along with easier system diagnostics and maintenance. Windows 98 supports graphics, sound, and multimedia technologies and provides the ability to easily add and remove peripheral devices and support for Universal Serial Bus (USB). Windows 98 was released in June 1998.

Windows 2000 Professional. The successor to Windows NT Workstation, Windows 2000 Professional operating system combined features to create a mainstream operating system for desktop and notebook computing in all organizations. Windows 2000 Professional contains the enhanced business features of Windows 98 such as Plug and Play, easy-to-use user interface, and power management and integrated the strengths of Windows NT Workstation including standards-based security, manageability, and reliability. Windows 2000 Professional was released in February 2000.

Windows NT Workstation. A fully integrated, multitasking 32-bit PC operating system, Windows NT Workstation provides security, robustness, and portability. Windows NT Workstation is designed for mission-critical computing and provides the same features and applications programming interfaces (APIs) for Intel and Alpha AXP microprocessors. Microsoft Windows NT Workstation combines the Windows 98 operating system interface and usability features with the reliability and security of Windows NT for the business environment.

Windows 2000 Server, Advanced Server, and Datacenter Server. Windows 2000 Server family builds on the Windows NT technology, integrating standards-based directory, Web, application, communications, file and print services with high reliability, efficient management, and support for networking hardware to provide the foundation for integrating with the Internet. Windows 2000 Server is a multipurpose network operating system for businesses of all sizes. Windows 2000 Advanced Server operating system is ideal for e-commerce and line-of-business applications and provides enhanced performance and scalability through SMP and extended memory

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support. Windows Datacenter Server operating system is built for large-scale line-of-business and enterprise dotcom backend usage and supports server consolidation and enhanced scalability. Windows 2000 Server and Advanced Server were released in February 2000 and Windows Datacenter Server was released in September 2000.

Windows NT Server. Windows NT Server is an operating system foundation for both server applications and file and print sharing, with network management features, administration tools, security, and high availability. Windows NT Server provides a scalable platform for business critical applications and databases, connectivity, system management, and electronic mail (e-mail) servers. The operating system integrates Web services such as Microsoft Internet Information Server, a service used to manage intranet and Internet functionality, and Microsoft FrontPage(R) Web site creation and management tool. Windows NT Server, Terminal Server Edition, an extension to the Windows NT Server, offers the application support of the Windows operating system platform with the centrally managed environment of the mainframe with terminal. Windows NT Server Enterprise Edition provides the means for building and deploying large-scale distributed applications for large and mission-critical servers featuring comprehensive clustering for scalability and availability.

Other Servers. Microsoft Proxy Server creates a single, secure gateway to the Internet; Microsoft SNA Server provides connectivity to host data and applications; and Microsoft Systems Management Server helps centrally manages the distributed environment with integrated features, including hardware inventory, software inventory and metering, software distribution and installation, and remote troubleshooting tools.

Windows Media Technologies. Microsoft Windows Media Technologies provide the ability to create, deliver, and play streaming media files for applications ranging from news and entertainment to e-commerce and corporate training available across all types of devices, networks, and services. Windows Media Technologies components include the Windows Media Tools, Windows Media Services streaming server, and Windows Media Player.

Productivity Applications and Developer

The Productivity Applications and Developer segment develops desktop applications, server applications, developer tools, Web authoring tools, and solutions to businesses by providing software and services to conduct commerce on the Internet.

Business Productivity

The Business Productivity Division delivers integrated business productivity solutions for the knowledge worker, including the Office family of products, other desktop applications, server applications, and the Windows CE operating system for productivity appliances.

Microsoft Office. Microsoft Office is a suite of software programs featuring seamless integration of the most commonly used desktop applications. Microsoft Office is based upon a document-centric concept, with common commands and extensive use of cross-application capabilities. Microsoft Office is available in several versions, with certain combinations of products, and available for the Windows and Macintosh operating systems. Microsoft Office 2000 integrates core productivity tools with the Web to simplify publishing Office documents to an intranet or Internet site, simplifies information system support with a self-repairing installation, and has enhanced usability with customizable menus based on IntelliSense(R) technology rules. Products offered in the various versions include the word processor Microsoft Word, Microsoft Excel spreadsheet, Microsoft Outlook(TM) messaging and collaboration client, Microsoft PowerPoint(R) presentation graphics program, Microsoft Access database management application, and others. Microsoft Word is a word-processing program designed to easily create professional-looking documents for the Web, e-mail, and print. Microsoft Excel creates data-rich spreadsheets for universal viewing on the Internet and for collaboration, allows users to analyze data with charts, and incorporates Microsoft PivotTable(R) views and graphs. Microsoft Outlook messaging and collaboration client provides a single location for organizing and managing day-to-day information, including e-mail, calendars,

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business contacts, and task lists. Microsoft PowerPoint presentation graphics program is a complete set of tools for creating professional presentations. Microsoft Access database management application allows for easy access and retrieval of information and includes pre-packaged solutions to create databases quickly. Microsoft FrontPage is a Web site creation and management tool for Web sites on the Internet or intranets. Microsoft PhotoDraw(TM) business graphics software is a program for creating custom business graphics by editing illustrations and photos.

Other Desktop Application Products. The Company also offers other stand-alone desktop application products. Microsoft Project is a critical path project scheduling and resource allocation program. Microsoft Visio(R) enables you to communicate effectively with easy-to-assemble drawings and diagrams; create organizational charts and flowcharts; draw technical schematics and annotate CAD drawings; build Web site maps; and manually or automatically work on network, software, and database design. Microsoft Publisher is an easy-to-use, entry-level desktop publishing program. Most of the applications included in the various productivity suites are also licensed separately.

Server Applications. The Microsoft BackOffice(R) family of server applications is an integrated suite of software products based on Windows NT Server that includes file and print services, applications, database, messaging, groupware, desktop management, Internet access, transaction processing, and host connectivity. The BackOffice suite enables organizations to share information, collaborate, and manage and deploy business-critical applications and includes BackOffice Server, Exchange Server, Proxy Server, Site Server, SQL Server(TM) and others. Microsoft BackOffice Small Business Server is designed for smaller companies of 25 users or less as an integrated solution for sharing files, databases, printers, electronic mail, fax services, applications, and other resources. Microsoft Site Server allows a comprehensive management of sophisticated Web sites and their content.

Microsoft Site Server Commerce helps businesses engage customers and partners with creating cost-effective commerce sites and applications, targeted online advertising and marketing, and personalized promotion.

Microsoft Exchange Server. The Company's messaging and collaboration server is Microsoft Exchange Server, which provides e-mail, group scheduling, task management, and document routing capabilities. Exchange Server offers a scalable, reliable, and secure environment for multiple clients, and Internet protocols as part of the core server architecture. It also includes tools to create collaboration applications.

Windows CE. The Company delivers software and platform technologies for a broad range of productivity appliances. Microsoft develops and markets Windows CE, a scaleable Windows platform for communications, entertainment, and mobile computing devices. The Windows CE operating system is built around an API that is consistent with other 32-bit Windows-based operating systems. Windows CE allows productivity appliances to communicate with each other, share information with Windows-based PCs, and connect to the Internet. Microsoft teams up with hardware companies that build Windows CE-based devices.

bCentral. Microsoft's small businesses portal, bCentral, allows companies to leverage the Internet to drive their business forward. Microsoft bCentral Site Manager is a web site management and hosting service which empowers small businesses to easily create and manage their own web sites, while allowing for higher-end editing in Microsoft FrontPage. Microsoft bCentral LinkExchange, which the Company acquired in November 1998, provides services to small businesses and Web site owners to increase their online traffic and sales with free advertising banner ads on their site in exchange for placing ads on other network sites.

Developer

The Developer Group provides software development tools and distributed application platforms to developers of Windows-based applications and Internet applications. These products and services empower independent software developers, corporate developers, solutions developers, and Webmasters to create a broad spectrum of applications. Microsoft Windows Distributed interNet Applications (DNA) Architecture is the application development model for the Windows platform. Windows DNA specifies how to develop robust,

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scalable, distributed applications using the Windows platform; extend existing data and external applications to support the Internet; and support a wide range of client devices. Windows DNA provides for the integration of Web and client/server application development models through the Component Object Model (COM). COM underlies a large majority of the code developed for Windows and Windows NT operating systems. COM+, an extension of COM, builds on COM's integrated services and features, making it easier for developers to create and use software components in any language, using any tool.

Developer Tools. Software development tools and computer languages allow software developers to write programs in a particular computer language and translate programs into a binary machine-readable set of commands that activate and instruct PC hardware. The Company develops and markets a number of software development environments and language compilers. Microsoft Visual C++(R) development system is the Company's development system for Windows-based application development. The Microsoft Visual Basic(R) development system provides easy access to a wide variety of data sources by integrating the Microsoft Access database engine and the ability to take advantage of investments in commercial applications. The Microsoft Visual InterDev(TM) Web development system includes integrated, team-based development tools for building Web-based applications based on HTML, Script, and components written in any language. Microsoft Visual J++(TM) development system for Java contains a high productivity Integrated Development Environment and a collection of integrated components to create, test, tune, and deploy Java code on multiple platforms. Microsoft Visual Studio(R) development system for Windows-based development is a suite of developer tools enabling developers to build components and applications using Visual Basic, Visual C++, Microsoft Visual FoxPro(R) database development system, Visual InterDev, and Visual J++. Developers can subscribe to the Microsoft Developer Network (MSDN(TM)) information service and receive periodic updates via CD-ROMs, magazines, and several on-line information services.

Microsoft SQL Server. Microsoft SQL Server(TM) is a scalable, high-performance database management system designed specifically for distributed client/server computing. SQL Server has built-in data replication, management tools, Internet integration, and online analytical processing (OLAP) to aid in the analysis of information for reporting and data modeling. Its open system architecture provides a Windows NT-based platform for delivering cost-effective information solutions.

Consumer

The Consumer Group supplies services and content to consumers over the Internet including MSN Internet Access; WebTV(R) Internet Service; MSN Portal and vertical properties; and develops software and hardware products that are designed to meet the needs of consumers in the home environment. Most software and hardware products are licensed and sold to and through retail channels to consumers. Major product categories include learning, productivity, entertainment, and hardware peripherals.

The Microsoft Network. MSN Internet Access is a Web-based online service. MSN provides easy and inexpensive access for users to a wide range of graphically rich online content. MSN Internet Access provides dial-up Internet access, free Web-based e-mail through MSN Hotmail, and Microsoft MSN Messenger Service. MSN Hotmail, one of the largest e-mail services with 40 million members, provides members with an e-mail account they can access from any PC with Internet access and has localized versions in French, German, and Japanese. MSN Messenger Service is a free Internet messaging service that enables users to see when other users are online to exchange instant messages.

WebTV. WebTV Networks is an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on WebTV(TM) technologies. WebTV operates the WebTV Network Service and develops the WebTV Internet Terminal and WebTV Plus Receiver, which are available through the Company's licensees. Future versions of the set-top terminals will use the Windows CE operating system.

MSN Portal. The MSN Portal business provides services on the Internet, encompassing the home page as well as the vertical services. The vertical services provide an online decision support infrastructure for end users

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in many fields such as automobiles, travel, finance, and home purchasing. Microsoft CarPoint(TM) online automotive service provides objective information for new car purchases, including test-drive reviews, dealer invoices, surround videos, and interactive classified advertisements for used car purchasing. Microsoft HomeAdvisor(TM) online real estate service is a complete guide to the home-buying process and provides comprehensive tools for finding homes and loans on the Internet. Expedia, Inc., a majority owned subsidiary of Microsoft, is a provider of branded online travel services for leisure and small business travelers operating its own website with localized versions in the United Kingdom, Germany, and Canada and certain other websites in the United States and Europe. Expedia offers one-stop travel shopping and reservation services, providing reliable, real-time access to schedule, pricing and availability information. Expedia acquired Travelscape.com, Inc. and VacationSpot.com, Inc. in March 2000. MSN MoneyCentral(TM) personal finance online service is a free interactive personal finance resource to track securities by providing company and mutual fund research, an investment finder, daily editorial and market summaries, e-mail notifications and alerts, and access to online trading through leading financial services firms. MSNBC is an Internet news service that complements the MSNBC Cable Network, providing in-depth reporting and information on a wide range of news topics, from local to national to international news. Microsoft Passport is a platform technology that makes it safer and easier for consumers to access information and buy products and services online. Microsoft Passport allows consumers to create a single sign-in, registration, and electronic wallet that can be shared between all of the sites that support Microsoft Passport. TransPoint is an end-to-end system for Internet bill delivery and payment. TransPoint's service, using existing payment systems, allows consumers to access and pay their bills through the branded home banking services of participating financial institutions and other consumer service providers.

Learning. Learning titles include Microsoft Encarta(R) multimedia encyclopedia and Microsoft Bookshelf CD-ROM reference library. The Encarta family of products includes a multimedia encyclopedia database with interactive information, an interactive world atlas with three-dimensional maps, a world English dictionary, and an online version with monthly updates. Microsoft Bookshelf is a multimedia reference library that integrates a dictionary, world atlas, world almanac, thesaurus, concise encyclopedia, and two books of quotations. Titles for children include My Personal Tutor, a comprehensive, grade-based learning suite with TutorAssist(TM) learning technology that identifies a child's specific learning needs and offers instruction, and a series of products based on the popular children's book and television series, Scholastic's The Magic School Bus(TM).

Productivity and Finance. Microsoft's productivity offerings include Microsoft Works, an integrated software program that contains basic word-processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Microsoft Money is a financial organization product that allows users to computerize their finances and provides online home-banking services with numerous different banks in the United States. The Works Suite provides a comprehensive collection of software, including Microsoft Works, Microsoft Word, Microsoft Money, Microsoft Encarta encyclopedia, Microsoft Graphics Studio Greetings, and Microsoft Expedia Streets.

Entertainment. The Company offers a line of entertainment products from classical software games to online games, simulations, sport products, and strategy games. Microsoft Flight Simulator is a popular aircraft flight simulation product. Other games include Combat Flight Simulator, Age of Empires(R), Monster Truck Madness(R) racing simulation, Microsoft Baseball, Microsoft Links, and other sports and action titles. The Microsoft Internet Gaming Zone is a gaming community on the Internet allowing multiplayer gaming competitions of Microsoft's popular CD-ROM games and classic card, board, and puzzle games.

Hardware Peripherals. The Company develops and markets several PC input devices including the Microsoft Mouse, a hand-held pointing device that facilitates using the PC. The Microsoft IntelliMouse(R) pointing device with an electronic eye that tracks movements over surfaces, and works for left- and right-handed users. The Company also markets several types of keyboards including the Microsoft Natural(R) Keyboard, an ergonomically designed keyboard. Microsoft sells various Microsoft SideWinder(R) game controllers and force feedback joysticks with realistic performance technology to use with PC games.

Joint Ventures. The Company has entered into joint venture arrangements to take advantage of creative talent and content from other organizations. Microsoft owns 50 percent of MSNBC Cable L.L.C., a 24-hour cable

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news and information channel; and 50 percent of MSNBC Interactive News L.L.C., an interactive online news service. National Broadcasting Company (NBC) owns the remaining 50 percent of these two joint ventures. Microsoft is an investor in Transpoint L.L.C., a joint venture between Microsoft, First Data Corporation, and Citibank. Microsoft owns a 49 percent of Avanade, a joint venture with Andersen Consulting which offers solutions and services based on Windows 2000.

Microsoft Press

Microsoft Press offers comprehensive learning and training resources to help new users, power users, and professionals get the most from Microsoft technology through books, CDs, self-paced training kits, and videos that are created to accommodate different learning styles and preferences. Microsoft Press(R) books are authored by professional and technical writers, both by Microsoft employees and independent authors.

Microsoft Press contracts with an independent commercial printer for the printing of its books. Publisher's Resources, Inc. acts as the Company's main fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press books. Books are marketed by independent sales representatives and by Microsoft Press sales personnel. Internationally, Microsoft Press has numerous agreements with publishers for the worldwide distribution of its books. Microsoft Press has granted a publisher in England the right to distribute English language versions of its books in all countries except the United States, Canada, Latin America, and certain Asian countries. In most cases, Microsoft Press provides each publisher with a book's manuscript, and the publisher arranges for its translation and the printing, marketing, and distribution of the translated version.

Customer Groups

The enterprise and partner sales group (EPG) has responsibility for providing strategic leadership and creating programs for enterprise customers and partners, assisting the field organization. The organization is responsible for coordinating the enterprise strategy by industry, market, partner and customer segment. EPG focuses on enterprise solutions including large and medium organizations enterprise strategy, industry solutions, integrated small organization strategy, anti-piracy, sales processes and readiness; sales and support systems; partner strategy and programs including global partner management; enterprise services; executive and technical sales including corporate account technical marketing, industry evangelism and executive sales events; and global account management. The group also creates an integrated end-to-end service continuum for enterprise customers.

The industry solutions group includes full-service practices for financial services, telecommunications, federal and state and local government, and the educational market .

The network solutions customer group is responsible for introducing the Company's products and technologies to public infrastructure owners and Internet Content Providers. The customer group also focuses on embedded and dedicated systems. Infrastructure owners include network operators (telephone companies, cable companies, Internet service providers, etc.) who build, own, and operate the public networks.

The consumer customer group has responsibility for activities that target end users that make individual buying decisions for home PCs. Most sales and marketing activities aimed at end-user customers are performed by this group, including developing and administering reseller relationships; reseller sales terms and conditions; channel marketing and promotions; end-user marketing programs; and seminars, events, and sales training for resellers. The customer group's sub-segments include direct marketing resellers and retailers.

Product Development

The software industry is characterized by extremely rapid technological change, which requires constant attention to computing technology trends, and shifting consumer demand, and rapid product innovation. The pace of change is accelerating, as the computing needs of our customers move beyond the PC toward intelligent devices and appliances.

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Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third-party development and localization of certain products. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved development methodologies for creating and enhancing its products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, or computing devices. Product documentation is generally created internally.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to new user needs or advances in intelligent devices, PCs, servers, and the Internet, without compromising product quality. The Company strives to become informed at the earliest possible time about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, Microsoft provides to software vendors a range of development, training, testing resources, and guidelines for developing applications to software vendors.

To best serve the needs of users around the world, Microsoft "localizes" many of its products to reflect local languages and conventions and to improve the quality and usability of the product in international markets. Localizing a product might require modifying the user interface, altering dialog boxes, and translating text. In Japanese versions, for example, all user messages and documentation are in Japanese with monetary references in the Japanese yen. Various Microsoft products have been localized into more than 30 languages.

During fiscal years 1998, 1999, and 2000, the Company spent $2.60 billion, $2.97 billion, and $3.78 billion, respectively, on product research and development activities. Those amounts represented 17.0%, 15.0%, and 16.4%, respectively, of revenue in each of those years, excluding funding of joint venture activity. The Company is committed to continue high expenditures for research and product development.

In fiscal 2000, Microsoft announced its most significant software research and development initiative, Microsoft .NET. The fundamental strategy behind Microsoft .NET is to focus on the shift from individual Web sites or devices connected to the Internet, to constellations of computers, devices, and services that work together to deliver broader, richer solutions. Microsoft's

.NET strategy includes the delivery of software as a service, built on the XML standard; a new user experience that is accessible across and optimized for a wide range of devices; and the creation of new opportunities for developers to build Internet services and business more easily. Microsoft .NET builds on Microsoft's core businesses, including Windows desktop and server operating systems, enterprise server applications, Microsoft Office, and MSN. Microsoft will offer a range of .NET products and services including Windows.NET--the next generation Windows platform designed with customized applications and services to allow user to control their digital information; MSN.NET--an integrated consumer experience built on the .NET platform to deliver a more integrated and personalized experience; subscription services--a set of consumer-oriented services on the .NET platform that will build on existing Microsoft entertainment, gaming, education, and productivity products; Office.NET-- advanced communications and productivity tools; bCentral.NET--subscription-based services and tools for small and growing businesses including hosted messaging, commerce services, and customer relationship management services; and Visual Studio.NET--XML-based programming model and tools, fully supported by MSDN and Windows DNA 2000 servers.

Manufacturing

Microsoft contracts out most of its manufacturing activity to third parties. Outside manufacturers produce various retail software packaged products and hardware peripherals. There are other custom manufacturers Microsoft could use in the event outsourced manufacturing becomes unavailable from current vendors.

The Company's remaining manufacturing facilities are located in Puerto Rico and Ireland. The Irish facility and the Puerto Rico facilities manufacture CD-ROMs. Microsoft outsources its manufacturing of packaged

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products. Quality control tests are performed on purchased parts, CD-ROMs, and other products. The chief materials and components used in Microsoft products include CD-ROMs, books, and multicolor printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.

The Company's sales mix has shifted to OEM and organizational licenses from packaged products. Also, online distribution of software is increasing.

Operations

Microsoft manages all product fulfillment, licensing, and logistics services. The Company has regional operations centers in Ireland, Singapore, and the Greater Seattle area. The regional centers support all operations activities, including information processing, vendor management, logistics, and related supporting functions by geographical regions. The regional center in Dublin, Ireland supports the European, African, and Middle East regions, the center in Singapore supports the Asia Pacific region, and the center in the Greater Seattle area supports North and South America. The Company established Microsoft Licensing Incorporated (MSLI) in Reno, Nevada, a wholly owned subsidiary, which manages the Company's OEM and certain organizational licensing operations.

Marketing and Distribution

The Company's sales and marketing group seeks to build long-term relationships with customers of Microsoft products. The OEM sales group includes the sales force that works with original equipment manufacturers that preinstall Microsoft software on their PCs. In addition to the OEM channel, Microsoft has three major geographic sales and marketing organizations: the South Pacific and Americas; Europe, Middle East, and Africa; and Asia.

Finished Goods Channels

Distributors and Resellers. The Company licenses and sells its products in the finished goods channels primarily to and through independent non-exclusive distributors and resellers. Distributors include Inacom, Ingram Micro, SoftBank, Tech Data, and Merisel. Resellers include Software Spectrum, Corporate Software & Technology, CompUSA, Software House International, Softmart, ASAP Software Express, and Best Buy. Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

Enterprise Accounts. The Microsoft Select program offers flexible software acquisition, licensing, and maintenance options specially customized to meet the needs of large multinational organizations. Targeted audiences include technology specialists and influential end users in large enterprises. Marketing efforts and fulfillment are generally coordinated with large account resellers. The Microsoft Open program is a licensing program that is targeted for small and medium size organizations. It is available through the reseller channel and offers discounts based on initial purchase volumes. The Microsoft Enterprise Agreement program is a licensing program designed to provide a flexible licensing and service solution tailored to customers making a long-term licensing commitment. The agreements are designed to increase customer satisfaction by simplifying license administration, payment terms, and the contract process.

Solution Providers. Microsoft's Solution Providers program is a comprehensive support relationship with independent organizations that provide network and system integration, custom development, training, and technical support for business computing solutions. The program supports system integrators, value-added resellers (VARs), consultants, custom application developers, solution developers, Internet service and hosting organizations, independent content providers, and site builders (companies that build Web sites for other companies), as well as technical support and training organizations. Under this business collaboration strategy,

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the Company provides sales and product information, development services, early access to Microsoft products, and customer support tools, including priority telephone support, education, and business development support. To ensure high-quality technical services for the Company's products, Microsoft Solution Providers are required to have Microsoft-certified professionals on staff. Microsoft Direct Access is a comprehensive and open program that allows independent technology providers to actively work with Microsoft through the Microsoft Direct Access program online, quarterly briefings, training, and action packs.

Certified Professionals. Microsoft receives certification fees through the Microsoft Certified Professional (MCP) program, a program that provides credentials for those who have demonstrated in-depth knowledge of at least one Microsoft product. To become an MCP, a candidate must pass a certification exam that provides a valid and reliable measure of technical proficiency and expertise. MCP exams are developed with the input of professionals in the industry and reflect how Microsoft products are used in organizations throughout the world. The exams are administered by independent organizations at more than 1,400 testing centers around the world. MCPs receive access to technical and product information through an MCP Web site, MSDN Online Certified Membership, and invitations to conferences, technical training sessions, and special events. Candidates may pass additional Microsoft certification exams to further qualify their skills with Microsoft BackOffice products, development tools, and desktop applications.

Consulting Services. Microsoft Consulting Service assists customers in deploying and using the Company's computer operating systems, applications, and communications products. The group works with Solution Providers and helps create enterprise-wide computing solutions for large corporate accounts. Microsoft Consulting Services also works with technology solutions providers to enable them to offer a wide range of Microsoft product-related services backed by high levels of technical skill and knowledge.

International Sales Sites. The Company has established marketing and/or support subsidiaries in more than 70 countries. Product is generally delivered by the Company's owned or outsourced manufacturing operations, which are located in the geographical region in which the product was sold. By organizing geographically, the Company is able to provide service to international channel customers and access to Microsoft professionals located in the same region to serve their specific needs. Subsidiaries have the responsibility for selling products to customers, managing licensing programs, and providing support to all types of customers based in international countries. Notes to Financial Statements--(see Item 8) describe foreign operations and export sales.

The Company's international operations, both OEM and finished goods, are subject to certain risks common to foreign operations in general, such as governmental regulations, import restrictions, and foreign exchange rate fluctuations. Microsoft hedges a portion of its foreign exchange risk.

Product Support

The Company provides product support coverage options aligned to the customer segments, partner segments, and communities. Coverage options range from standard no-charge toll telephone support to fee-based offerings providing unlimited 800 number telephone and electronic technical support for all Microsoft products 24 hours per day, 7 days per week. Support offerings include the Alliance program, tailored for large enterprises running mission-critical applications on Microsoft platforms; the Premier program for enterprises and technical account managers needing regular managed support; the Authorized Premier Support for all types of businesses who work jointly with Microsoft and Microsoft Certified Support Center (MCSC) providers; and the Professional program for small organizations, developers and OEMs. The Personal program for home users, which provides free online self-help resources and paid assisted phone support. Users have access to troubleshooting "wizards" and Microsoft's KnowledgeBase, an online library of thousands of technical articles that is updated regularly with useful information regarding Microsoft products. Additionally, several support offerings include Microsoft TechNet and Microsoft Developer Network information subscription services.

Support personnel are located in various sites in the United States and around the world. Certain support is also supplied by qualified third-party support organizations.

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As a supplement or alternative to direct support, the Company enhances the third-party support channel by providing Microsoft Certified Solution Providers with education, training, tools, and support. Microsoft Certified Solution Providers include Authorized Training Centers, which offer advanced product education and certification on Microsoft products; and Authorized

Support Centers, which provide a wide spectrum of multinational support, multi-vendor support, and integration services.

OEM Channel

Microsoft operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of the Company's products with their computing devices, principally PCs. The Company also markets and licenses certain server operating systems, desktop applications, hardware devices, and consumer software programs to OEMs under similar arrangements. In almost all cases, the products are distributed under Microsoft trademarks. The Company has OEM agreements covering one or more of its products with virtually all of the major PC OEMs, including, Acer, Actebis, Compaq, Dell, eMachines, Fujitsu, Fujitsu Siemens Computers, Gateway, Hewlett Packard, IBM, Micron, NEC, Samsung, Sony, and Toshiba. A substantial amount of OEM business is also conducted with system builders, which are low-volume customized PC vendors.

Advertising

The Company works closely with large advertising and direct marketing firms. Advertising, direct marketing, worldwide packaging, and marketing materials are targeted to various end-user segments. The Company uses broad consumer media (television, radio, the Internet, and business publications) and trade publications. Microsoft has programs under which qualifying resellers and OEMs are reimbursed for certain advertising expenditures. The company has also formed an alliance with Best Buy to provide for joint marketing in Best Buy's retail stores, online, and through other vehicles to demonstrate and sell MSN Internet access and connectivity solutions.

Customers

The Company's customers include consumers, small and medium-sized organizations, enterprises, dotcoms, educational institutions, ISPs, application developers, and OEMs. Most consumers of Microsoft products are individuals in businesses, government agencies, educational institutions, and at home. The consumers and organizations obtain Microsoft products primarily through resellers and OEMs, which include certain Microsoft products with their computing hardware. Notes to Financial Statements (see Item 8) quantify customers that represent more than 10% of the Company's revenue. The Company's practice is to ship its products promptly upon receipt of purchase orders from its customers and, consequently, backlog is not significant.

Competition

The software business is intensely competitive and subject to extremely rapid technological change. As the company pursues its largest strategic initiative, Microsoft .NET, the Company could experience more intense competition during the transition from the traditional core businesses to its new products based on the .NET platform. The Company continues to face movements from PC-based applications to server-based applications or Web-based application hosting services, from proprietary software to open source software, and from PCs to Internet-based devices. A number of Microsoft's most significant competitors, including IBM, Sun Microsystems, Oracle, and AOL, are collaborating with one another on various initiatives directed at competing with Microsoft. These initiatives relate in part to efforts to move software from individual PCs to centrally managed servers, which would present significant challenges to the Company's historical business model. Other competitive collaborative efforts also include the development of new platform technologies that are intended to replicate much of the value of Microsoft Windows operating systems. New computing form factors, including non-PC information devices, are gaining popularity and competing with PCs running Microsoft's software products.

Microsoft faces formidable competition in these new areas and in all areas of its current business activity, including competition from many companies much larger than Microsoft. The rapid pace of technological change, particularly in the area of Internet platforms and services, continually creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. The Company also faces relentless competition from software pirates who unlawfully copy and distribute Microsoft's copyrighted software products, depriving the Company of large amounts of revenue on an annual basis.

Operating Systems. Microsoft's operating system products face substantial competition from a wide variety of companies. Competitors such as IBM, Apple Computer, Sun Microsystems, and others are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on computers of their own manufacture. Many of these operating system software products are also licensed to third-party OEMs for preinstallation on their computers. Microsoft's operating system products compete with UNIX-based operating systems from a wide range of companies, including IBM, AT&T, Hewlett-Packard, Sun Microsystems, The Santa Cruz Operation, and others. Variants of UNIX run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems. With an increased attention toward open-source software, the Linux operating system has gained increasing acceptance. Several computer manufacturers preinstall Linux on PC Servers and many leading software developers have written applications that run on Linux. Microsoft Windows operating systems are also threatened by alternative platforms such as those based on Internet browsing software and Java technology promoted by AOL and Sun Microsystems.

Business Solutions. The Company competes in the business of providing enterprise-wide computing solutions with several competitors who enjoy a larger share of sales and larger installed bases. Many companies offer operating system software for mainframes and midrange computers, including IBM, Hewlett-Packard, and Sun Microsystems. Since legacy business systems are typically support-intensive, these competitors also offer substantial support services. Software developers that provide competing server applications for PC-based distributed client/server environments include Oracle, IBM, Computer Associates, Sybase, and Informix. There are also several software vendors who offer connectivity servers. As mentioned above, there are numerous companies and organizations that offer Internet and intranet server software, that compete against the Company's business systems. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with the Company's collaboration and e-mail products.

Desktop Applications. The Company's competitors include many software application vendors, such as IBM (Lotus), Oracle, Apple (Filemaker, Inc.), Sun Microsystems, Corel, Qualcomm, and local application developers in Europe and Asia. IBM and Corel have large installed bases with their spreadsheet and word-processor products, respectively, and both have aggressive pricing strategies. Also, IBM and Apple preinstall certain of their application software products on various models of their PCs, competing directly with Microsoft's desktop application software. Additionally, Web-based application hosting services provide an alternative to PC-based applications such as Microsoft Office.

Developer Tools. The Company's developer products compete against offerings from Borland, Macromedia, Oracle, Sun Microsystems, Sybase, Symantec, and other companies.

Consumer Platforms. A wide variety of companies develop operating systems for information appliances, including Palm, Apple, Motorola, 3Com, Psion

Software, Sun Microsystems, Microworkz, Be, Inc., WindRiver, Symbian and others. The Company's WebTV offerings and other multimedia consumer products face competitors such as AOL, Oracle, Liberate Technologies, NetChannel, and others. An enormous range of companies, including media conglomerates, telephone companies, cable companies, retailers, hardware manufacturers, and software developers, are competing to make interactive services widely available to the home.

E-Commerce. Microsoft competes with many companies in the e-commerce business and its major components, including business-to-consumer, business-to-business, procurement, and supply chain integration. In the development and marketing of Internet and intranet solutions, major commerce software competitors

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provide many different ranges of products and solutions that compete with Microsoft, including IBM, Oracle, AOL, Sun Microsystems, Broadvision, and many others.

Online Services. Microsoft's online services network, MSN, faces formidable competition from AOL (including its CompuServe unit), Yahoo, and a vast array of Web sites and portals that offer content of all types and e-mail, instant messaging, calendaring, chat, and search and shopping services, among other things. In addition, the ease of entry into Internet services has allowed numerous Web-based service companies to build significant businesses in areas such as e-mail, electronic commerce, Web search engines, directories, and information of numerous types. Competitors include AOL, Yahoo, Excite, Lycos, Infoseek, AltaVista, and many others. The Company's MSNBC joint ventures face formidable competition from other 24-hour cable and Internet news organizations such as CNN, CNN Headline News, and Fox News Network. MSNBC also competes with traditional news media such as newspapers, magazines and broadcast TV.

Consumer Software and Hardware. The Company's Consumer Group faces smaller, but focused and branded competitors, particularly in the areas of hardware, learning, and entertainment. Consolidation in this area of software development has made certain competitors even stronger. Competitors include Intuit, Electronic Arts, Mattel (The Learning Company), Hasbro, Logitech, Voyager, Cendant, and Dorling Kindersley. Still other competitors own branded content, such as Disney and Lucas Arts.

Additionally, PC-based games and the Company's future Xbox compete and will compete head-to-head against games created for proprietary systems such as Nintendo, Sony PlayStation, and Sega. Input devices face substantial competition from computer manufacturers, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices.

The Company's competitive position may be adversely affected by one or more of these factors in the future, particularly in view of the fast pace of technological change in the computing industry.

Employees

As of June 30, 2000, the Company employed approximately 39,100 people on a full-time basis, 27,000 in the United States and 12,100 internationally. Of the total, 16,000 were in product research and development, 18,200 in sales, marketing, and support, 1,500 in manufacturing and distribution, and 3,400 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees is subject to collective bargaining agreements. The Company believes relations with its employees are excellent.

Item 2. Properties

The Company's corporate offices consist of approximately 6.8 million square feet of office building space located in King County, Washington situated on two sites that total approximately 306 acres of land. The Company recently completed the construction of an office building comprising approximately 145,000 square feet of space and is constructing two buildings with approximately 495,000 square feet of space that will be occupied in the winter of 2002. The Company owns 4.8 million square feet of its corporate campus and leases many buildings in the Puget Sound Region. The Company has leased several buildings totaling approximately 710,000 square feet of space that will be occupied by the fall of 2000. To accommodate expansion needs the Company has an option to purchase 150 acres of land in Issaquah, Washington.

The Company leases many sites domestically totaling approximately 2.4 million square feet of office building space. The construction of a 575,000 square foot campus in the San Francisco, California area was recently completed.

The Company leases many sites internationally totaling approximately 3.7 million square feet. The Company's European operations center and localization division consist of a 345,000 square foot campus situated on 17 acres

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in Dublin, Ireland. The Ireland facilities are partially owned by the Company. The Company leases a 45,000 square-foot disk duplication facility in Humacao, Puerto Rico and leases a 36,000 square-foot facility in Singapore for its Asia Pacific operations center. The Company has large office building space leased in the following locations: Tokyo, Japan 343,000 square feet; Unterschleissheim, Germany 253,000 square feet; United Kingdom campus 242,000 square feet; Les Ulis, France 229,000 square feet; and Beijing, China 115,000 square feet.

The Company's facilities are fully used for current operations of all segments and suitable additional space is available to accommodate expansion needs.

Item 3. Legal Proceedings

The information set forth in Notes to Financial Statements--Contingencies on pages 39-41 of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

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

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2000.

Executive Officers of the Registrant

The executive officers of Microsoft as of September 8, 2000 were as follows:

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Name	Age	Position with the Company
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William H. Gates........	44	Chairman of the Board; Chief Software Architect
Steven A. Ballmer.......	44	President; Chief Executive Officer
Robert J. Herbold.......	58	Executive Vice President; Chief Operating Officer
William H. Neukom.......	58	Executive Vice President, Law and Corporate Affairs; Secretary
James E. Allchin........	48	Group Vice President, Platforms
Orlando Ayala Lozano....	44	Group Vice President, Sales, Marketing and Services
Richard E. Belluzzo.....	46	Group Vice President, Personal Services and Devices
Paul A. Maritz..........	45	Group Vice President, Platforms Strategy and Developer
Robert L. Muglia........	40	Group Vice President, .NET Services
Jeffrey S. Raikes.......	42	Group Vice President, Productivity and Business Services
Robert J. Bach..........	38	Senior Vice President, Home and Retail
Brad Chase..............	40	Senior Vice President, MSN.com
David Cole..............	38	Senior Vice President, Personal Services Platform
John G. Connors.........	41	Senior Vice President, Finance and Administration; Chief Financial Officer
Jean-Philippe Courtois..	40	Senior Vice President; President, Microsoft Europe, Middle East, and Africa
Jon DeVaan..............	39	Senior Vice President, TV Service and Platform
Paul Flessner...........	41	Senior Vice President, .NET Enterprise Server
Paul H. Gross...........	39	Senior Vice President, Collaboration and Mobility
Joachim Kempin..........	58	Senior Vice President, OEM
Michel Lacombe..........	49	Senior Vice President; Chairman, Microsoft Europe, Middle East, and Africa
Brian MacDonald.........	38	Senior Vice President, Subscription Service
Craig Mundie............	51	Senior Vice President, Consumer Strategy
Richard F. Rashid.......	48	Senior Vice President, Research
Steven J. Sinofsky......	35	Senior Vice President, Office
Brian Valentine.........	40	Senior Vice President, Windows
David Vaskevitch........	47	Senior Vice President, Business Applications
Bernard P. Vergnes......	55	Senior Vice President; Chairman Emeritus, Microsoft Europe, Middle East, and Africa

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Mr. Gates co-founded Microsoft in 1975 and served as its Chief Executive Officer from the time the original partnership was incorporated in 1981 until January 2000, when he resigned as Chief Executive Officer and took on the position of Chief Software Architect. Mr. Gates has served as Chairman of the Board since the Company's incorporation.

Mr. Ballmer was named Chief Executive Officer and a director of the Company in January 2000. He has been President since July 1998, and prior to that, he had served as Executive Vice President, Sales and Support since February 1992. He was Senior Vice President, Systems Software from 1989 to 1992. From 1984 until 1989, Mr. Ballmer served as Vice President, Systems Software. He joined Microsoft in 1980.

Mr. Herbold joined Microsoft as Executive Vice President and Chief Operating Officer in November 1994. Mr. Herbold had been with The Procter & Gamble Company since 1968, with experience in information services, advertising and market research. Most recently, he was P&G's Senior Vice President, Information Services and Advertising.

Mr. Neukom was named Executive Vice President, Law and Corporate Affairs in October 1999. He had been Senior Vice President, Law and Corporate Affairs since February 1994. He joined Microsoft in 1985 as Vice President, Law and Corporate Affairs.

Mr. Allchin was named Group Vice President, Platforms in December 1999. He had been Senior Vice President, Platforms since March 1999. He was previously Senior Vice President, Personal and Business Systems since February 1996, Senior Vice President, Business Systems Division since November 1994, and had been Vice President, Business Systems Division since July 1991. Mr. Allchin joined Microsoft in 1991.

Mr. Ayala was named Group Vice President, Sales, Marketing and Services in August 2000. He had been Senior Vice President, South Pacific and Americas since February 1998 and before holding that position was Vice President of the developing markets of Africa, India, the Mediterranean and Middle East, Latin America, Southeast Asia and the South Pacific. He joined Microsoft in May 1991 as Senior Director of the Latin America Region.

Mr. Belluzzo was named Group Vice President, Personal Services and Devices in August 2000. He joined Microsoft as Group Vice President, Consumer and Commence in September 1999. Mr. Belluzzo had been Chairman of the Board and Chief Executive Officer, Silicon Graphics, Inc. since January 1998. Prior to his employment at Silicon Graphics, Inc., Belluzzo was employed by the Hewlett-Packard Company for 22 years, serving since 1995 as Executive Vice President and General Manager of the computer organization.

Mr. Maritz was named Group Vice President, Platforms Strategy and Developer in March 2000. He had been Group Vice President, Developer since March 1999. He was previously Group Vice President, Platforms and Applications since October 1996 and before holding that position was Group Vice President, Platforms since May 1995. Mr. Maritz had been Senior Vice President, Product and Technology Strategy since November 1994 and had been Senior Vice President, Systems Division since February 1992. He had been Vice President, Advanced Operating Systems since 1989. Mr. Maritz joined Microsoft in 1986. On September 13, 2000, Microsoft announced that Mr. Maritz is retiring from the Company, but will continue to serve as a consultant to Microsoft on strategic and business issues.

Mr. Muglia was named Group Vice President, .NET Services in August 2000. He had been Group Vice President, Business Productivity since December 1999. He was named Senior Vice President, Business Productivity in March 1999 and was named Senior Vice President, Applications and Tools in February 1998. He had been Vice President, Server Applications since 1997 and was Vice President, Developer Tools since 1995. He joined Microsoft in January 1988.

Mr. Raikes was named Group Vice President, Productivity and Business Services in August 2000. He had been Group Vice President, Sales and Support since July 1998. Before holding that position, he had been Group

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Vice President, Sales and Marketing since July 1996. He was named Senior Vice President, Microsoft North America in January 1992 and had been Vice President, Office Systems since 1990. Mr. Raikes joined Microsoft in 1981.

Mr. Bach was named Senior Vice President, Home and Retail in March 2000. He had been Vice President, Home and Retail since March 1999. Before holding that position, he had been Vice President, Learning, Entertainment and Productivity since 1996. Mr. Bach joined Microsoft in 1988.

Mr. Chase was named Senior Vice President, MSN.com in December 1999. He had been Senior Vice President, Consumer and Commerce since September 1999. Mr. Chase had been Vice President, Consumer and Commerce since March 1999. He was Vice President, Developer Relations and Windows Marketing. Mr. Chase joined Microsoft in July 1987.

Mr. Cole was named Senior Vice President, Personal Services Platform in August 2000. He had been Senior Vice President, Consumer Services since December 1999. Before holding that position, he had been Vice President, Consumer Windows since March 1999. He was Vice President, Web Client and Consumer Experience and Vice President, Internet Client and Collaboration. Mr. Cole joined Microsoft in 1986.

Mr. Connors was named Senior Vice President, Finance and Administration, and Chief Financial Officer in December 1999. He had been Vice President, Enterprise since March 1999. Mr. Connors had been Vice President, Information Technology, and Chief Information Officer since July 1996. He joined Microsoft in January 1989.

Mr. Courtois was named Senior Vice President and President, Microsoft Europe, Middle East, and Africa in July 2000. He had been Vice President, Customer Marketing since July 1998. Before holding that position, he had been Vice President of Microsoft Europe since 1997 and General Manager for Microsoft France since 1994. Mr. Courtois joined Microsoft in 1984.

Mr. DeVaan was named Senior Vice President, TV Service and Platform in December 1999. He had been Senior Vice President, Consumer and Commerce since September 1999. Mr. DeVaan had been Vice President, Consumer and Commerce since March 1999. He had been Vice President, Desktop Applications since 1995. Mr. DeVaan joined Microsoft in 1985.

Mr. Flessner was named Senior Vice President, .NET Enterprise Server in December 1999. He had been Vice President, Database and Data Access. Since joining the Company, Mr. Flessner's primary responsibilities have been the development of Microsoft's database business. He assumed responsibility for the engineering of Microsoft SQL Server in 1995. He joined Microsoft in 1994.

Mr. Gross was named Senior Vice President, Collaboration and Mobility in March 2000. He had been Senior Vice President, Server Applications since December 1999 and Vice President, Server Applications since March 1999. Before holding that position, he had been Vice President, Developer Tools. Mr. Gross joined Microsoft in September 1996. Before joining Microsoft, he was Senior Vice President of Research and Development at Borland International Inc.

Mr. Kempin was named Senior Vice President, OEM in August 1993. He had been Vice President, OEM Sales since 1987. Mr. Kempin joined Microsoft in 1983.

Mr. Lacombe is Chairman, Microsoft Europe, Middle East, and Africa. He was named Senior Vice President, Europe, Middle East, and Africa in February 1998. He had been President, Microsoft Europe and Senior Vice President, Microsoft since July 1997. He had been Vice President, Europe since September 1995. Mr. Lacombe joined Microsoft in 1983.

Mr. MacDonald was named Senior Vice President, Subscription Service in August 2000. He had been Vice President, New Application Technologies since December 1999. Before holding that position, he started and led the team that created the Microsoft Outlook messaging and collaboration client. He joined Microsoft in 1989.

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Mr. Mundie is Senior Vice President, Consumer Strategy. He was named Senior Vice President, Consumer Platforms in February 1996. He was named Senior Vice

President, Consumer Systems in May 1995 and had been Vice President, Advanced Consumer Technology since July 1993. He joined Microsoft as General Manager, Advanced Consumer Technology in December 1992.

Mr. Rashid was named Senior Vice President, Research in May 2000. He had been Vice President, Research since July 1994. He joined Microsoft in September 1991.

Mr. Sinofsky was named Senior Vice President, Office in December 1999. He had been Vice President, Office since December 1998. Mr. Sinofsky joined the Office team in 1994, increasing his responsibility with each subsequent release of the desktop suite. He joined Microsoft in July 1989.

Mr. Valentine was named Senior Vice President, Windows in December 1999. He had been Vice President, Business and Enterprise since March 1999. He had been Vice President, Windows since December 1998. Before managing the Windows group, Mr. Valentine managed the server applications division and had been responsible for the Exchange product unit. He joined Microsoft in 1987.

Mr. Vaskevitch was named Senior Vice President, Business Applications in March 2000. He had been Senior Vice President, Developer since December 1999. Before holding that position, he had been Vice President, Distributed Applications Platform. He joined Microsoft in 1986.

Mr. Vergnes is a Senior Vice President and Chairman Emeritus, Microsoft Europe, Middle East, and Africa. He was named President, Microsoft Europe in April 1992. He had been Vice President, Europe since 1989. Mr. Vergnes joined Microsoft in 1983.

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PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

The information set forth on page 43 of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.1.

Reference is also made to the information on put warrants described in the notes to financial statements incorporated herein by reference and filed herewith as Exhibit 13.4. All such transactions are exempt from registration under Section 4 (2) of the Securities Act of 1933. Each transaction was privately negotiated and each offeree and purchaser was an accredited investor/qualified institutional buyer. No public offering or public solicitation was used by the registrant in the placement of these securities.

On June 2, 2000, the Company issued an aggregate of 37,530 of its common shares pursuant to the acquisition by the Company of substantially all of the assets of NetGames USA, Inc., a Kansas corporation ("NetGames") owned by eleven shareholders. All of the Company common shares issued in this transaction were issued in a non-public offering pursuant to an exemption from the registration requirements of the Securities Act of 1933, as amended (the "1933 Act"), under Section 4(2) of the 1933 Act. This sale was made without general solicitation or advertising. The Company has filed a Registration Statement on form S-3 covering the resale of such securities. All net proceeds from the sale of such securities will go to the selling shareholders who offer and sell their shares. The Company has not received and will not receive any proceeds from the sale of these common shares other than the assets and liabilities of NetGames.

Item 6. Selected Financial Data

The information set forth on the inside front cover of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.2.

Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition

The information set forth on pages 15-24 of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

Item 7a. Quantitative and Qualitative Disclosures about Market Risk

The information set forth on page 23 of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

Item 8. Financial Statements and Supplementary Data

The following financial statements for the Company and independent auditors' report set forth on pages 14, 25-42, and 45 of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

. Income Statements for the three years ended June 30, 2000

. Cash Flows Statements for the three years ended June 30, 2000

. Balance Sheets as of June 30, 1999 and 2000

. Stockholders' Equity Statements for the three years ended June 30, 2000

. Notes to Financial Statements

. Independent Auditors' Report

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None.

<PAGE>

PART III

Item 10. Directors of the Registrant

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" on pages 1 and 2 of the Company's Proxy Statement dated September 8, 2000, for the Annual Meeting of Shareholders to be held November 9, 2000 (the "Proxy Statement"). Such information is incorporated herein by reference.

Item 11. Executive Compensation

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" on pages 4 through 6 and "Information Regarding the Board and its Committees" on page 2 is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information set forth under the caption "Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management" on page 3 of the Proxy Statement is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information set forth under the caption "Certain Relationships and Related Transactions" on page 8 of the Proxy Statement is incorporated herein by reference. The information in Notes to Financial Statements--Operational Transactions on pages 38 through 39 of the 2000 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

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PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) Financial Statements and Schedules

The financial statements as set forth under Item 8 of this report on Form 10-K are incorporated herein by reference.

Financial statement schedules have been omitted since they are either not required, not applicable, or the information is otherwise included.

(b) Reports on Form 8-K

The Company filed one report on Form 8-K during the quarter ended June 30, 2000. The Company disclosed that on June 7, 2000, the United States District Court for the District of Columbia entered a Final Judgment and Memorandum and Order in the case United States of America v. Microsoft Corporation. Also, the Company disclosed that on June 13, 2000, it filed a Notice of Appeal and Motion for a Stay of the Judgment Pending Appeal, appealing to the United States Court of Appeals for the District of Columbia Circuit the Final Judgment and the Findings of Fact and Conclusions of Law entered on April 3, 2000 finding that Microsoft violated the federal and state antitrust laws. In addition, the United States Court of Appeals for the District of Columbia Circuit entered an Order on June 13, 2000 agreeing to hear the appeal by the court sitting en banc.

(c) Exhibit Listing

<TABLE>
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Exhibit Number	Description
<C>	<S>
3.1	Restated Articles of Incorporation of Microsoft Corporation (1)
3.2	Bylaws of Microsoft Corporation (1)
10.1	Microsoft Corporation 1991 Stock Option Plan (2)
10.2	Microsoft Corporation 1981 Stock Option Plan (3)
10.3	Microsoft Corporation 1999 Stock Option Plan for Non-Employee Directors (4)
10.4	Microsoft Corporation Stock Option Plan for Consultants and Advisors (5)
10.5	Microsoft Corporation 1997 Employee Stock Purchase Plan
10.6	Microsoft Corporation Savings Plus Plan
10.7	Trust Agreement dated June 1, 1993 between Microsoft Corporation and First Interstate Bank of Washington (6)

10.8 Form of Indemnification Agreement (6)
11. Computation of Earnings Per Share (7)
13.1 Quarterly and Market Information Incorporated by Reference to Page 43 of 2000 Annual Report to Shareholders ("2000 Annual Report")
13.2 Selected Financial Data Incorporated by Reference to the inside front cover of 2000 Annual Report
13.3 Management's Discussion and Analysis of Results of Operations and Financial Condition Incorporated by Reference to Pages 15-24 of 2000 Annual Report
13.4 Financial Statements Incorporated by Reference to Pages 14, 25-42, and 45 of 2000 Annual Report
21. Subsidiaries of Registrant
23. Independent Auditors' Consent
27. Financial Data Schedule

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(1) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1999.
(2) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1997.

<PAGE>

(3) Incorporated by reference to Registration Statement 33-37623 on Form S-8.
(4) Incorporated by reference to Registration Statement 333-91755 on Form S-8.
(5) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1994.
(6) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.
(7) Incorporated by reference to Exhibit 13.4 filed herein.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned; thereunto duly authorized, in the City of Redmond, State of Washington, on September 28, 2000.

MICROSOFT CORPORATION

/s/ John G. Connors
By ______________________________
John G. Connors
Senior Vice President, Finance and Administration; Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on September 28, 2000.

<TABLE>
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Signature	Title
<S>	<C> Chairman of the Board of Directors and

William H. Gates	Chief Software Architect
/s/ Steven A. Ballmer Steven A. Ballmer	President and Chief Executive Officer
/s/ Paul G. Allen Paul G. Allen	Director
Richard A. Hackborn	Director
/s/ David F. Marquardt David F. Marquardt	Director
/s/ Ann McLaughlin Ann McLaughlin	Director
/s/ Wm. G. Reed, Jr. Wm. G. Reed, Jr.	Director
/s/ Jon A. Shirley Jon A. Shirley	Director
/s/ John G. Connors John G. Connors	Senior Vice President, Finance and Administration; Chief Financial Officer

</TABLE>

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Exhibit Index

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(6) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.
(7) Incorporated by reference to Exhibit 13.4 filed herein.

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EXHIBIT 10.5

Microsoft Corporation

1997 Employee Stock Purchase Plan

As approved by the Board of Directors
on August 10, 1996 and the
Shareholders on November 12, 1996

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MICROSOFT CORPORATION
1997 EMPLOYEE STOCK PURCHASE PLAN

Microsoft Corporation (the "Company") does hereby establish its 1997 Employee Stock Purchase Plan as follows:

1. Purpose of the Plan. The purpose of this Plan is to provide eligible employees who wish to become shareholders in the Company a convenient method of doing so. It is believed that employee participation in the ownership of the business will be to the mutual benefit of both the employees and the Company.

2. Definitions.

2.1 "Base pay" means regular straight time earnings, plus review cycle bonuses and overtime payments, payments for incentive compensation, and other special payments except to the extent that any such item is specifically excluded by the Board of Directors of the Company (the "Board").

2.2 "Account" shall mean the funds accumulated with respect to an individual employee as a result of deductions from his paycheck for the purpose of purchasing stock under this Plan. The funds allocated to an employee's account shall remain the property of the respective employee at all times but may be commingled with the general funds of the Company.

3. Employees Eligible to Participate. Any employee of the Company or any of its subsidiaries who is in the employ of the Company or subsidiary on an offering commencement date is eligible to participate in that offering, except (a) employees whose customary employment is less than 20 hours per week, (b) employees whose customary employment is for not more than five months in any calendar year, and (c) employees of a subsidiary that offers its employees the opportunity to participate in an employee stock purchase plan covering such subsidiary's common stock.

4. Offerings. There will be twelve separate consecutive six-month offerings pursuant to the Plan. The first offering shall commence on January 1, 1997. Thereafter, offerings shall commence on each subsequent July 1 and January 1, and the final offering under this Plan shall commence on July 1, 2002 and terminate on December 31, 2002. In order to become eligible to purchase shares, an employee must sign an Enrollment Agreement, and any other necessary papers on or before the commencement date (January 1 or July 1) of the particular offering in which he wishes to participate. Participation in one offering under the Plan shall neither limit, nor require, participation in any other offering.

5. Price. The purchase price per share shall be the lesser of (1) 85% of the fair market value of the stock on the offering date; or (2) 85% of the fair market value of the stock on the last business day of the offering. Fair market value shall mean the closing bid price as reported on the National Association of Securities Dealers Automated Quotation System or, if the stock is traded on a stock exchange, the closing price for the stock on the principal such exchange.

6. Offering Date. The "offering date" as used in this Plan shall be the commencement date of the offering, if such date is a regular business day, or the first regular business day following such commencement date. A different date may be set by resolution of the Board.

7. Number of Shares to be Offered. The maximum number of shares that will be offered under the Plan is 80,000,000 shares. The shares to be sold to participants under the Plan will be common stock of the Company. If the total number of shares for which options are to be granted on any date in accordance with Section 10 exceeds the number of shares then available under the Plan (after deduction of all shares for which options have been exercised or are then outstanding), the Company shall make a pro rata allocation of the shares remaining available in as nearly a uniform manner as shall be practicable and as it shall determine to be equitable. In such event, the payroll deductions to be made pursuant to the

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authorizations therefor shall be reduced accordingly and the Company shall give written notice of such reduction to each employee affected thereby.

8. Participation.

8.1 An eligible employee may become a participant by completing an Enrollment Agreement provided by the Company and filing it with Shareholder Services prior to the Commencement of the offering to which it relates.

8.2 Payroll deductions for a participant shall commence on the offering date, and shall end on the termination date of such offering unless earlier terminated by the employee as provided in Paragraph 14.

8.3 Payroll deduction shall be the sole means of accumulating funds in a participant's account, except in foreign countries where payroll deductions are not allowed, in which case the Company may authorize alternative payment methods.

9. Payroll Deductions.

9.1 At the time a participant files his authorization for a payroll deduction, he shall elect to have deductions made from his pay on each payday during the time he is a participant in an offering at any non-fractional percentage rate between 1% and 10%.

9.2 All payroll deductions made for a participant shall be credited to his account under the Plan. A participant may not make any separate cash payment into such account nor may payment for shares be made other than by payroll deduction.

9.3 A participant may discontinue his participation in the Plan as provided in Section 14, but no other change can be made during an offering and, specifically, a participant may not alter the rate of his payroll deductions for that offering.

10. Granting of Option. On the offering date, this Plan shall be deemed to have granted to the participant an option for as many full shares as he will be able to purchase with the payroll deductions credited to his account during his participation in that offering. Notwithstanding the foregoing, no participant may purchase more than 8,000 shares of stock during any single offering.

11. Exercise of Option. Each employee who continues to be a participant in an offering on the last business day of that offering shall be deemed to have exercised his option on such date and shall be deemed to have purchased from the Company such number of full shares of common stock reserved for the purpose of the Plan as his accumulated payroll deductions on such date will pay for at the option price.

12. Employee's Rights as a Shareholder. No participating employee shall have any right as a shareholder with respect to any shares until the shares have been purchased in accordance with Section 11 above and the stock has been issued by the Company.

13. Evidence of Stock Ownership.

13.1 Promptly following the end of each offering, the number of shares of common stock purchased by each participant shall be deposited into an account established in the participant's name at a stock brokerage or other financial services firm designated by the Company (the "ESPP Broker").

13.2 The participant may direct, by written notice to the Company at the time of his enrollment in the Plan, that his ESPP Broker account be established in the names of the participant and

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one other person designated by the participant, as joint tenants with right of survivorship, tenants in common, or community property, to the extent and in the manner permitted by applicable law.

13.3 A participant shall be free to undertake a disposition (as that term is defined in Section 424(c) of the Code) of the shares in his account at any time, whether by sale, exchange, gift, or other transfer of legal title, but in the absence of such a disposition of the shares, the shares must remain in the participant's account at the ESPP Broker until the holding period set forth in Section 423(a) of the Code has been satisfied. With respect to shares for which the Section 423(a) holding period has been satisfied, the participant may move those shares to another brokerage account of participant's choosing or request that a stock certificate be issued and delivered to him.

13.4 A participant who is not subject to payment of U.S. income taxes may move his shares to another brokerage account of his choosing or request that a stock certificate be issued and delivered to him at any time, without regard to the satisfaction of the Section 423(a) holding period.

14. Withdrawal.

14.1 An employee may withdraw from an offering, in whole but not in part, at any time prior to the last business day of such offering by delivering a Withdrawal Notice to the Company, in which event the Company will refund the entire balance of his deductions as soon as practicable thereafter.

14.2 To re-enter the Plan, an employee who has previously withdrawn must file a new Enrollment Agreement in accordance with Section 8.1. The employee's re-entry into the Plan will not become effective before the beginning of the next offering following his withdrawal, and if the withdrawing employee is an officer of the Company within the meaning of Section 16 of the Securities Exchange Act of 1934 he may not re-enter the Plan before the beginning of the second offering following his withdrawal.

15. Carryover of Account. At the termination of each offering the Company shall automatically re-enroll the employee in the next offering, and the balance in the employee's account shall be used for option exercises in the new offering, unless the employee has advised the Company otherwise. Upon termination of the Plan, the balance of each employee's account shall be refunded to him.

16. Interest. No interest will be paid or allowed on any money in the accounts of participating employees.

17. Rights Not Transferable. No employee shall be permitted to sell, assign, transfer, pledge, or otherwise dispose of or encumber either the payroll deductions credited to his account or any rights with regard to the exercise of an option or to receive shares under the Plan other than by will or the laws of descent and distribution, and such right and interest shall not be liable for, or subject to, the debts, contracts, or liabilities of the employee. If any

such action is taken by the employee, or any claim is asserted by any other party in respect of such right and interest whether by garnishment, levy, attachment or otherwise, such action or claim will be treated as an election to withdraw funds in accordance with Section 14.

18. Termination of Employment. Upon termination of employment for any reason whatsoever, including but not limited to death or retirement, the balance in the account of a participating employee shall be paid to the employee or his estate.

19. Amendment or Discontinuance of the Plan. The Board shall have the right at any time and without notice to amend, modify or terminate the Plan, and to authorize by resolution changes to the application of eligibility criteria in Section 3 to employees of the Company's subsidiaries outside the United States when the Board deems such changes to be necessary and appropriate according to laws applicable to such non-U.S. subsidiaries; provided, that no employee's existing rights under any offering already made under Section 4 hereof may be adversely affected thereby, and provided further that no

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such amendment of the Plan shall, except as provided in Section 20, increase above 80,000,000 shares the total number of shares to be offered unless shareholder approval is obtained therefor.

20. Changes in Capitalization. In the event of reorganization, recapitalization, stock split, stock dividend, combination of shares, merger, consolidation, offerings of rights, or any other change in the structure of the common shares of the Company, the Board may make such adjustment, if any, as it may deem appropriate in the number, kind, and the price of shares available for purchase under the Plan, and in the number of shares which an employee is entitled to purchase.

21. Share Ownership. Notwithstanding anything herein to the contrary, no employee shall be permitted to subscribe for any shares under the Plan if such employee, immediately after such subscription, owns shares (including all shares which may be purchased under outstanding subscriptions under the Plan) possessing 5% or more of the total combined voting power or value of all classes of shares of the Company or of its parent or subsidiary corporations. For the foregoing purposes the rules of Section 425(d) of the Internal Revenue Code of 1986 shall apply in determining share ownership. In addition, no employee shall be allowed to subscribe for any shares under the Plan which permits his rights to purchase shares under all "employee stock purchase plans" of the Company and its subsidiary corporations to accrue at a rate which exceeds $25,000 of the fair market value of such shares (determined at the time such right to subscribe is granted) for each calendar year in which such right to subscribe is outstanding at any time.

22. Administration. The Plan shall be administered by the Board. The Board may delegate any or all of its authority hereunder to such committee of the Board or officer of the Company as it may designate. The administrator shall be vested with full authority to make, administer, and interpret such rules and regulations as it deems necessary to administer the Plan, and any determination, decision, or action of the administrator in connection with the construction, interpretation, administration, or application of the Plan shall be final, conclusive, and binding upon all participants and any and all persons claiming under or through any participant.

23. <u>Notices.</u> All notices or other communications by a participant to the Company under or in connection with the Plan shall be deemed to have been duly given when received by Shareholder Services of the Company or when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.

24. <u>Termination of the Plan.</u> This Plan shall terminate at the earliest of the following:

24.1 December 31, 2002;

24.2 The date of the filing of a Statement of Intent to Dissolve by the Company or the effective date of a merger or consolidation wherein the Company is not to be the surviving corporation, which merger or consolidation is not between or among corporations related to the Company. Prior to the occurrence of either of such events, on such date as the Company may determine, the Company may permit a participating employee to exercise the option to purchase shares for as many full shares as the balance of his account will allow at the price set forth in accordance with Section 5. If the employee elects to purchase shares, the remaining balance of his account will be refunded to him after such purchase.

24.3 The date the Board acts to terminate the Plan in accordance with Section 19 above.

24.4 The date when all shares reserved under the Plan have been purchased.

25. <u>Limitations on Sale of Stock Purchased Under the Plan.</u> The Plan is intended to provide common stock for investment and not for resale. The Company does not, however, intend to restrict or influence any employee in the conduct of his own affairs. An employee, therefore, may sell stock purchased under the Plan at any time he chooses, subject to compliance with any applicable Federal or state securities laws. THE EMPLOYEE ASSUMES THE RISK OF ANY MARKET FLUCTUATIONS IN THE PRICE OF THE STOCK.

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26. <u>Governmental Regulation.</u> The Company's obligation to sell and deliver shares of the Company's common stock under this Plan is subject to the approval of any governmental authority required in connection with the authorization, issuance, or sale of such shares.

[The number of shares in Sections 7, 10, and 19 have been increased to reflect the 2-for-1 stock splits in December 1996, February 1998, and March 1999.]

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EXHIBIT 10.6

MICROSOFT CORPORATION

SAVINGS PLUS 401(k) PLAN

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MICROSOFT CORPORATION

SAVINGS PLUS 401(k) PLAN

MICROSOFT CORPORATION has adopted the Microsoft Corporation Savings Plus 401(k) Plan effective January 1, 1987, for the exclusive benefit of its employees. The Microsoft Corporation Savings Plus 401(k) Plan is restated by this document to incorporate prior amendments since the last restatement, effective March 25, 1999.

[Note: As explained in the preceding sentence, the last restatement of the Plan was as of March 25, 1999. This document is an updated restatement, and incorporates the amendments to the Plan that were adopted by Microsoft Corporation between March 25, 1999 and July 1, 2000.]

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ARTICLE I

DEFINITIONS

The following words shall have the following meanings unless the context clearly indicates otherwise.

1.1 BENEFICIARY means a person designated by a participant, or by this Plan if there is no effective designation, to receive benefits payable under this Plan in the event of the participant's death.

1.2 CODE means the Internal Revenue Code of 1986, as amended.

1.3 COMPENSATION is defined and limited as set forth in Appendix I, attached hereto and incorporated herein.

1.4 EMPLOYEE means any common law employee of the employer who receives remuneration for personal services rendered to the employer, and any "leased employee" as defined in Code (S) 414(n)(2). For purposes of this Section 1.4, a "`leased employee' as defined in Code (S) 414(n)(2)" means any person who is not an employee of the employer (as defined in Plan Section 1.6, "recipient") and who provides services to such recipient if (i) such services are provided pursuant to an agreement between the recipient and any other person ("leasing organization"), (ii) such person has performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least 1 year, and (iii) such services are performed under primary direction or control by the recipient. The definition in the preceding sentence shall be interpreted by applying the definition of "leased employee" under Code (S) 414(n)(2) and any Treasury Regulations thereunder.

1.5 ELIGIBLE EMPLOYEE means a regular employee of the employer who satisfies the eligibility requirements of section 2.1. For purposes of this Plan, a "regular employee" of the

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employer is an employee who is in an approved headcount "regular" employment position with the employer and on the employer's U.S. payroll. An approved headcount "regular" employment position is one that is (1) authorized in writing during the annual or out-of-cycle budgeting process as a "regular" employment position and approved by an officer of Microsoft (or by a Regional Director for positions in subsidiaries of Microsoft) and (2) reflected on the official human resources database of Microsoft or one of its subsidiaries as a "regular" employment position (e.g., "hourly regular" or "salaried regular"). For example, a worker who is reflected on the human resources database as "contingent" or an "agency temp" is not in an approved headcount "regular" employment position even though the contingent or agency temp position was authorized as part of Microsoft's budgeting process. An employee is on an employer's U.S. payroll if the employee is paid from a payroll department of the employer where such payroll department is located within the United States of America, and the employer withholds U.S. employment taxes (e.g., income tax, FICA) from the employee's pay. Under no circumstances are the payroll departments of the employer's foreign branches and subsidiaries treated as U.S. payroll departments of the employer for purposes of this Plan.

Notwithstanding the foregoing, the following persons are not eligible employees and are not eligible to participate in this Plan even if they meet the definition of regular employee of the employer:

a. interns and visiting researchers;

b. cooperatives;

c. apprentices;

d. nonresident aliens with no U.S. source income;

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e. employees covered by a collective bargaining agreement resulting from negotiations in which retirement benefits were the subject of good faith bargaining and participation in this Plan was not provided for;

f. leased employees. For purposes of this Section 1.5(f), a leased employee includes any person who provides services to the employer (as defined in Plan Section 1.6, which in the rest of this Section 1.5 may also be referred to as "recipient" or "recipient employer") pursuant to an agreement between such recipient and any other person ("leasing organization"), regardless of (i) the length of time the person has performed such services for the recipient (or for the recipient and related persons), (ii) whether or not the person is an employee of the recipient, (iii) whether or not the person has performed such services for the recipient (or for the recipient and related persons) on a part-time or full-time basis, and (iv) whether or not the person performed services under the primary direction or control by the recipient. This definition of leased employee includes, without limitation, "leased employees" as defined in Code (S) 414(n)(2) and any Treasury Regulations thereunder.

g. temporary workers engaged through or employed by temporary or leasing agencies, irrespective of the length of time that the workers perform or are expected to perform services at or for the recipient employer, and even if the workers are, or may be reclassified by the courts, the Internal Revenue Service ("IRS") or the U.S. Department of Labor ("DOL") as, employees of the recipient employer;

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h. temporary employees of the employer. For purposes of this Plan, a temporary employee of the employer is an employee of the employer who is hired by the employer to work on a specific project or series of projects which in the aggregate is not expected to exceed six (6) months; and

i. workers who hold themselves out to the recipient employer as being independent contractors, or as being employed by another company while providing services to the recipient employer, even if the workers are, or may be reclassified by the courts, the IRS or the DOL as, employees of the recipient employer.

1.6 EMPLOYER means MICROSOFT CORPORATION and any subsidiary or affiliate of Microsoft Corporation which, with MICROSOFT CORPORATION's approval, elects to adopt the Plan for its employees. Employers maintaining the Plan are listed in Appendix II, attached hereto and incorporated herein. No participating employers (other than Microsoft Corporation and its delegates) shall have discretionary authority over the Plan, including, without limitation, the authority to amend the Plan and appoint fiduciaries. The Plan Administrator (and his or her delegates) has discretionary authority under the Plan as provided elsewhere in this Plan. For purposes of applying to this Plan Code (S)(S) 401, 410, 411, 414, 415 and 416, which sections relate to tax-qualified plans generally, to minimum participation standards, to minimum vesting standards, to compensation, to limitations on benefits and contributions, and to top-heavy requirements under qualified retirement plans, all employees of businesses under common control, as defined in Code (S)(S) 414(b) and (c), employees of affiliated service groups under Code (S) 414(m), and employees of any group of employers who must be aggregated and treated as one employer pursuant to Code (S) 414(o), shall be considered to be employed by the employer.

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1.7 ERISA means the Employee Retirement Income Security Act of 1974, as amended.

1.8 PARTICIPANT means an employee who meets the eligibility requirements of Article II and who has entered the Plan. An employee shall be considered a participant as long as one or more accounts are maintained under this Plan on his or her behalf.

1.9 PLAN means the MICROSOFT CORPORATION SAVINGS PLUS 401(k) PLAN.

1.10 PLAN ADMINISTRATOR means the 401(k) Administrative Committee, which shall consist of the following three positions at Microsoft Corporation:

Vice President, Human Resources
Deputy Chief Financial Officer
Tax and Audit Vice President

Any references in this Plan to the Plan Administrator as "he", "she", "him" or "her" or references to "his" or "her" with respect to the Plan Administrator shall be deemed to refer to the 401(k) Administrative Committee or a member of the 401(k) Administrative Committee, as appropriate under the circumstances.

1.11 PLAN YEAR means the twelve month period beginning January 1 and ending December 31.

1.12 TRUST FUND means the assets of the trust established and maintained according to the provisions of this Plan.

1.13 TRUSTEE means any individual, life insurance company, bank or trust company or a combination of the foregoing, which the employer has designated to manage and invest the assets of the Plan.

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ARTICLE II

ELIGIBILITY TO PARTICIPATE IN PLAN

2.1 ELIGIBILITY AND ENTRY DATE. Each eligible employee who is 18 years of age or older shall be eligible to participate in this Plan except as provided in this Article II. The eligible employee shall be eligible to elect to defer a percentage of his or her compensation on the first entry date occurring after the date the eligibility requirements (e.g., meeting the definition of an eligible employee in Section 1.5 and being at least 18 years of age) are met. The participant's salary deferrals shall commence with the payroll period beginning on the first day of the month that falls after the participant has properly completed and submitted an enrollment application and such application has been processed by the Plan Administrator and the employer's payroll department. It may take several days after an employee becomes an eligible employee before the employee will be able to enroll in the Plan. The Plan Administrator shall establish the enrollment procedures (e.g., require on-line enrollment) from time to time in its sole discretion.

2.2 REEMPLOYMENT. If a former plan participant is reemployed as an eligible employee, that person shall immediately renew participation in the plan as of his or her date of rehire.

2.3 ELECTION AGAINST PARTICIPATION. Any eligible employee may elect not to participate in the Plan at any time for any reason in writing signed by the eligible employee, a copy of which is delivered to the employer.

2.4 ENTRY DATES. Plan entry dates shall be the first day of each month.

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ARTICLE III

EMPLOYEE CONTRIBUTIONS

3.1 ELECTION TO DEFER. Each participant may elect, in the manner provided by the Plan Administrator, to contribute from 1% to 15% of each of his or her compensation payments to a salary deferral account under the Plan, except that the aggregate of such contributions shall not for the plan year exceed the annual limitation on elective deferrals under Code (S) 402(g) in any taxable year, which limitation is increased as permitted by Internal Revenue Service publication to reflect cost-of-living adjustments ($9,500 for 1997). The employer may, from time to time, change the percentage of salary that may be deferred. Except as authorized by the Plan Administrator, all such contributions shall be by payroll reduction. Contributions shall be transferred to the trust fund on the earliest date by which they can reasonably be segregated from the employer's general assets, but in no event later than the 15th business day of the month following the month in which the employer receives or withholds the employee contributions. For purposes of determining the amount which may be deferred, only compensation earned while the participant is an eligible employee and making salary deferral contributions to the plan shall be considered. A participant may not defer more than 15% of any paycheck or other compensation payment. The 15% maximum limit on deferrals is applied per pay period not to the participant's annual compensation nor his or her total compensation earned while making salary deferral contributions to the Plan.

3.2 DEFERRAL ELECTION DATES. Upon reemployment, an employee may elect to contribute as of the day he or she is eligible to enter the Plan. All other employees or participants, including employees entering the plan initially, may elect to contribute effective as of the first day of the month that falls after the employee or participant has properly completed

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and submitted an enrollment application and such application has been processed by the Plan Administrator and the employer's payroll department. It may take several days after an employee becomes an eligible employee before the employee will be able to enroll in the Plan. The Plan Administrator shall establish the enrollment procedures (e.g., require on-line enrollment) from time to time in its sole discretion. Participants may change their contribution percentage effective as of the first day of any month subsequent to the date they request the change, provided, however, that the first month in which the change may apply shall not be earlier than the first month in which the change to the participant's payroll withholding can reasonably be made. An election to contribute may be made on any date prior to the effective date of the election, in the manner provided by the Plan Administrator.

3.3 TERMINATING AN ELECTION TO DEFER. A participant may terminate an election to contribute as of the first day of any month, provided notice of termination has been given by the fifteenth day of the previous month in the manner provided by the Plan Administrator. If an employee terminates an election to contribute, he or she must wait until the next entry date before being eligible again to elect to contribute to the Plan.

3.4 DISTRIBUTION OF EXCESS DEFERRALS. Notwithstanding any other provision of the Plan, excess deferrals (amounts in excess of the annual limitation on elective deferrals under Code (S) 402(g), as increased by a cost of living factor) and income allocable thereto may be distributed no later than April 15 to participants who claim for the preceding calendar year such excess deferrals under two or more plans or to participants who have such excess deferrals under this Plan. A participant may allocate excess deferrals to this Plan by submitting to the Plan Administrator no later than March 1 a statement specifying the excess deferral amount for the preceding calendar year and stating that, if such amount is not

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distributed, such excess deferral, when added to amounts deferred under other plans, exceeds the applicable annual limit. The excess deferrals distributed to a participant with respect to a calendar year shall be adjusted for income and, if there is a loss allocable to the excess deferral, shall in no event be less than the lesser of the participant's account under the Plan or the participant's elective deferrals for the calendar year.

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ARTICLE IV

EMPLOYER MATCHING CONTRIBUTIONS AND FORFEITURES

4.1 EMPLOYER MATCHING CONTRIBUTIONS. The employer shall contribute funds to the Plan, from its current or retained profits, and use forfeitures to match a portion of each of a participant's salary deferral contributions. The employer contribution shall match 50% of each of a participant's salary deferral contributions up to six percent of the participant's compensation for the pay period for which the participant's salary deferral is made, for a maximum employer matching contribution of three percent of the compensation paid to the participant for such pay period. The matching contribution shall be allocated to the participant's employer contribution account. The employer may from time to time change the amount of the employer matching contribution, provided any decrease in the matching contribution formula must be effective only for matching elective deferrals after the date of change. Total employer contributions for any plan year shall not exceed the maximum amount which is deductible by the employer for federal income tax purposes. The employer contribution shall be transferred to the trust fund at such times as the employer determines, but such contributions shall in no event be transferred to the trust fund later than the time prescribed by law for the employer to obtain a federal income tax deduction for the plan year for which the contribution is made. Employer contributions shall be credited to participants' employer contribution accounts as of the date of receipt by the plan. For purposes of determining the amount of matching contributions a participant will receive, only compensation earned while the participant is an eligible employee and making salary deferral contributions to the Plan shall be considered. The 3% limit on employer matching contributions is applied to each paycheck given or other compensation payment made to the participant. The 3% limit on matching contributions is applied per pay

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period, and not to the participant's annual compensation nor his or her total compensation earned while making salary deferral contributions to the Plan. Notwithstanding the foregoing, any participant whose salary deferrals cease because the Code Section 402(g) limit is reached, and not because the Participant terminated his or her election to defer, shall have his or her compensation earned after the Code Section 402(g) limit was reached considered when determining the maximum amount of matching contributions to be allocated to his or her account. Matching contributions will continue to be made to such participant's account until the match equals the lesser of 50% of his or her deferrals or 3% of the participant's compensation earned while the participant's salary deferral election was in effect (including compensation earned after deferrals reached the applicable 402(g) limit). The amount of the matching contributions made for pay periods occurring after the participant's salary deferral amount reached the 402(g) limit shall be calculated by multiplying the lesser of (i) 3% or (ii) one half of the participant's salary deferral election which was in effect when the 402(g) limit was reached, by his or her compensation for each pay period occurring after the limit was reached.

4.2 ALLOCATION OF FORFEITURES. As of the end of each plan year, forfeitures which have become available for allocation during such year because of the completion of benefit distributions to terminated participants or terminated participants' completion of a one-year period of severance pursuant to Section 5.6 shall be used first to restore previously forfeited amounts to the employer contribution accounts of former employees who are reemployed before sustaining five consecutive one-year periods of severance. Any remaining forfeiture amounts shall be used to reduce the employer matching contribution for the subsequent plan year. While this Plan is a multiple employer plan (as described in Code (S)413(c)), forfeitures with respect to employees who terminate employment with one employer (as defined in Treasury Regulation

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(S)1.413-2(a)(2)) shall be used first to restore previously forfeited amounts to the employer contribution accounts of former employees of such employer who are reemployed before sustaining five consecutive one-year periods of severance. Any remaining amounts from such forfeitures shall be used to reduce the employer matching contribution for the employees of such employer for the subsequent plan year and, if any forfeitures remain after the employer matching contributions for that employer are made for such plan year, such remaining forfeitures shall be used to reduce the employer matching contributions of other employers in the Plan.

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ARTICLE V

VESTING - YEARS OF SERVICE

5.1 EMPLOYEE CONTRIBUTIONS. Each participant shall be 100% vested in all amounts in his or her salary deferral account.

5.2 EMPLOYER CONTRIBUTIONS. A participant whose employment is terminated on or after reaching age 65, whose employment is terminated because of a total and permanent disability, or who dies while employed, shall be 100% vested in all amounts in his or her employer contribution account. All other participants who terminate shall be entitled to the vested percentage of their employer contribution account determined in accordance with the following schedule:

Years of Service	Vested Percentage	Forfeited Percentage
Less than 2	0%	100%
2 or more years	100%	0%

In computing years of service, all of an employee's years of service shall be taken into account, except that if an employee has five or more consecutive one-year periods of severance, years of service after such period of severance shall not be taken into account for purposes of determining the nonforfeitable percentage of the employee's accrued benefit derived from employer contributions which accrued before the period of severance. Preparticipation service with certain companies as set forth in Appendix II, attached hereto and incorporated herein, shall be counted toward vesting.

Effective July 8, 1997, an employee who (i) first becomes employed by Microsoft Corporation ("Microsoft") or one of its affiliates (within the meaning of Code Sections 414(b), (c), (m) or (o)) on or after July 8, 1997, and (ii) was previously employed by a company (or a trade or business thereof, hereinafter "Former Employer") which was acquired by or merged with

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Microsoft (or an affiliate of Microsoft), shall receive credit for his or her period of service with such Former Employer towards satisfying the vesting service requirements of this Plan, provided, however, that the credit shall only be given to those employees whose employment with Microsoft or one of its affiliates is connected with Microsoft's (or its affiliate's) acquisition of or merger with such Former Employer. This vesting service credit shall be granted effective as of the effective date of the closure of the acquisition of the Former Employer by, or the merger of the Former Employer with, Microsoft (or its affiliate). For informational purposes, the list of Former Employers for which vesting service credit is granted after July 8, 1997 shall be added to Appendix II from time to time, but pursuant to this Section 5.2, the grant of such service credit shall be effective regardless of whether or when the name of the Former Employer is added to Appendix II. In the event a plan of the Former Employer is merged into this Plan, any service credit shall be as specified in

Appendix V hereto. Notwithstanding the foregoing, no vesting service credit shall be granted under this paragraph for service with any Former Employer to the extent that this Plan is amended, prior to the closure of the acquisition of or merger with such Former Employer, to expressly deny service credit with respect to service with such Former Employer. Notwithstanding the foregoing, each participant with a positive employer contribution account balance in the Plan on or after March 2, 2000 shall be 100% vested in all amounts that are in his or her employer contribution account on or after March 2, 2000.

5.3 YEARS OF SERVICE. An employee's years of service at any date shall equal the number of years, including fractional portions of years, which have elapsed between the date the employee first performed an hour of service, or first performed an hour of service upon reemployment, and the date a period of severance begins. If a period of severance is less than twelve months, the period of severance shall be included in determining years of service.

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5.4 HOUR OF SERVICE. An hour of service means each hour for which an employee is paid or entitled to payment for the performance of duties for the employer.

5.5 PERIOD OF SEVERANCE. A period of severance is a period which begins on the earlier of (i) the date the employee quits, is discharged, retires, dies; or (ii) the first anniversary of the date the employee is absent from service for any other reason, such as disability leave, vacation, or leave of absence; and which ends when the employee performs an hour of service upon reemployment. However, if an employee is absent from employment for maternity or paternity reasons, the period of severance shall begin on the second anniversary of the first date of such absence. The period between the first and second anniversaries of the first date of absence from work is neither a year or fractional year of service, nor a period of severance. An absence for maternity or paternity reasons includes an absence because of the following: pregnancy of the individual, birth of a child of the individual, placement of a child with the individual in connection with the adoption of such child by such individual or caring for such child for a period beginning immediately following such birth or placement.

5.6 FORFEITURES. If, prior to incurring a one-year period of severance, a participant who is zero percent vested in his or her employer contribution account receives a distribution of his or her entire vested interest in the Plan (e.g., salary deferrals, rollovers) on or due to his or her termination of participation in the Plan, the participant's entire employer contribution account shall be forfeited as of the date of such distribution. If a terminated participant who is zero percent vested in his or her employer contribution account does not receive a distribution of his or her entire vested interest in the Plan prior to incurring a one-year period of severance, his or her entire employer contribution account shall be forfeited as of a date chosen by the Plan Administrator which is on or after the date the participant completes a one-

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year period of severance. Forfeited amounts shall be transferred to a separate forfeiture suspense account and made available for allocation as set forth in Article IV. If a terminated participant whose employer contribution account has been forfeited due to either the receipt of a distribution or the occurrence of a one-year period of severance is reemployed before sustaining five consecutive one-year periods of severance, any amount forfeited shall be restored to his or her employer contribution account, unadjusted by any gains or losses. If a reemployed participant's forfeiture was due to receipt of a distribution, the participant shall have neither the right nor obligation to repay the distributed amount to the Plan. Restorations of accounts shall be funded first from forfeitures held in the suspense account, and if such forfeiture amounts in the suspense account are not sufficient to restore the accounts, then from additional Company contributions. While this Plan is a multiple employer plan, the employer with the primary responsibility to make any Company contributions that are required to restore a rehired employee's account shall be the employer from which the employee terminated prior to being rehired. Upon the complete termination of the Plan, any terminated participant who, prior to the Plan's date of termination, had not (i) incurred five consecutive one-year periods of severance, nor (ii) received a distribution of his or her entire vested interest in the Plan, shall have any amount which was forfeited due to the prior occurrence of a one-year period of severance restored, unadjusted by any gains or losses, and such restored amount shall be nonforfeitable.

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ARTICLE VI

PARTICIPANTS' ACCOUNTS AND INVESTMENTS

6.1 INDIVIDUAL ACCOUNTS. The trustee shall maintain records to show the interest in the Plan of each participant and former participant. Such records shall be in the form of individual accounts. When appropriate, a participant shall have two accounts, a salary deferral account and an employer contribution account. The maintenance of individual accounts is only for accounting purposes, and a segregation of the assets of the trust fund to each account shall not be required. Notwithstanding the foregoing, to the extent provided in a written loan policy, a loan made to a participant will be treated as a participant direction of investment. The participant alone shares in any principal and interest paid on the loan, and he or she alone bears any expense or loss incurred in connection with the loan. The Trustee will reflect the participant's loan on his or her account. Distributions and withdrawals made from an account shall be charged to the account as of the date paid. Each participant and former participant shall be advised from time to time, but at least once a year, as to the status of his or her account or accounts.

6.2 INVESTMENT FUNDS. The trust fund shall consist of the following investment funds: common stock funds, bond funds, income funds, money market funds, the Microsoft Corporation stock fund, and any other funds or investment vehicles selected by the employer, including without limitation participant directed brokerage accounts. The employer may change the investment funds from time to time. Each participant and former participant shall direct the trustee as to what portion of his or her accounts shall be deposited in each fund (or, in the case of a Participant loan pursuant to Article XIX, what portion of his or her account shall be loaned). If a participant or former participant wishes to utilize more than one investment fund, he or she shall designate the percentage of his or her account balances to be invested in each fund, and the

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percentages designated shall be in 1% increments. The trust fund may hold qualified employer securities and qualified employer real estate in any amount. The Plan is intended to constitute a plan described in ERISA (S) 404(c), and the fiduciaries of the Plan may be relieved in accordance with ERISA (S) 404(c) of liability for any losses which are the direct and necessary result of investment instructions given by a participant or former participant.

6.3 CHANGING ACCOUNT INVESTMENTS. Up to six times in any plan year, a participant may change his or her direction as to the funds into which his or her account will be invested. The Plan Administrator may change the number of times that changes may be made, and the procedures for making changes in investment elections, at any time and from time to time.

6.4 PROCEDURES. The Plan Administrator shall adopt such rules and procedures as it deems advisable with respect to the direction of Plan investments by participants, including without limitation the procedure for allocating and charging fees, expenses or other charges connected with certain investment funds to the accounts of those participants who choose to invest in such funds. Any such rules and procedures shall be applied in a nondiscriminatory manner.

6.5 VALUATION OF ACCOUNTS. As often as directed by the employer, the trustee shall value the trust fund assets at fair market value and the Plan Administrator shall adjust the net credit balances in the accounts of participants and former participants, upward or downward, to reflect the allocation to the participant's or former participant's account of investment earnings, gains and losses, expenses paid out of the trust fund, and contributions made and allocated to and distributions and withdrawals from the participant's or former participant's account. In addition, as of the end of the fiscal quarter of each plan year and at such

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other times as the Plan Administrator shall reasonably determine, the Plan Administrator shall adjust the net credit balances in the accounts of participants and former participants in the trust fund, upward or downward, pro rata, so that the aggregate of such net credit balances will equal the net worth of each investment fund of the trust fund, using fair market values as determined by the trustee and after such net worth for the appropriate investment fund has been reduced by any expenses (to the extent not paid directly by the employer), withdrawals, distributions and transfers chargeable to that investment fund which have been incurred but not yet paid. All determinations made by the trustee with respect to fair market values and net worth shall be made in accordance with generally accepted principles of trust accounting, and such determinations when so made by the trustee shall be conclusive and binding upon all persons having an interest under the Plan.

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ARTICLE VII

PAYMENT OF ACCOUNT BALANCES UPON TERMINATION, DEATH, DISABILITY, QUALIFIED DOMESTIC RELATIONS ORDERS, SALE OF TRADE OR BUSINESS

7.1 TERMINATION OF EMPLOYMENT. Upon termination of employment for any reason other than death or disability, the participant shall elect to receive his or her balances upon termination or upon reaching age 65, or on any date between termination and age 65 at the participant's election, except that if the value of the participant's accounts does not exceed $5,000 (and did not exceed $5,000 at the time of any prior distribution), payment shall be made as soon as practicable after termination. Account balances shall be valued as of the most recent valuation date prior to date of payment and shall be paid in a single cash payment, except that the participant or former participant may elect to receive any or all of the shares allocated to him or her in the Microsoft Corporation stock fund. Account balances shall be distributed no later than 60 days after the latest of (i) the plan year in which the participant terminates or (ii) the plan year in which the participant reaches age 65. Notwithstanding the foregoing, a person's entire interest must be distributed, or must begin to be distributed, no later than the first day of April following the calendar year in which the participant reaches age 70-1/2. Furthermore, benefit payments will not be made to a participant who has a vested account balance greater than $5,000, prior to the participant attaining age 70 1/2 unless and until the participant files a proper claim for benefits with the Plan Administrator.

7.2 PAYMENT AT 59-1/2. A participant may elect to receive a distribution of all or a portion of his or her vested account balance or balances under this Plan upon or after reaching age 59-1/2. Payment shall be made in a single cash payment, except that the participant may

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elect to receive any or all of the shares allocated to him or her in the Microsoft Corporation stock fund.

7.3 PAYMENT OF ACCOUNT BALANCES UPON DEATH. If a participant dies while employed, his or her employer contribution account shall be 100% vested. Each participant shall designate a beneficiary or beneficiaries to receive all amounts credited to his or her accounts in the event of the participant's death. The accounts shall be valued as of the most recent valuation date prior to payment and shall be paid to the designated beneficiary or beneficiaries as soon as feasible after the death. Payment shall be made in a single cash payment, except that the beneficiary or beneficiaries may elect to receive any or all of the shares allocated to him or her in the Microsoft Corporation stock fund. Notwithstanding the foregoing, if the deceased participant's vested account balance exceeds $5,000 and the designated beneficiary is the participant's spouse, the spouse may elect to delay distribution of the lump sum amount until any date on or before the date the Participant would have been age 65. If the deceased participant's vested account balance exceeds $5,000 and the beneficiary is a designated beneficiary who is not the participant's spouse, the beneficiary may elect to delay distribution of the lump sum amount until any date on or before the end of the calendar year in which the fifth anniversary of the participant's date of death occurs. Beneficiaries who are not designated beneficiaries may not delay distribution of the death benefit. If a participant is married, the participant may not designate a beneficiary other than his or her spouse without the spouse's written consent which has been witnessed by a plan representative or a notary public. If a participant fails to designate a beneficiary, or the participant has no surviving beneficiary, the amounts payable to a married participant shall be distributed to his or her spouse and the benefits of a single participant shall be distributed to his or her estate.

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7.4 PAYMENT OF ACCOUNT BALANCES UPON DISABILITY. If a participant's employment is terminated prior to retirement because of a total and permanent disability, the employer contribution account shall be 100% vested and payment of the participant's account balances shall be made as soon as practicable. A participant shall be deemed to be totally and permanently disabled if the participant meets the definition of having a total disability under the employer-provided long-term disability plan. The participant's accounts shall be valued as of the most recent valuation date prior to payment and shall be paid in a single cash payment within sixty (60) days after the disability has been established under this section, except that the participant may elect to receive any or all of the shares allocated to him or her in the Microsoft Corporation stock fund. Notwithstanding the foregoing, if the value of the disabled participant's accounts exceeds $5,000 (or exceeded $5,000 at the time of a prior distribution), the participant may elect to delay receipt of the balance of his or her accounts until reaching age 65. Notwithstanding the foregoing, benefit payments will not be made to a participant who has a vested account balance greater then $5,000, prior to the participant attaining age 70 1/2 unless and until the participant files a proper claim for benefits.

7.5 EARLY RETIREMENT. Upon reaching age 55, a participant may elect early retirement and terminate employment. Each such participant shall receive the value of his or her salary deferral account and the vested portion of his or her employer contribution account, which shall be paid in the time and manner described in Section 7.1.

7.6 DISTRIBUTIONS UNDER QUALIFIED DOMESTIC RELATIONS ORDERS. Distribution to an alternate payee under a qualified domestic relations order as defined in Code (S) 414(p) may be made at any time, including prior to the participant's attainment of earliest retirement age if the court order specifies distribution at an earlier time or permits an agreement

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between the Plan and the alternate payee to authorize an earlier distribution and the alternate payee consents to the distribution.

7.6.1 Qualified Status of Order. The Plan Administrator shall establish reasonable procedures to determine the qualified status of a domestic relations order. Upon receiving a domestic relations order, the Plan Administrator shall promptly notify the participant and any alternate payee named in the order in writing of the receipt of the order and the Plan's procedures for determining the qualified status of the order. Within a reasonable period of time after receiving the domestic relations order, the Plan Administrator shall determine the qualified status of the order and shall notify the participant and each alternate payee in writing of its determination. The Plan Administrator shall provide notice under this paragraph by mailing to the individual's address specified in the domestic relations order, or in a manner consistent with Department of Labor regulations.

7.6.2 Amounts Payable During Determination Process. If any portion of the participant's nonforfeitable accrued benefit is payable during the period the Plan Administrator is making its determination of the qualified status of the domestic relations order, the Trustee shall make a separate accounting of the amounts payable. If the Plan Administrator determines the order is a qualified domestic relations order within 18 months of the date amounts first are payable following receipt of the order, the amounts shall be payable in accordance with the order. If the Plan Administrator does not make its determination of the qualified status of the order within the 18 month determination period, the amounts shall be payable in the manner in which they would be distributed if the order did not exist. The order shall be applied prospectively if the Plan Administrator determines after the 18 month period that the order is a qualified domestic relations order.

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7.6.3 Investment of Amounts Payable. To the extent it is not inconsistent with the provisions of the qualified domestic relations order, any partitioned funds payable to the alternate payee(s) may be invested in a segregated subaccount and may be invested in fixed income investments or, at the direction of the alternate payee(s), in any investment funds available to participants. If an order specifies that the alternate payee is entitled to any portion of the account of a participant who has an outstanding Plan loan, the loan will continue to be held in the participant's account and will not be transferred to an account for the alternate payee. A segregated subaccount shall remain a part of the Trust, but it alone shall share in any income it earns, and it alone shall bear any expense or loss it incurs. The Trustee shall make any payments or distributions to the alternate payee(s) by separate benefit checks or other separate distribution.

7.7 SALE OF TRADE OR BUSINESS. Distributions may also be made in the event of termination of the Plan, or any part thereof, as described in Code (S) 401(k)(a)(A)(i) and the regulations thereunder, or a disposition of the assets of a trade or business or the stock of a subsidiary with respect to employees who continue employment with the acquiring corporation or subsidiary as described in Code (S) 401(k)(10)(A)(ii) and (iii) and the regulations thereunder. In no event may amounts attributable to 401(k) elective deferrals be distributed earlier than upon one of the following events:

(a) Retirement, death, disability or separation from service (see Code (S) 401(k)(10)(A)(i));

(b) Termination of this Plan without establishment of a successor plan (see Code (S) 401(k)(10)(A)(i));

(c) The employee's attainment of age 59-1/2;

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(d) The sale or other disposition by a corporation to an unrelated corporation, which does not maintain this Plan, of substantially all of the assets used in a trade or business, but only with respect to employees who continue employment with the acquiring corporation (see Code (S) 401(k)(10)(A)(ii));

(e) The sale or other disposition by a corporation of its interest in a subsidiary to any unrelated entity which does not maintain this Plan, but only with respect to employees who continue employment with the subsidiary (see Code (S) 401(k)(10)(A)(iii)).

7.8 NOTICE OF RIGHT TO DEFER PAYMENT. A participant whose total account balances exceed (or have exceeded at the time of a prior distribution) $5,000 shall be given an explanation of the optional forms of benefit available, and of his or her right to defer receipt of distribution. If a participant fails to consent to an immediate distribution, it shall be deemed an election to defer the commencement of payment of any benefit. However, any election to defer the receipt of benefits shall not apply with respect to distributions which are required under Code (S) 401(a)(9). Notice of the rights specified under this

Section 7.8 shall be provided no less than 30 days and no more than 90 days before the "Annuity Starting Date." The "Annuity Starting Date" is the first day on which all events have occurred which entitle the participant to receive a distribution (e.g., termination of employment, consent to distribution). Distribution may commence less than 30 days after the notice required under Section 1.411(a)-11(c) of the Income Tax Regulations is given if:

(A) the plan administrator clearly informs the participant that the participant has a right to a period of at least 30 days after receiving the notice to consider the decision of whether or not to elect a distribution (and, if applicable, a particular distribution option), and

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(B) the participant, after receiving the notice, affirmatively elects a distribution.

Written consent of the participant to the distribution must not be made before the participant receives the notice and must not be made more than 90 days before the Annuity Starting Date. No consent shall be valid if a significant detriment is imposed under the plan on any participant who does not consent to the distribution. Consent to an immediate distribution is not required after the participant has reached age 65 or has died.

7.9 DIRECT ROLLOVER DISTRIBUTIONS. Notwithstanding any provision of the Plan to the contrary and subject to the following limitations, a distributee may elect, at the time and in the manner prescribed by the Plan Administrator, to have any portion of an eligible rollover distribution paid directly to an eligible retirement plan. Direct rollovers may not be divided among several plans. A participant may elect to receive a distribution partly as a direct rollover and partly in a direct payment to the participant only if the direct rollover amount equals or exceeds $500.

The following definitions shall apply to this section 7.9:

(a) Eligible Rollover Distribution. An eligible rollover distribution is any distribution of all or any portion of the balance to the credit of the distributee, except that an eligible rollover distribution does not include:

(i) any distribution that is one of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the distributee or the joint lives (or joint life expectancies) of the distributee and the distributee's designated beneficiary, or for a specified period of ten years or more;

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(ii) any mandatory minimum distribution at age 70 1/2 under Code (S) 401(a)(9); and

(iii) the portion of any distribution that is not includible in gross income (determined without regard to the exclusion for net unrealized appreciation with respect to employer securities).

(b) Eligible Retirement Plan. An eligible retirement plan is an individual retirement account described in Code (S) 408(a), an individual retirement annuity described in Code (S) 408(b) (other than an endowment contract), an annuity plan described in Code (S) 403(a), or a qualified trust described in Code (S) 401(a) of a defined contribution plan, that accepts the distributee's eligible rollover distribution. However, in the case of an eligible rollover distribution to the surviving spouse, an eligible retirement plan is an individual retirement account or individual retirement annuity.

(c) Distributee. A distributee includes an employee or former employee. In addition, the employee's or former employee's surviving spouse and the employee's or former employee's spouse or former spouse who is the alternate payee under a qualified domestic relations order, as defined in Code (S) 414(p), are distributees with regard to the interest of the spouse or former spouse.

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ARTICLE VIII

HARDSHIP WITHDRAWALS

If a participant has a financial hardship, the participant may withdraw so much of the following amount as is necessary to meet the hardship:

(a) his or her salary deferral contributions plus net investment gains and earnings on such deferrals as of December 31, 1988, plus

(b) his or her salary deferral contributions made after December 31, 1988, minus

(c) any prior withdrawals, distributions, assignments via qualified domestic relations orders, expenses and net investment losses made or incurred with respect to the amounts described in (a) or (b) above.

The salary deferral contributions will be valued as of the valuation date on or immediately before the withdrawal. Hardship withdrawals may not be made from net investment gains and earnings which have accrued after December 31, 1988 on salary deferral contributions. Notwithstanding the foregoing, a participant who has an outstanding loan from the Plan (or must take such a loan prior to the hardship distribution pursuant to this Article VIII) may not take a hardship distribution in an amount which exceeds 40% of his or her vested account balance.

A hardship withdrawal shall be available for any of the following reasons:

(a) Medical expenses incurred by the participant, the participant's spouse, or any dependents of the participant or expenses necessary for those persons to obtain medical care;

(b) Purchase (excluding mortgage payments) of a principal residence for the participant;

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(c) Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of post-secondary education for the participant, his or her spouse, children or dependents;

(d) Preventing the eviction of the participant from his or her principal residence or foreclosure on the mortgage of the participant's principal residence; or

(e) Need due to critical financial emergencies, defined as circumstances of sufficient severity that a participant is confronted by present or impending financial ruin. The need shall be based on the participant's net worth statement, which shall form an objective criterion for determining hardship.

A participant who receives a hardship distribution

(a) shall not receive a distribution in excess of the participant's immediate and heavy financial need;

(b) shall, prior to the distribution, have exercised all vested stock options and received all other distributions and loans available under all plans maintained by the employer;

(c) shall not make elective contributions or have nonelective participant contributions made to this Plan or any other retirement plan, stock purchase plan, stock option or similar plan of the employer, until the first January 1 or July 1 following the one-year anniversary of the date the hardship distribution is made; and

(d) shall not make contributions to any plan of the employer, including this Plan, for his or her tax year immediately following the tax year in which the hardship distribution was received, in excess of (i) the annual limit applicable under Code (S) 402(g) ($9,500 for 1997), as increased by a cost of living factor, minus

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(ii) the amount of participant contributions in the tax year of the hardship distribution.

Hardship withdrawals may not be taken from a Participant's employer contribution account, rollover account, or acquisition rollover account. Amounts transferred from the plans of other employers pursuant to a plan merger (e.g., see Appendix V to this Plan) or plan-to-plan transfer of plan assets may in some cases by held in the acquisition rollover account, and therefore be unavailable for hardship withdrawals.

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ARTICLE IX

LIMITATIONS ON EMPLOYEE AND EMPLOYER CONTRIBUTIONS

9.1 LIMITATIONS ON TOTAL CONTRIBUTIONS TO ACCOUNTS. Notwithstanding anything in this Plan to the contrary, the total of employee and employer contributions and forfeitures allocated to a participant's accounts under this and any other employer sponsored defined contribution plan for any year shall not exceed the applicable limits described in Code (S) 415 (e.g., the lesser of (i) 25% of the participant's compensation (as defined in Section 9.9), or (ii) $30,000). Effective March 31, 1988, the year used to determine the limits on annual additions shall be the calendar year. If such additions exceed the limitation, the Plan shall distribute to the participant the participant's elective deferrals to this Plan (within the meaning of Code (S) 402(g)(3)) and any gains attributable thereto to the extent that the distribution would reduce the excess amounts in the participant's account (see Treasury Regulations (S) 1.415-6(b)(6)(iv)). Any remaining excess annual additions to the participant's account for the year shall be used to reduce future employer contributions pursuant to Treasury Regulation (S) 1.415-6(b)(6)(ii).

9.2 AVERAGE ACTUAL DEFERRAL PERCENTAGE TESTS. With respect to participant contributions in a plan year, the actual deferral percentage shall satisfy one of the tests described in (a) or (b) below. (Definitions of words used in the tests are given in Section 9.9.)

(a) The average actual deferral percentage for eligible participants who are highly compensated employees for the plan year shall not exceed the average actual deferral percentage for eligible participants who are non-highly compensated employees for the plan year multiplied by 1.25;

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(b) the average actual deferral percentage for eligible participants who are highly compensated employees for the plan year shall not exceed the average actual deferral percentage for eligible participants who are non-highly compensated employees for the plan year multiplied by 2, provided that the average actual deferral percentage for eligible participants who are highly compensated employees does not exceed the average actual deferral percentage for eligible participants who are non-highly compensated employees by more than two (2) percentage points or such lesser amount as the Secretary of the Treasury shall prescribe to prevent the multiple use of this alternative limitation with respect to any highly compensated employee.

9.3 ELECTIVE DEFERRALS OR QUALIFIED EMPLOYER DEFERRAL CONTRIBUTIONS UNDER TWO OR MORE PLANS OR ARRANGEMENTS. The actual deferral percentage for any eligible participant who is a highly compensated employee for the plan year and who is eligible to have elective deferrals or qualified employer deferral contributions allocated to his account under two or more plans or arrangements described in Code (S) 401(k) that are maintained by the employer or an affiliated employer shall be determined as if all such elective deferrals and qualified employer deferral contributions were made under a single arrangement.

9.4 ELECTIVE DEFERRALS, QUALIFIED EMPLOYER DEFERRAL CONTRIBUTIONS, AND COMPENSATION OF FAMILY MEMBERS. For purposes of determining the actual deferral percentage of a participant who is a highly compensated employee subject to the family aggregation rules of Code (S) 414(q)(6), the elective deferrals, qualified employer deferral contributions and compensation of such participant shall include the elective deferrals, qualified employer deferral contributions and compensation of family

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members, and such family members shall be disregarded in determining the actual deferral percentage for participants who are non-highly compensated employees.

The determination and treatment of the elective deferrals, qualified nonelective contributions and actual deferral percentage of any participant shall satisfy such other requirements as may be prescribed by the Secretary of the Treasury.

9.5 ACTIONS AVAILABLE WHEN TESTS UNSATISFIED. In the event that the Plan Administrator shall at any time have reasonable cause to conclude that neither of the tests will be satisfied for a plan year, then the Plan Administrator shall take such actions as the Plan Administrator deems necessary in accordance with Appendix III, attached hereto and incorporated herein.

9.6 DISTRIBUTION OF EXCESS CONTRIBUTIONS. Excess contributions and income allocable thereto shall be distributed no later than the last day of each plan year to participants on whose behalf such excess contributions were made for the preceding plan year. "Excess contributions" shall mean the difference between the participant contributions made by highly compensated employees and the maximum amount of allowable participant contributions for those employees. The income allocable to excess contributions shall be determined by multiplying income allocable to the participant's elective deferrals and qualified employer deferral contributions for the plan year by a fraction, the numerator of which is the excess contribution on behalf of the participant for the preceding plan year and the denominator of which is the sum of the participant's account balances attributable to elective deferrals and qualified employer deferral contributions on the last day of the preceding plan year. The excess contributions which would otherwise be distributed to the participant shall be adjusted for income; shall be reduced, in accordance with regulations, by the amount of excess deferrals

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distributed to the participant; shall, if there is a loss allocable to the excess contributions, in no event be less than the lesser of the participant's account under the Plan or the participant's elective deferrals and qualified employer deferral contributions for the plan year. Amounts distributed under this section shall be treated as distributions from the participant's elective deferral account and shall be treated as distributed from the participant's qualified employer deferral contribution account only to the extent such excess contributions exceed the balance in the participant's elective deferral account.

9.7 AVERAGE CONTRIBUTIONS PERCENTAGE TESTS. With respect to participant contributions and employer matching contributions, the average contribution percentage shall satisfy one of the tests described in, (a) or (b) below (definitions of words used in the tests are given in Section 9.9).

(a) The average contribution percentage for eligible participants who are highly compensated employees for the plan year shall not exceed the average contribution percentage for eligible participants who are non-highly compensated employees for the plan year multiplied by 1.25;

(b) the average contribution percentage for eligible participants who are highly compensated employees for the plan year shall not exceed the average contribution percentage for eligible participants who are non-highly compensated employees for the plan year multiplied by 2, provided that the average contribution percentage for eligible participants who are highly compensated employees does not exceed the average contribution percentage for eligible participants who are non-highly compensated employees by more than two (2) percentage points or such lesser amount as the Secretary of the Treasury shall prescribe to

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prevent the multiple use of this alternative limitation with respect to any highly compensated employee.

9.8 DISTRIBUTION OF EXCESS AGGREGATE CONTRIBUTIONS. Excess aggregate contributions and income allocable thereto shall be distributed no later than the last day of each plan year to participants to whose accounts employee contributions or matching contributions were allocated for the preceding plan year. "Excess aggregate contributions" shall mean the amount described in Code (S) 401(m)(6)(B). The income allocable to excess aggregate contributions shall be determined by multiplying the income allocable to the participant's employee contributions and matching employer contributions for the plan year by a fraction, the numerator of which is the excess aggregate contributions on behalf of the participant of the preceding plan year and the denominator of which is the sum of the participant's account balances attributable to employee contributions and matching employer contributions on the last day of the preceding plan year. The excess aggregate contributions to be distributed to a participant shall be adjusted for income, and, if there is a loss allocable to the excess aggregate contribution, shall in no event be less than the lesser of the participant's account under the Plan or the participant's employee contributions and matching contributions for the plan year. Excess aggregate contributions shall be distributed from the participant's matching contribution account in proportion to the participant's employee contributions and matching contributions for the plan year.

9.9 DEFINITIONS APPLICABLE TO DISCRIMINATION TESTS. For purposes of this Article, the following definitions shall be used:

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Actual deferral percentage shall mean the ratio (expressed as a percentage) of effective deferrals and qualified employer deferral contributions on behalf of the eligible participant for the plan year to the eligible participant's compensation for the plan year.

Average actual deferral percentage shall mean the average (expressed as a percentage) of the actual deferral percentages of the eligible participants in a group.

Compensation shall mean wages within the meaning of Code (S) 3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under Code (S)(S) 6041(d), 6051(a)(3), and 6052. Compensation excludes amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under Code (S) 217. Compensation shall be determined without regard to any rules under Code (S) 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in Code (S) 3401(a)(2)). For purposes of performing the average actual deferral percentage test and the average contributions percentage test, the annual compensation of each employee taken into account shall not exceed the limitation under Code (S) 401(a)(17), which is the OBRA '93 annual compensation limit. The OBRA '93 annual compensation limit is $150,000 ($160,000 in 1997), as adjusted by the Commissioner for increases in the cost of living in accordance with Code (S) 401(a)(17)(B). In addition, in performing the average actual deferral percentage test and the average contributions percentage test for any year, Microsoft Corporation may elect to include in the definition of compensation for all employees the elective contributions that are made by the

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employer on behalf of its employees that are not includible in gross income under Code (S) 125 (cafeteria plan) or Code (S) 402(e)(3) (cash or deferred arrangement).

Elective deferrals shall mean contributions made to the Plan during the plan year by the employer, at the election of the participant, in lieu of cash compensation and shall include contributions made pursuant to a salary reduction agreement.

Eligible participant shall mean any employee of the employer who is otherwise authorized under the terms of the Plan to have elective deferrals or qualified employer deferral contributions allocated to his or her account for the plan year.

Family Member shall mean an individual described in Code (S) 414(q)(6)(B).

Highly Compensated Employee shall mean an individual described in Code (S) 414(q).

Inactive Participant shall mean any employee or former employee who has ceased to be an eligible employee and on whose behalf an account is maintained under the Plan.

Matching contribution shall mean any contribution to the Plan made by the employer for the plan year and allocated to a participant's account by reason of the participant's employee contributions or elective deferrals.

Non-highly compensated employee shall mean an employee of the employer who is neither a highly compensated employee nor a family member.

Participant shall mean any employee of the employer who has met the eligibility and participation requirements of the Plan.

Qualified employer deferral contributions shall mean qualified nonelective contributions taken into account under the terms of the Plan in determining the actual deferral percentage.

Qualified nonelective contributions shall mean contributions (other than matching contributions) made by the employer and allocated to participants' accounts that the participant

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may not elect to receive in cash until distributed from the Plan; that are 100 percent vested and nonforfeitable when made; and that are not distributable under the terms of the Plan to participants or their beneficiaries except in events upon which elective deferrals may be distributed as described in Section 7.7(a) through (e) of this Plan.

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ARTICLE X

ROLLOVER CONTRIBUTIONS

10.1 PERMITTED ROLLOVERS. Subject to terms and conditions established by the Plan Administrator, an employee, whether or not a participant, may transfer rollover or direct rollover amounts to the trust from other eligible retirement plans as permitted under, and pursuant to the provisions of, Code (S)(S) 402(c) and 401(a)(31), respectively. The Plan Administrator shall require written certification that the contribution qualifies under Code (S)(S) 402(c) or 401(a)(31), respectively.

10.2 VESTING AND ACCOUNTING. Rollover contributions and earnings shall be 100% vested and shall be accounted for separately in a rollover account. All rollover contributions shall be invested and reinvested along with the assets of the Plan and treated in all respects as other assets of the Plan.

10.3 DISTRIBUTION UPON TERMINATION. The rollover account shall be distributed at the same time and in the same manner as the employee's other accounts. If an employee terminates with no other amounts payable from this Plan, the rollover account shall be valued as of the valuation date coinciding with or preceding the date of termination and shall be paid in a single sum within 60 days after the end of the plan year.

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ARTICLE XI

ADMINISTRATION

11.1 NAMED FIDUCIARY. The employer and the Plan Administrator are named fiduciaries for purposes of ERISA. The Plan Administrator is the named fiduciary with the authority to control and manage the operation and administration of the Plan, and is the "administrator" of the Plan within the meaning of ERISA Section 3(16)(A).

11.2 PLAN ADMINISTRATOR. The Plan Administrator may from time to time employ agents to aid in the administration of the Plan. The Plan Administrator shall have the sole power and discretion to interpret and construe the provisions of this Plan and to determine all questions, including both interpretive and factual questions arising in connection with the administration, interpretation and application of the Plan, and shall supply any omission or reconcile any inconsistency in the Plan. The Plan Administrator's authority includes, without limitation, the sole authority to interpret and construe the Plan and determine a participant's eligibility to participate in the Plan and to receive benefits, and amount of benefits, if any. Any such action shall be final and conclusive upon all persons. The Plan Administrator shall decide any disputes which may arise under this Plan relative to the rights of employees, past and present, and their beneficiaries. Further, the Plan Administrator shall adopt such rules as it deems necessary, and give instructions and directions to the trustee as necessary and, in general, shall direct the administration of the Plan. The Plan Administrator's authority includes, but is not limited to, the following:

a. to compute, certify, and direct the trustee with respect to the amount and the kind of benefits to which any participant shall be entitled hereunder;

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b. to authorize and direct the trustee with respect to all nondiscretionary or otherwise directed disbursements from the trust;

c. to compute and certify to the employer and to the trustee from time to time the sums of money necessary or desirable to be contributed to the Plan;

d. to consult with the employer and the trustee regarding the short and long-term liquidity needs of the Plan in order that the trustee can exercise any investment discretion in a manner designed to accomplish specific objectives; and

e. to prepare and implement a procedure to notify eligible employees that they may elect to have a portion of their compensation deferred or paid to them in cash.

11.3 FACILITY OF PAYMENTS. Whenever, in the Plan Administrator's opinion, a person who is entitled to receive any payment of a benefit or installment thereof is under a legal disability or is incapacitated in any way so as to be unable to manage his or her financial affairs, the Plan Administrator may direct the trustee to make payments to such person or to the participant's legal representative or to a relative or friend of the participant for his or her benefit. Any payment of a benefit or installment thereof made in accordance with the provisions of this section shall be a complete discharge of any liability for the making of such payment under this Plan.

11.4 APPOINTMENT OF INVESTMENT MANAGER. The employer shall have the authority described in ERISA (S) 402(c)(3) to appoint one or more investment managers and contract with each for management of any part of the trust fund for a reasonable fee. Selection and retention of an investment manager shall be in the trustee's discretion. Each investment

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manager shall have the power to manage, acquire, and dispose of the part of the trust fund designated by the employer. The investment manager shall have no responsibility for plan operation or administration.

11.5 INVESTMENT MANAGER AND TRUSTEE. If an investment manager is appointed:

(a) The trustee shall segregate the trust fund or any part thereof into one or more investment accounts. The trustee shall appoint an investment manager for each account and designate the part of the trust fund to be managed by each investment manager.

(b) The trustee may terminate at any time the authority of an investment manager to manage an account. In such event or upon resignation of an investment manager, the trustee may appoint a successor investment manager for the account.

(c) Each investment manager to whom any fiduciary responsibility with respect to the Plan or the trust funds allocated is delegated, shall discharge such responsibility in accordance with the standards set forth in ERISA 404(a) and shall acknowledge such responsibility in writing.

11.6 DELEGATION OF AUTHORITY AND DUTIES BY PLAN ADMINISTRATOR. The 401(k) Administrative Committee may allocate to a specific 401(k) Administrative Committee member or members the authority and duty to carry out some or all of the Plan Administrator's fiduciary responsibilities under the Plan. In addition, the 401(k) Administrative Committee (or a 401(k) Administrative Committee member who has been allocated authority and duties pursuant to the preceding sentence) may designate one or more persons, positions, committees or entities either within or outside of Microsoft Corporation to carry out some or all of the Plan Administrator's fiduciary responsibilities under the Plan. Any

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such designee and any 401(k) Administrative Committee member who has been allocated authority shall have the same authority and discretion as would the 401(k) Administrative Committee in performing the delegated or allocated responsibilities. The 401(k) Administrative Committee's allocation or delegation described in this Section 11.6 may include, without limitation, its fiduciary authority and duties under Articles XI and XII, including authority, power and discretion that is assigned solely to the Plan Administrator. The Plan Administrator's allocation or delegation may be made either orally or in writing, and shall be effective only after the person receiving the allocation or delegation agrees to accept the authority and duties allocated or delegated.

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ARTICLE XII

CLAIMS PROCEDURE

12.1 DENIAL OF CLAIMS. Any denial of a claim for benefits under the trust by a participant or beneficiary shall be stated in writing and delivered or mailed to the participant or beneficiary. Such notice shall set forth the specific reasons for the denial in a manner that may be understood without legal or actuarial counsel. Any denial of a claim may be appealed to the Plan Administrator by sending to the Plan Administrator a written request for review within 90 days after receiving notice of denial. The Plan Administrator shall give the applicant an opportunity to review pertinent documents in preparing the applicant's request for review. The request shall set forth all grounds on which it is based, supporting facts and other matters which the applicant deems pertinent. The Plan Administrator may require the applicant to submit such additional facts, documents or other material as it deems necessary or advisable in making its review and shall act upon such request within 60 days after the receipt thereof, unless special circumstances require further time. If the Plan Administrator confirms the denial in whole or in part, the Plan Administrator shall notify the applicant, setting forth in a manner calculated to be understood by the applicant, specific reasons for denial and specific references to Plan provisions on which the decision was based.

12.2 ARBITRATION. Any controversy or claim arising out of or relating to this Plan, which is asserted by any person as an employee, former employee, participant, or beneficiary, shall be settled by arbitration in accordance with the Commercial Rules of the American Arbitration Association. Judgment upon the award rendered by the arbitrator shall be entered in a court having jurisdiction thereof. All such arbitration cases shall be heard by an attorney licensed in the jurisdiction where the arbitration hearing is to occur.

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ARTICLE XIII

NONALIENATION PROVISION

No participant shall have the right or power to alienate, anticipate, commute, pledge, encumber, or assign any of the funds allocated to the participant under the terms of this Plan, and such funds shall not be subject to seizure by any creditor of the participant under any writ or proceedings at law or in equity; provided, that the terms of this Article shall not prohibit the creation, assignment or recognition of a right to any benefit payable with respect to a participant if such creation, assignment or recognition of a right is made under a qualified domestic relations order defined under Code (S) 414(p).

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ARTICLE XIV
TERMINATION

14.1 PLAN TERMINATION. The employer shall have the right to terminate the Plan at any time as to its employees by action of its board of directors or by action of any committee or officer to whom such board of directors has delegated the right to terminate the Plan. In addition, Microsoft Corporation reserves the right to terminate the Plan in its entirety at any time by action of the Board of Directors of Microsoft Corporation or by action of any committee or officer to whom the Board of Directors has delegated such authority to terminate the Plan, and the Plan shall terminate in its entirety unless Microsoft Corporation permits employers wishing to continue the Plan as to their respective employees to arrange a spin-off of Plan assets attributable to accounts of their employees.

14.2 NO REVERSION TO EMPLOYER -- ACCRUED RIGHTS NONFORFEITABLE. No termination shall have the effect of vesting in the employer any part of the principal or income of the plan funds. In the case of a termination, partial termination, or complete discontinuance of contributions, the rights of all affected employees accrued to the date of such termination or partial termination, to the extent funded as of such date, shall be nonforfeitable. See Section 5.6 of this Plan for the treatment of certain forfeitures upon complete termination of the Plan.

14.3 DISTRIBUTION UPON TERMINATION OR DISCONTINUANCE OF CONTRIBUTIONS. Upon termination of the Plan or a complete discontinuance of contributions to the Plan the interests of all participants shall fully vest and distribution shall be made to each participant in the form and manner determined by the Plan Administrator and as permitted by the Code and ERISA. See Section 7.7 of this Plan.

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ARTICLE XV

MERGER OR CONSOLIDATION

In the case of any merger or consolidation with, or transfer of, assets or liabilities to any other retirement Plan, the termination benefits of participants, former participants and beneficiaries immediately subsequent to the merger, consolidation or transfer shall be equal to or greater than the termination benefits immediately prior to such merger, consolidation, or transfer. In the case of any plan which has merged into this Plan or any assets and liabilities which have been transferred to this Plan from another plan, see Appendix V (as added pursuant to this amendment) of this Plan for (i) special provisions which apply to any accounts which were transferred to this Plan or established in connection with such transfer or merger and (ii) special provisions which apply to participants who formerly participated in the transferor or nonsurviving plan.

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ARTICLE XVI
AMENDMENTS

Microsoft Corporation reserves the right, from time to time, to make any amendment or amendments to this Plan by resolution of its Board of Directors, or by action of any committee, person(s) or job position(s) to whom the Board of Directors has delegated authority to amend the Plan, which amendment or amendments shall not cause any part of the plan funds to be used for, or directed to, any purposes other than the exclusive benefit of participants, former participants or their beneficiaries, nor shall any such amendment reduce the amount of accrued benefit of any participant or beneficiary within the meaning of Code (S) 411(d)(6) except to the extent permitted by Code (S) 411(d)(6) or the Treasury Regulations thereunder.

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ARTICLE XVII
RIGHTS RESERVED

The establishment of the Plan as evidenced hereby or as hereafter modified, the creation of any funds or accounts or the payment of any benefit hereunder shall not be construed as giving any participant, or any other person, any legal or equitable right against the employer, the trustee, or the Plan Administrator, unless the same shall be specifically provided for in this document or conferred by affirmative action of the employer in accordance with the terms and provisions of this Plan or as giving any employee or participant the right to be retained in the service of the employer. All employees shall remain subject to discharge by the employer to the same extent as if this Plan had never been executed.

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ARTICLE XVIII
TOP-HEAVY PROVISIONS

If the Plan is top-heavy in any plan year, the provisions of Appendix IV, attached hereto and incorporated herein, shall supersede any conflicting provisions in the Plan.

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ARTICLE XIX
LOANS

A participant may borrow from his or her account in accordance with a non-discriminatory written loan policy, which is incorporated herein by reference.

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ARTICLE XX

ANNUITY DISTRIBUTIONS TO PARTICIPANTS AND BENEFICIARIES

20.1 APPLICABILITY. The provisions of this Article XX shall apply only to the participants who (1) had accounts transferred to this Plan from a plan which provided the option of receiving distributions in the form of an annuity (as shown in Appendix V), and (2) have chosen to receive their distribution upon death, disability, or termination of employment in the form of a life annuity. This Article XX applies only to those accounts described in Appendix V that were transferred from the prior plan in a plan merger, plan-to-plan asset transfer or other transfer for which the annuity distribution option is required by law to be preserved with respect to the transferred accounts. Thus, for example, this Article XX does not apply to regular rollovers.

20.2 DEFINITIONS.

(a) ANNUITY STARTING DATE means the first day of the first period for which an amount is paid as an annuity.

(b) ELECTION PERIOD means the period beginning on the first day of the plan year in which a participant attains 35 and ending on the date of the participant's death. If a participant separates from service before the first day of the plan year in which he reaches age 35, the election period with respect to his or her account balance as of the date of separation shall begin on the date of separation. A participant who will not attain age 35 as of the end of a plan year may make a valid waiver election to waive the qualified preretirement survivor annuity for the period beginning on the date of the election and ending on first day of the plan year in which the participant will attain age 35. Qualified preretirement survivor annuity coverage will be

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automatically reinstated as of the first day of the plan year in which a participant attains age 35. Any new waiver on or after that date shall be subject to the full requirements of this Article XX.

(c) QUALIFIED JOINT AND SURVIVOR ANNUITY means an immediate annuity purchasable with the participant's vested account balance which provides a life annuity for the participant and a survivor annuity payable for the remaining life of the participant's surviving spouse equal to at least 50% and not more than 100% of the amount of the annuity payable during the life of the participant.

(d) PRERETIREMENT SURVIVOR ANNUITY means an annuity which is purchasable with 100% of the participant's vested account balance (as determined on the date of the participant's death) and which is payable for the life of the participant's surviving spouse.

(e) SPOUSE means the current spouse or surviving spouse of a participant except that a former spouse will be treated as a spouse or surviving spouse (and a current spouse will not be treated as the spouse or surviving spouse) to the extent provided under a qualified domestic relations order.

20.3 DISTRIBUTION IN THE FORM OF A JOINT AND SURVIVOR ANNUITY.

A participant who is married shall receive his or her vested account balance in the form of a joint and survivor annuity unless the participant completes a valid waiver election within the 90-day period ending on the annuity starting date. The participant's waiver election will not be required to meet the spousal consent requirements if: (1) the participant does not have a spouse; (2) the Plan is unable to locate the participant's spouse; (3) the participant is legally separated or has been abandoned (within the meaning of state law) and the participant has a court order to that effect; or (4) other circumstances exist under which the Secretary of the Treasury will excuse the

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consent requirement. If the participant's spouse is legally incompetent to give consent, the spouse's legal guardian (even if the legal guardian is the participant) may give consent.

20.4 DISTRIBUTION IN THE FORM OF A PRERETIREMENT SURVIVOR ANNUITY. If a married participant dies prior to his or her annuity starting date, the participant's surviving spouse shall receive a portion of the participant's vested account balance in the form of a preretirement survivor annuity, unless the participant had a valid waiver election in effect, or unless the participant and his or her spouse were not married through a one year period ending on the date of the participant's death.

20.5 WAIVER ELECTION - QUALIFIED JOINT AND SURVIVOR ANNUITY.

During the 90-day period prior to the participant's annuity starting date, a participant may waive the requirement to receive his or her benefit under the Plan in the form of a joint and survivor annuity. In order to waive the election, the participant must have received a written explanation of the terms and conditions of the qualified joint and survivor annuity as described in Section 20.7.

A married participant's waiver election shall not be valid unless the participant's spouse: (1) has consented in writing to the election waiver and a notary public or the plan administrator (or his or her representative) witnesses the spouse's consent; (2) the spouse consents to the alternate form of payment designated by the participant or to any change in the designated form of payment; and (3) unless the spouse is the participant's sole beneficiary, the spouse consents to the participant's beneficiary designation or to any change in the participant's beneficiary designation.

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20.6 WAIVER ELECTION - PRERETIREMENT SURVIVOR ANNUITY. A participant's waiver election of the preretirement survivor annuity is not valid unless: (1) the participant makes the waiver election during the election period as defined in this section; and (2) the participant's spouse (to whom the preretirement survivor annuity is payable) satisfies the consent requirements described in Section 20.5, except that the spouse need not consent to the form of benefit payable to the designated beneficiary. The spouse's consent to the waiver of the preretirement survivor annuity is irrevocable, unless the participant revokes the waiver election. A waiver election described in this paragraph is not valid unless made after the participant has received the written explanation described in Section 20.7.

20.7 NOTICE REQUIREMENTS. In the case of a qualified joint and survivor annuity, no less than 30 days and no more than 90 days before a participant's annuity starting date the plan administrator shall provide to the participant a written explanation of: (1) the terms and conditions of a qualified joint and survivor annuity; (2) the participant's right to make, and the effect of, an election to waive the qualified joint and survivor annuity form of benefit; (3) the rights of the participant's spouse; and (4) the right to make, and the effect of, a revocation of a previous election to waive the qualified joint and survivor annuity. The Plan may provide the written explanation described above after the annuity starting date, provided that the distribution begins at least 30 days after the date on which such explanation is provided. Notwithstanding the foregoing, the Plan may permit a participant to elect to waive the requirement that the written explanation be provided at least 30 days before the annuity starting date. Such a waiver is allowed only if the distribution commences more than 7 days after the written explanation is provided.

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In the case of a qualified preretirement annuity, the plan administrator shall provide to the participant a written explanation of the qualified preretirement survivor annuity, in terms and manner comparable to the requirements applicable to the explanation of a qualified joint and survivor annuity as described in the preceding paragraph. The explanation shall be provided by the latest of the following periods: (1) the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35; (2) a reasonable period ending after an individual becomes a participant; or (3) a reasonable period ending after this Article XX first applies to the participant. Notwithstanding the foregoing, in the case of a participant who separates from service before attaining age 35, notice must be provided within a reasonable time ending after his separation from service.

A reasonable period of time shall be the end of a two-year period beginning one year before the date the applicable event occurs, and ending one year after that date. In the case of a participant who separates from service before the plan year in which he reaches age 35, notice shall be provided within the two-year period beginning one year before the separation and ending one year after the separation. If such a participant thereafter returns to employment with the employer, the applicable period for the participant shall be redetermined.

20.8 DISTRIBUTION OF ACCOUNTS OF LESS THAN $5,000. Notwithstanding any provision of this Article XX to the contrary, if a participant's vested account balance does not exceed $5,000 on the date of distribution (and has never exceeded $5,000 at the time of a prior distribution), the participant's benefit shall be distributed in the form of a lump sum.

20.9 PROVISION OF ANNUITIES. All annuities provided under this Plan shall be purchased from an insurance company selected by Microsoft Corporation.

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ARTICLE XXI
VOLUNTARY AFTER-TAX CONTRIBUTIONS

21.1 ELECTION TO MAKE VOLUNTARY AFTER-TAX CONTRIBUTIONS. In the same manner as described in Article III for employee salary deferrals, a participant may elect to contribute on an after-tax basis from 1% to 7% of each of his or her compensation payments to an employee after-tax contribution account under the Plan, provided, however, that the contributions shall be subject to the limitations of Code (S)415 (as described in Section 9.1 of the Plan) and Code (S)401(m) (as described in Section 9.7 and Appendix III.9.5.C. of the Plan).

21.2 VESTING OF VOLUNTARY AFTER-TAX CONTRIBUTIONS. A participant's voluntary after-tax contributions made to the Plan in accordance with Section 21.1 shall be fully vested at all times.

21.3 ESTABLISHMENT OF VOLUNTARY AFTER-TAX CONTRIBUTIONS ACCOUNTS. For participants who elect to make a contribution under this Article XXI, the employer shall establish a separate account for the participant. These accounts shall be labeled employee after-tax contribution accounts.

21.4 LIMITATIONS ON VOLUNTARY AFTER-TAX CONTRIBUTIONS. A participant's voluntary after-tax contributions shall be subject to the limitations on total account contributions under Section 9.1 of the Plan. If a participant who has made voluntary after-tax contributions during the plan year exceeds the limitation under Section 9.1, the after-tax contributions shall be distributed to the participant before any distribution from the participant's salary deferral account is made.

A participant's voluntary after-tax contributions shall also be subject to the average contributions percentage test as described in Section 9.7 and Appendix III.9.5.C. of the Plan. For

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purposes of such test and calculating a participant's contribution percentage, an employee's voluntary after-tax contributions shall be added to the employer matching contributions, the sum of which shall then be divided by the participant's compensation. If a participant who has made voluntary after-tax contributions during the plan year exceeds the limitations under Section 9.7 and Appendix III.9.5.C. of the Plan, the after-tax contributions shall be distributed to the participant before any distribution from the participant's employer contribution account is made.

21.5 DEFINITION OF COMPENSATION. Any employee voluntary after-tax contributions made by a participant during the plan year shall be included in the definition of compensation in Appendix I of the Plan.

21.6 PLAN TERMS APPLICABLE TO VOLUNTARY AFTER-TAX CONTRIBUTIONS. The provisions of Article III applicable to the method of making an election to contribute a portion of compensation, the provisions of Article VI regarding participant's accounts and investments, the provisions of Article VII regarding the payment of account balances upon termination, age 59 1/2 , death, disability, qualified domestic relations orders, or the sale of the trade or business, the provisions of Article VIII regarding hardship distributions, and the provisions of Article XIX (which incorporates by reference the loan policy of the Plan) and the loan policy shall all apply to participant voluntary after-tax contributions. For purposes of these sections, except to the extent provided otherwise under this Article, voluntary after-tax contributions shall be treated in the same manner as participant salary deferral contributions. In addition, the general provisions of the Plan found in Article XI Administration, Article XII Claims Procedure, Article XIII Nonalienation Provision, Article XIV Termination, Article XV Merger or Consolidation, Article XVI Amendments, Article XVII Rights Reserved,

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Article XVIII Top-Heavy Provisions and similar articles or appendices shall apply to the voluntary after-tax contributions to the Plan.

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APPENDIX I

DEFINITION OF COMPENSATION

Section 1.3

I.1.3.A. Compensation:

Compensation means an employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, bonuses, commissions, and overtime pay). Compensation includes the employee's elective salary reduction contributions not includible in gross income under Code (S) 125 (cafeteria plans) or (S) 402(e)(3) (401(k) plans); and compensation includes foreign earned income (as defined in Code (S) 911(b)), whether or not excludable from gross income under Code (S) 911. Compensation shall not include:

(a) (even if includible in gross income) reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, welfare benefits, and bonuses and expense allowances which are not based upon the participant's performance as an employee (examples of non-performance based compensation include signing, relocation, press, and patent bonuses, tax and foreign currency equalization payments, and anniversary stock awards);

(b) employer contributions to a simplified employee pension described in Code (S) 408(k), distributions from a plan of deferred compensation (regardless of whether such amounts are includible in the gross income of the employee when distributed);

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(c) amounts realized from the exercise of a nonqualified stock option, or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture;

(d) amounts realized by the employee from the sale, exchange or other disposition of stock acquired under a qualified stock option; and

(e) other amounts which receive special tax benefits, such as premiums for group-term life insurance.

I.1.3.B. Compensation for Employees of Controlled Group

In the case of an employee of an employer which is a member of a controlled group of corporations (as defined in Code (S) 414(b) as modified by Code (S) 415(h)), the term "compensation" for such employee includes compensation from all employers that are members of the group, regardless of whether the employee's particular employer has a qualified plan. This rule is also applicable to an employee of two or more trades or businesses (whether or not incorporated) that are under common control (as defined in Code (S) 414(c) as modified by Code (S) 415(h)), to an employee of two or more members of an affiliated service group as defined in Code (S) 414(m), and to an employee of two or more members of any group of employers who must be aggregated and treated as one employer pursuant to Code (S) 414(o).

I.1.3.C. Limitations on Compensation

(a) In addition to the applicable limitations set forth in the Plan, and notwithstanding any other provisions of the Plan to the contrary the annual compensation of each employee taken into account under the Plan shall not exceed the OBRA '93 annual compensation limit. The OBRA '93 annual compensation limit is $150,000, as adjusted by the Commissioner for increases in the cost of living in accordance with Code (S) 401(a)(17)(B) (e.g., $160,000 in

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1997). The cost-of-living adjustment in effect for a calendar year applies to any period, not exceeding 12 months, over which compensation is determined (the "determination period") beginning in such calendar year. If a determination period consists of fewer than 12 months, the OBRA '93 annual compensation limit will be multiplied by a fraction, the numerator of which is the number of months in the determination period, and the denominator of which is 12.

Any reference in this Plan to the limitation under Code (S) 401(a)(17) shall mean the OBRA '93 annual compensation limit set forth in this provision.

For purposes of determining the maximum dollar amount referred to in this provision, the compensation of any participant who is either a 5% owner (as defined in Code (S) 416(i)) or one of the ten most highly paid highly compensated employees during the Plan year shall be aggregated with: (i) the compensation of any lineal descendant who has not attained the age of 19, and (ii) the compensation of a participant who is his or her spouse.

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APPENDIX II
Sections 1.6, 2.1 and 5.2

EMPLOYERS MAINTAINING THE PLAN

Employer	Effective Date

Microsoft Corporation	January 1, 1987
Technology Resources Management Corporation	November 23, 1992
Vermeer Technologies, Inc.	April 1, 1996 - March 13, 1998
Microsoft Licensing, Inc.	August 1, 1997
WebTV Networks, Inc.	January 1, 1998
Hotmail Corporation	April 1, 1998
Microsoft - Health, LLC	September 21, 1998
MSNBC Interactive News L.L.C.	January 1, 1999
Expedia, Inc.	November 1 - December 31, 1999
Visio Corporation	March 1, 2000

EMPLOYEES' PREPARTICIPATION SERVICE WITH THESE COMPANIES
IS COUNTED FOR ELIGIBILITY AND VESTING

Company	Effective Date Credit is Granted
Microsoft Corporation	January 1, 1987
Technology Resources Management Corporation	November 23, 1992
Fox Software, Inc.	July 1, 1992
SOFTIMAGE, Inc.	June 27, 1994
Bauer Group, Inc.	July 1, 1989
Forethought, Inc.	August 1, 1987
Altamira Software Corporation	September 16, 1994
NextBase, Ltd.	October 31, 1994
Automap, Inc.	October 31, 1994
One Tree Software, Inc.	November 10, 1994
Natural Language Inc.	February 22, 1995
Network Managers Ltd.	August 28, 1995

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Company	Effective Date Credit is Granted
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Blue Ribbon SoundWorks	October 13, 1995
Netwise	October 28, 1995
Bruce Artwick Organization	December 1, 1995
Vermeer Technologies, Inc. (Note: service credit is as described in Appendix V)	January 12, 1996
Colusa Software, Inc.	February 9, 1996
Aspect Software Engineering, Inc.	March 22, 1996
Aha! software corp.	March 27, 1996
EXOS, Inc.	April 12, 1996
EShop Inc. (Note: service credit is as described in Appendix V)	June 20, 1996
ResNova Software, Inc.	November 14, 1996

Panorama Software Systems Ltd.	January 2, 1997

EMPLOYEES' PREPARTICIPATION SERVICE WITH THESE COMPANIES IS COUNTED FOR VESTING

Company	Effective Date Credit is Granted
NetCarta Corporation	January 31, 1997
Interse` Corporation	February 25, 1997
Dimension X	May 13, 1997
Cooper & Peters, Inc.	June 11, 1997
LinkAge Software (1997) Inc. (and its predecessor, LinkAge Software Inc.)	June 27, 1997
VXtreme, Inc.	July 31, 1997
WebTV Networks, Inc. (Note: service credit is as described in Appendix V)	August 1, 1997
Hotmail Corporation	December 30, 1997
Firefly Network, Inc.	April 15, 1998
The Mesa Group, Inc.	April 24, 1998
Valence Research	August 7, 1998

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Company	Effective Date Credit is Granted
LinkExchange Inc.	November 4, 1998
Virtual World Entertainment Group, Inc.	January 11, 1999
FASA Interactive Technology, Inc.	January 11, 1999
Compare Net, Inc.	March 4, 1999
Access Software Incorporated	April 29, 1999
Jump Networks, Inc.	April 30, 1999
Intrinsa Corporation	June 29, 1999
Entropic Research Laboratory, Inc.	November 4, 1999
Visio Corporation	January 7, 2000

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In order to receive preparticipation service credit for service with any of the foregoing companies except Microsoft Corporation ("Microsoft"), Technology Resources Management Corporation ("TRMC"), Vermeer Technologies, Inc. ("VTI") and eShop Inc. (each of the foregoing is hereinafter referred to as a "Former Employer"), the employee must be employed by Microsoft, TRMC, VTI or a company which is affiliated (within the meaning of Code Sections 414(b), (c), (m) or (o)) with Microsoft, TRMC or VTI, in connection with Microsoft's (or its affiliate's) acquisition of or merger with such Former Employer (or a trade or business thereof). Any employee who has previously worked for one of the Former Employers and whose employment with Microsoft, TRMC, VTI or one of its affiliates is not connected with Microsoft's (or its affiliate's) acquisition of or merger with such Former Employer (or a trade or business thereof) will not receive credit for his or her prior service with the Former Employer.

Preparticipation service credit is counted for eligibility and vesting purposes for an employee's service with the following companies despite the fact that neither Microsoft nor an affiliate of Microsoft acquired or merged with such company (or a trade or business thereof). Notwithstanding the foregoing, service with the following companies will only be counted for

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those employees who are employed with Microsoft (or an affiliate of Microsoft) on the effective date set forth below on which service credit is granted for service with such company.

EMPLOYEES' PREPARTICIPATION SERVICE WITH THESE COMPANIES
IS COUNTED FOR ELIGIBILITY AND VESTING
(NOTE: These Companies were not Acquired)

Company	Effective Date Credit is Granted
Charles View Software, Inc.	June 1, 1996

Prior service with MSNBC Interactive News L.L.C. and, for employees of MSNBC Interactive News L.L.C., service with National Broadcast Company, shall also be counted towards vesting. See Appendix V.G. regarding calculation of such vesting service credit.

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APPENDIX III

CODE (S) 401(k) LIMITATIONS OF COMPENSATION DEFERRALS AND CODE (S) 401(m)

LIMITATIONS ON COMPENSATION DEFERRALS

III.9.5.A. Definition of Highly Compensated Employee.

"Highly compensated employee" shall mean:

(a) Any employee who performs services for the employer during the "determination year" and who, during the "determination year" (1) was a 5% owner of the employer; (2) received compensation from the employer in excess of $75,000 (as adjusted for increases in cost of living as reported in IRS publications); (3) received compensation from the employer in excess of $50,000 (as adjusted for increases in cost of living as reported in IRS publications) and was a member of the "top-paid group" for such year; or (4) was an officer of the employer and received compensation during such year that is greater than 50% of the dollar limitation in effect under Code (S) 415(c)(1(A);

(b) Any employee who separated from service (or was deemed to have separated) prior to the determination year, and met the description in (a) above for either the separation year or any determination year ending on or after the employee's 55th birthday.

(c) If no officer of the employer has compensation in excess of 50% of the dollar limitation in effect under Code (S) 415(b)(1)(A) during a determination year, the highest paid officer for such year shall be treated as a highly compensated employee.

(d) If an employee is, during a determination year, a "family member" of either a 5% owner who is an employee or of a highly compensated employee in the group consisting of the 10 most highly compensated employees ranked on the basis of compensation paid by the employer during such year, then the family member and 5% owner or top-ten highly

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compensated employee shall be treated as a single employee, and their compensation and contributions or benefits under this Plan shall be aggregated. Except as otherwise provided under Code (S) 401(a)(17), "family member" includes the spouse, lineal ascendants and descendants of the employee or former employee, and the spouses of such lineal ascendants and descendants.

(e) The "determination year" shall be the plan year for which compliance is being tested, and the "look-back year" shall be the calendar year ending at the end of the determination year (see the calendar year calculation election pursuant to Temporary Treasury Regulation 1.414(q)-IT, Q&A-14(b)). Because the look-back year is the same as the determination year, the look-back year shall be referred to herein as the determination year.

(f) The "top-paid group" for a determination year shall consist of the top 20% of employees ranked on the basis of compensation received during the year excluding employees described in Code (S) 414(q)(8) and Treasury regulations thereunder. The number of employees treated as officers shall be limited to 50 (or, if less, the greater of 3 employees or 10% of the employees). For purposes of this definition of "highly compensated employee", "compensation" means compensation within the meaning of Code (S) 415(c)(3), but including elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement, or tax-sheltered annuity.

(g) Notwithstanding the foregoing, for any year that the requirements set forth in Code Section 414(q)(12) and any regulations thereunder are satisfied, (a)(2) above shall be applied by substituting "$50,000" for "$75,000", and (a)(3) above shall not apply.

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III.9.5.B. Code (S) 401(k) Limitations on Compensation Deferrals.

(a) The Plan Administrator will estimate as soon as practicable before the close of the plan year and at such other times as the Plan Administrator in its discretion determines, the extent, if any, to which any participant or class of participants will have to reduce contributions under this Plan.

(b) For each plan year, an actual deferral percentage will be determined for each participant equal to the ratio of the total amount of the participant's salary deferrals under section 3.1 for the plan year divided by the participant's compensation in the plan year. In the case of family members treated as a single highly compensated employee under the definition of "highly compensated employee", in accordance with the family aggregation rules of Code (S) 414(q)(6), the actual deferral percentage shall be the greater of the (1) the actual deferral percentage determined by combining the compensation deferrals and compensation of all eligible family members who are highly compensated employees without regard to family aggregation, and (2) the actual deferral percentage determined by combining the salary deferrals and compensation of all eligible family members. Except to the extent taken into account in the preceding sentence, the deferrals and compensation of such family members shall be disregarded for purposes of this section. Except as otherwise provided in this paragraph (b), with respect to participants who have made no salary deferrals under this plan, such actual deferral percentage will be zero.

(c) The average of the actual deferral percentages for highly compensated employees ("high average") when compared with the average of the actual deferral percentages for non-highly compensated employees ("low average") must meet one of the following requirements:

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(1) The high average is no greater than 1.25 times the low average; or

(2) The high average is no greater than two times the low average and the high average is no greater than the low average plus two percentage points.

(d) If, pursuant to the estimates by the Plan Administrator under (a) and (b) above, a participant or class of participants is not eligible for salary deferral treatment for any or all of the amounts deferred, then the Plan Administrator may elect, at its discretion, to pursue any of the following courses of action or any combination thereof:

(1) Excess salary deferrals, and any earnings attributable thereto through the date of distribution, may be returned to the employer employing the participant, solely for the purpose of enabling the employer to withhold any federal, state, or local taxes due on such amounts. The employer will pay all remaining amounts to the participant within the 2-1/2 month period following the close of the plan year to which the excess salary deferrals relate to the extent feasible. but in all events no later than 12 months after the close of such plan year.

(2) The Plan Administrator may authorize a suspension or reduction of salary deferrals.

(3) The company, in its discretion, may make a contribution to the Plan, which will be allocated as a fixed dollar amount among the accounts of non-highly compensated employees who have met the requirements of section 2.1

(e) The amount of the excess salary deferrals will be determined by the Plan Administrator by reducing the actual deferral percentage of the highly compensated employee(s) with the highest actual deferral percentage to the extent required to enable the plan to meet the limits in (c) above or to cause the actual deferral percentage of such employee(s) to equal the actual deferral percentage of the highly compensated employee(s) with the next-highest actual

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deferral percentage. The process in the preceding sentence shall be repeated until the Plan satisfies the limits in (c) above. In the case of family members subject to the family aggregation rules of Code (S) 414(q)(6), excess salary deferrals will be allocated among family members in proportion to the salary deferrals of each family member that have been combined under section III.9.5.B.(b) above. Where the actual deferral percentage is determined under section III.9.5.B.(b)(1) above, however, excess salary deferrals will be allocated first among the eligible highly compensated employee family members in proportion to the salary deferrals of each such highly compensated employee family member until the actual deferral percentage of the eligible highly compensated employee family members has been reduced to the actual deferral percentage of the eligible non-highly compensated employee family members. If reduction of the actual deferral percentage below that of the eligible non-highly compensated employee family members is required under section III.9.5.B.(b)(1) to enable the plan to meet the limits in section III.9.5.B.(c) above, such further reduction shall take into account the salary deferrals of all eligible family members and shall be allocated among all such family members in proportion to their salary deferrals. The earnings attributable to excess salary deferrals will be determined in accordance with Treasury Regulations.

(f) In the discretion of the Plan Administrator, the tests described in this section may be applied by aggregating the Plan with any other defined contribution plans permitted under the Code.

III.9.5.C. Code (S) 401(m) Limitations on Employer Matching Contributions.

(a) For each plan year, a contribution percentage will be determined for each participant equal to the ratio of the total amount of the participant's employer matching contributions under section 4.1 for the plan year divided by the participant's compensation for the

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plan year. Any employer matching contributions or employer contributions treated as salary deferrals under section III.9.5.B.(b) shall not be used to satisfy the requirements of this Section III.9.5.B.(a), except as otherwise permitted by the Code or Treasury Regulations. In the case of family members treated as a single highly compensated employee under the definition of "highly compensated employee" in accordance with the family aggregation rules of Code (S) 414(q)(6), the contribution percentage shall be the greater of (1) the contribution percentage determined by combining the employer matching contributions and compensation of all eligible family members who are highly compensated employees without regard to family aggregation, and (2) the actual contribution percentage determined by combining the employer matching contributions and compensation of all eligible family members. Except to the extent taken into account in the preceding sentence, the employer matching contributions, compensation and all amounts treated as employer matching contributions of such family members shall be disregarded for purposes of this section III.9.5.C. Except as otherwise provided in this Section III.9.5.C.(b), with respect to participants and for whom there were no employer matching contributions under this plan, such contribution percentage will be zero.

(b) The average of the contribution percentages for highly compensated employees ("high average") when compared with the average of the contribution percentages for non-highly compensated employees ("low average") does not exceed the greater of:

(1) 1.25 times the low average; or

(2) The lesser of two times the low average, or the low average plus two percentage points.

(c) If the contribution percentage for any plan year for highly compensated employees exceeds the limits established in (b), the excess contributions for such plan year (and

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the earnings attributable to such excess contributions through the date of distribution) shall be distributed to the highly compensated employees so that the contribution percentage of the highly compensated employee(s) with the highest contribution percentage is reduced to the extent required to enable the plan to meet the limits in (b) above or to cause the contribution percentage of such employee(s) to equal the contribution percentage of the highly compensated employee(s) with the next-highest contribution percentage. The process in the preceding sentence shall be repeated until the plan satisfies the limits in (b) above. In the case of family members subject to the family aggregation rules of Code (S) 414(q)(6), excess contributions will be allocated among family members in proportion to the employer matching contributions of each family member that have been combined under section III.9.5.C.(a) above. Where the contribution percentage is determined under section III.9.5.C.(a)(1) above, however, excess employer matching contributions will be allocated first among the eligible highly compensated employee family members in proportion to the employer matching contributions of each such highly compensated employee family member until the contribution percentage of the eligible highly compensated employee family members has been reduced to the contribution percentage of the eligible non-highly compensated employee family members. If reduction of the contribution percentage below that of the eligible non-highly compensated employee family members is required under section III.9.5.C.(a)(1) to enable the plan to meet the limits in section A.3(b) above, such further reduction shall take into account the employer matching contributions of all eligible family members in proportion to their employer matching contributions. The earnings attributable to excess contributions will be determined in accordance with Treasury Regulations.

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(d) The tests of sections III.9.5.B.(c) and III.9.5.C.(b) shall be met in accordance with the prohibition against the multiple use of the alternative limitation under Code (S) 401(m)(9).

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APPENDIX IV

IV.18.A. TOP-HEAVY DEFINITIONS. The definitions relating to top-heavy plan provisions are as follows:

(a) Key Employee shall mean any employee or former employee (and the beneficiaries of such employee) who, in the plan year containing the determination date, or any of the four preceding plan years is:

(i) An officer of the employer having an annual compensation from the employer greater than 50 percent of the amount in effect under Code (S) 415(b)(1)(A) for any such plan year. Not more than fifty employees (or, if fewer, the greater of three employees or ten percent of the employees), including those employees included under subparagraph (ii), (iii) and (iv) below, shall be considered as officers for purposes of this subparagraph.

(ii) One of the ten employees having an annual compensation from the employer of more than the amount in effect under Code (S) 415(c)(1)(A) in the plan year and owning (or considered as owning within the meaning of Code (S) 318) the largest interests in the employer.

(iii) A five-percent owner of the employer.

(iv) A one-percent owner of the employer having an annual compensation (within the meaning of Code (S) 414(q)(7)) from the employer of more than $150,000 for a plan year.

Whether an employee is a five-percent owner or a one-percent owner shall be determined in accordance with Code (S) 416(i). If any individual has not performed services for the employer at any time during the five-year period ending on the determination date, any accrued benefit for such individual shall not be taken into account.

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(b) Top-Heavy Plan shall mean that this Plan is considered top-heavy for any plan year if any of the following conditions exists:

(i) If the top-heavy ratio for this Plan exceeds 60% and this Plan is not part of any required aggregation group or permissive aggregation group of plans.

(ii) If this Plan is a part of a required aggregation group of plans but not part of a permissive aggregation group and the top-heavy ratio for the group of plans exceeds 60%.

(iii) If this Plan is a part of a required aggregation group and part of a permissive aggregation group of plans and the top-heavy ratio for the permissive aggregation group exceeds 60%.

(c) Top-Heavy Ratios shall mean the ratios calculated as follows:

(i) If the employer maintains one or more defined contribution plans (including any simplified employee pension plan) and the employer has not maintained any defined benefit plan which during the 5-year period ending on the determination date(s) has or has had accrued benefits, the top-heavy ratio for this Plan alone or for the required or permissive aggregation group as appropriate is a fraction, the numerator of which is the sum of the account balances of all key employees as of the determination date(s) (including any part of any account balance distributed in the 5-year period ending on the determination date(s)), and the denominator of which is the sum of all account balances (including any part of any account balance distributed in the 5-year period ending on the determination date(s)), both computed in accordance with Code (S) 416 and the regulations thereunder. Both the numerator and denominator of the top-heavy ratio are adjusted to reflect any contribution not actually made as

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of the determination date, but which is required to be taken into account on that date under Code (S) 416 and the regulations thereunder.

(ii) If the employer maintains one or more defined contribution plans (including any simplified employee pension plan) and the employer maintains or has maintained one or more defined benefit plans which during the

5-year period ending on the determination date(s) has or has had any accrued benefits, the top-heavy ratio for any required or permissive aggregation group as appropriate is a fraction, the numerator of which is the sum of account balances under the aggregated defined contribution plan or plans for all key employees, determined in accordance with (i) above, and the present value of accrued benefits under the aggregated defined benefit plan or plans for all key employees as of the determination date(s), and the denominator of which is the sum of the account balances under the aggregated defined contribution plan or plans for all participants, determined in accordance with (i) above, and the present value of accrued benefits under the defined benefit plan or plans for all participants as of the determination date(s), all determined in accordance with Code (S) 416 and the regulations thereunder. The accrued benefits under a defined benefit plan in both the numerator and denominator of the top-heavy ratio are adjusted for any distribution of an accrued benefit made in the five-year period ending on the determination date.

(iii) For purposes of (i) and (ii) above the value of account balances and the present value of accrued benefits will be determined as of the most recent valuation date that falls within or ends with the 12-month period ending on the determination date, except as provided in Code (S) 416 and the regulations thereunder for the first and second plan years of a defined benefit plan. The account balances and accrued benefits of a participant (1) who is not a key employee but who was a key employee in a prior year, or (2) who has not been credited with

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at least one hour of service with any employer maintaining the Plan at any time during the 5-year period ending on the determination date will be disregarded. The calculation of the top-heavy ratio, and the extent to which distributions, rollovers, and transfers are taken into account will be made in accordance with Code (S) 416 and the regulations thereunder. Deductible employee contributions will not be taken into account for purposes of computing the top-heavy ratio. When aggregating plans the value of account balances and accrued benefits will be calculated with reference to the determination dates that fall within the same calendar year.

(d) Permissive Aggregation Group shall mean the required aggregation group of plans plus any other plan or plans of the employer which, when considered as a group with the required aggregation group, would continue to satisfy the requirements of Code (S)(S) 401(a) (4) and 410.

(e) Required Aggregation Group shall mean each qualified plan of the employer in which at least one key employee participates or participated at any time during the determination period (regardless of whether the plan has terminated), and any other qualified plan of the employer which enables such a plan to ,meet the requirements of Code (S) 401(a)(4) or (S) 410.

(f) Determination Date shall mean for any plan year subsequent to the first plan year, the last day of the preceding plan year; for the first plan year of the Plan, the last day of that year.

(g) Valuation Date shall mean the date as of which account balances or accrued benefits are valued for purposes of calculating the top-heavy ratio.

(h) Present value shall be based only on the interest and mortality rates specified in the adoption agreement.

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IV.18.B. MINIMUM ALLOCATION.

The employer contributions and forfeitures allocated on behalf of any participant employed on the last day of the plan year, who is not a key employee, shall not be less than the lesser of three percent of such participant's compensation or in the case where the employer has no defined benefit plan which designates this plan to satisfy Code (S) 401, the largest percentage of employer contributions and forfeitures, as a percentage of the first $160,000 (or the adjusted limitation under Code (S) 401(a)(17)) of the key employee's compensation, allocated on behalf of any key employee for that year. If the highest rate allocated to a key employee for a year in which the Plan is top heavy is less than 3%, amounts contributed as a result of a salary deferral agreement shall be included in determining contributions made on behalf of key employees. The minimum allocation is determined without regard to any Social Security contribution. This minimum allocation shall be made even though, under other plan provisions, the participant would not otherwise be entitled to receive an allocation, or would have received a lesser allocation for the year because of (1) the participant's failure to complete 1,000 hours of service (or any equivalent provided in the Plan), or (2) the participant's failure to make mandatory employee contributions to the Plan, or (3) compensation less than a stated amount. An allocation under this section shall not be made if the participant is covered under any other plan or plans of the employer and the minimum allocation or benefit requirement applicable to top-heavy plans will be met in the other plan or plans. The definition of compensation in section 1.3 of the Plan shall be the definition for determining minimum allocations under this section. This definition shall be used for all top-heavy purposes, including determining whether an employee is a key employee.

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APPENDIX V

SPECIAL PROVISIONS FOR ACCOUNTS OR PARTICIPANTS TRANSFERRED

FROM OTHER PLANS IN CONNECTION WITH PLAN

MERGERS OR TRUST-TO-TRUST TRANSFERS

A. Former Accounts and Participants of the Vermeer Technologies 401(k) Plan

1. History of Corporate Merger. On January 12, 1996, Vermeer Technologies, Inc. merged with a wholly-owned subsidiary of Microsoft Corporation, and the merged entity remained a wholly-owned subsidiary of Microsoft. On February 21, 1996 the name of the subsidiary (i.e., the merged entity) was changed from Vermeer Technologies, Inc. to Microsoft Web Authoring Product Unit, Inc. ("MWAPUI"). On March 26, 1996 the name of the subsidiary was changed back to Vermeer Technologies, Inc. ("VTI"). At the time of the merger, VTI was the plan sponsor of the Vermeer Technologies 401(k) Plan ("V-Plan"). After the merger, VTI employees continued to actively participate in the V-Plan.

2. Plan Merger. Effective April 1, 1996, the V-Plan is merged into the Microsoft Corporation Savings Plus 401(k) Plan ("Plan"), and this plan document for the plan, as amended previously and by this Amendment, is the surviving plan document.

Only employee 401(k) salary deferrals and rollovers have been contributed to the V-Plan; no employer matching or discretionary profit sharing contributions have ever been made to the V-Plan. The only accounts which participants have in the V-Plan are 401(k) salary deferral and rollover accounts ("V-Accounts"), both of which are and always have been nonforfeitable. The V-Accounts are transferred to the Plan without alteration and shall be kept separate from other accounts held in the Plan by former V-Plan participants. The V-Accounts shall only contain amounts transferred from the V-Plan, and shall always be kept separate from the salary deferral,

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matching and rollover accounts that former V-Plan participants have after April 1, 1996. However, each former V-Plan participant's V-Plan salary deferral and rollover account (if any) may be consolidated into one V-Account at the Plan Administrator's discretion if the accounts have identical rights, features, conditions, and limits.

3. Eligibility. The age 18 minimum age requirement set forth in Plan Section 2.1 shall not apply to any person who was ever employed by MWAPUI or VTI on or before April 1, 1996. Every employee of VTI who on April 1, 1996 is an eligible employee (as defined in Section 1.5 of the Plan) shall immediately begin active participation in the Plan without having to satisfy the age 18 minimum age requirement set forth in Plan Section 2.1. Any participant in the V-Plan on April 1, 1996 who is not an eligible employee as defined in Plan Section 1.5 shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee. Any person who is employed by VTI on April 1, 1996 but is neither a participant in the V-Plan nor an eligible employee as defined in Plan Section 1.5 shall become a participant in the Plan if and when they become an eligible employee. Any person employed by VTI after April 1, 1996 who was not employed by VTI or MWAPUI at any time on or before April 1, 1996 shall be required to satisfy all of the eligibility conditions of Plan Sections 1.5 and 2.1, including the age 18 minimum age requirement.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their V-Accounts which are transferred to the Plan effective April 1, 1996. For purposes of determining their vested percentage in their employer matching contribution account in this Plan, participants shall be credited with the whole years of vesting service credited to them under the V-Plan as of December 31, 1995. Beginning with the 1996 plan year (commencing January 1, 1996), the participant shall begin to earn vesting service credit under the elapsed time method as

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set forth in Article V of the Plan. In addition, if a participant worked at least 1,000 hours between January 1, 1996 and March 31, 1996, the participant shall be credited with one year of service for 1996 even if they do not work every day in 1996. Notwithstanding anything in this Subsection 4 to the contrary, a participant who is described in the previous sentence shall not begin to earn credit under the elapsed time method of Article V until the 1997 plan year (commencing January 1, 1997).

5. Special Provisions Applicable to the V-Accounts. The following special provisions apply only to the V-Accounts. With respect to the V-Accounts, the following special provisions shall supersede any other provisions of this Plan which are inconsistent with the following provisions.

6. Form of Benefit Payments. The participant may elect to have his or her V-Accounts distributed in a single lump sum payment or in installments, and in cash or in kind. If the participant elects an in-kind distribution, the participant's interest in the investments of his or her V-Accounts shall be distributed in-kind. For example, if a participant's V-Account were invested 50% in the Microsoft Stock Fund and 50% in the Magellan Fund and the participant requested an in-kind distribution, the participant would receive half of her account in the form of Microsoft stock and the other half of her account in units of interest in the Magellan mutual fund (less any applicable tax withholding). Participants may elect to have their V-Accounts distributed in installments over a period not to exceed the participant's life expectancy or the joint life expectancies of the participant and the participant's designated beneficiary. The participant may elect to have the installments paid monthly, quarterly, semi-annually or annually. If at the time of distribution to a participant or beneficiary the participant's total vested account balance in the Plan (including V-Accounts and other accounts) does not exceed $5,000 (and never exceeded

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$5,000 at the time of a prior distribution), then the V-Account balance will be distributed in an immediate lump sum and installment payments will not be a payment option.

7. Timing of Benefit Payments. Upon a participant's termination of employment for reasons other than death, the participant's V-Account shall be distributed as soon as possible after the account is valued. The distribution shall be in cash or in kind, as elected by the participant. If a participant's total vested account balance in the Plan (including V-Accounts and other accounts) exceeds $5,000 at the time of distribution (or ever exceeded $5,000 at the time of a prior distribution), then the participant may elect to delay receipt or commencement of his or her V-Account until any date on or before the date the participant reaches age 70 1/2. Any delayed distribution must comply with the requirements of Code Section 401(a)(9) and the regulations thereunder (including without limitation the incidental death benefit requirements). If the participant with total vested plan account balance in excess of $5,000 does not select a distribution date, the participant's V-Account shall be distributed as soon as practicable after the participant reaches age 65 or terminates employment, whichever occurs last.

The timing of the distribution of the V-Account upon a participant's death shall depend upon whether the participant died before or after the commencement of his or her benefit payments, and whether the participant was survived by a beneficiary who was designated by the participant. If a participant dies prior to the commencement of the distribution of his or her V-Account and is survived by a designated beneficiary who is not his or her spouse, the distribution must be made by December 31 of the calendar year in which the fifth anniversary of the participant's death occurs unless the beneficiary elects to have installment payments commence by the end of the first calendar year after the participant's death. If the designated beneficiary is the participant's spouse, then the same distribution rules described in the previous sentence apply,

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except that the spouse may elect to delay distribution or commencement of installment payments until the end of the calendar year in which the participant would have attained age 70 1/2. Notwithstanding the foregoing, if the participant dies before benefit payments from the Plan have commenced to the participant and his or her vested account balance in the Plan does not exceed $5,000 (and have never exceeded $5,000 at the time of a prior distribution), distribution to the beneficiary shall be made in an immediate lump sum payment in cash or in kind, as elected by the beneficiary. If the participant dies before benefit payments have commenced, the participant's total vested account balance in the Plan (including V-Accounts and other accounts) exceeds $5,000 (or exceeded $5,000 at the time of a prior distribution), and the death beneficiary is not a designated beneficiary, distribution of the participant's V-Account balance will be made in a lump sum or installment payments (e.g., installment payments over four years) as elected by the beneficiary provided, however, that the total V-Account balance must be distributed no later than December 31 of the calendar year in which the fifth anniversary of the participant's death occurs.

If the participant died while he was receiving installment payments of his V-Account, the remaining portion of the V-Account shall be distributed at least as rapidly as under the length and frequency of installment payments which the participant had selected.

Distributions to beneficiaries may be made in cash or in kind, at the election of the beneficiary.

Notwithstanding the foregoing, upon the death or termination of employment of a participant with a vested total account balance in the Plan in excess of $5,000, neither the participant nor his or her surviving spouse death beneficiary may delay distribution beyond the date the participant attains (or would have attained) age 65. Any references to age 70 1/2 in this

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Subsection 7 shall be replaced with a reference to age 65. This paragraph shall not be effective unless and until the Plan receives a favorable determination letter from the Internal Revenue Service stating that this Amendment will not adversely affect the tax-qualified status of the Plan.

8. Plan Loans. Any loans to a participant which are outstanding on April 1, 1996 shall be transferred in kind along with the rest of the participant's V-Accounts. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her V-Plan loan documents.

B. Former Accounts and Participants of the eShop Inc. 401(k) Savings Plan

1. History of Corporate Merger. On June 20, 1996, eShop Inc. was merged into Microsoft Corporation, with Microsoft Corporation being the surviving corporation. After the corporate merger, certain former employees of eShop Inc. became employees of Microsoft Corporation. As a result of the corporate merger, Microsoft Corporation became the plan sponsor and administrator of the eShop Inc. 401(k) Savings Plan ("E-Plan"), a tax-qualified profit sharing plan which has a 401(k) feature. Although the E-Plan provides for discretionary employer contributions (e.g., profit sharing and matching contributions), only employee salary deferral contributions and rollover contributions have been made to the E-Plan. The E-Plan was frozen as of June 20, 1996, and former eShop Inc. employees stopped making salary deferral contributions to the E-Plan effective June 20, 1996. The former eShop Inc. employees will begin making salary deferral contributions to the Microsoft Corporation Savings Plus Plan ("Plan") effective August 1, 1996.

2. Plan Merger. Effective November 1, 1996, the E-Plan is merged into the Plan, and this plan document for the Plan, as amended previously and by this

Amendment, is the surviving plan document. Although the E-Plan provides for discretionary employer

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contributions (e.g., profit sharing and matching contributions), only employee salary deferral contributions and rollover contributions have been made to the E-Plan; no employer matching or discretionary profit sharing contributions have ever been made to the E-Plan. The only accounts ("E-Accounts") which participants have in the E-Plan are a 401(k) salary deferral account ("Deferral E-Account") and a rollover contribution account ("Rollover E-Account") containing amounts which the participant had rolled into the E-Plan from another plan or IRA. The E-Accounts are and always have been nonforfeitable. The E-Accounts are transferred to the Plan without alteration. The Rollover E-Account shall only contain amounts transferred from the E-Plan and shall always be kept separate from the salary deferral, matching and rollover accounts that former E-Plan participants have in this Plan after August 1, 1996. The Deferral E-Account shall be merged with the former E-Plan participant's new salary deferral account in the Plan which will hold deferrals which are made from salary earned on or after August 1, 1996.

3. Eligibility. The age 18 minimum age requirement set forth in Plan Section 2.1 shall not apply to any person who was ever employed by eShop Inc. (previously known as Ink Development Corporation). Every former employee of eShop Inc. or Ink Development Corporation who on or after August 1, 1996 is an eligible employee (as defined in Section 1.5 of the Plan) shall immediately begin active participation in the Plan without having to satisfy the age 18 minimum age requirement set forth in Plan Section 2.1. Any participant in the E-Plan on November 1, 1996 who is not an eligible employee as defined in Plan Section 1.5 shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee. Any person who is employed on November 1, 1996 but is neither a participant in the E-Plan nor an eligible employee as defined in Plan Section 1.5 shall become a participant in the Plan if and when they become an eligible employee.

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4. Vesting and Vesting Service Credit. Participants are 100% vested in their E-Accounts which are transferred to the Plan effective November 1, 1996. For purposes of determining their vested percentage in their employer matching contribution account in this Plan, participants shall be credited with the whole years of vesting service credited to them under the E-Plan as of December 31, 1995. Beginning with the 1996 plan year (commencing January 1, 1996), the participant shall begin to earn vesting service credit under the elapsed time method as set forth in Article V of the Plan. In addition, if a participant worked at least 1,000 hours between January 1, 1996 and October 31, 1996, the participant shall be credited with one year of service for 1996 even if they do not work every day in 1996. Notwithstanding anything in this Subsection 4 to the contrary, a participant who is described in the previous sentence shall not begin to earn credit under the elapsed time method of Article V until the 1997 plan year (commencing January 1, 1997).

5. Special Provision Applicable to the Rollover E-Account. A participant may elect to withdraw from the Rollover E-Account once during each plan year, any amount up to 100% of the value of the Rollover E-Account. The participant shall notify the plan administrator of his election to make a withdrawal under this Section. The distribution will be made as soon as reasonably practicable after such notice is given.

6. Plan Loans. Any loans from the E-Plan to an E-Plan participant which are outstanding on November 1, 1996 shall be transferred to the Plan in kind as an asset allocated to the participant's E-Accounts. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her E-Plan loan documents.

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C. Former Accounts and Participants of Dimension X 401(k) Plan

1. History of Corporate Merger. On May 14, 1997, Dimension X was merged with DX Acquisition Inc., a wholly-owned subsidiary of Microsoft Corporation, with Dimension X being the surviving corporation and becoming a wholly-owned subsidiary of Microsoft Corporation. Over several months after the corporate merger, the employees of Dimension X became employees of Microsoft Corporation. At the time of the merger with DX Acquisition Inc., Dimension X was the sponsor of the Dimension X 401(k) Plan ("D-Plan"). The plan remained in existence after Dimension X was merged into the DX Acquisition Inc.

2. Plan Merger. Effective January 1, 1998, the D-Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document.

The D-Plan contains employee salary deferral contributions, and employer discretionary matching contributions. No employee after-tax contributions were made, nor were any employer discretionary contributions made. As of January 1, 1998, there were no roll-over accounts maintained in the D-Plan. The salary deferral contributions have always been nonforfeitable. The employer matching contributions are 100% vested pursuant to the amendment to the Dimension X 401(k) Plan effective April 1, 1997. The employer matching D-accounts and the salary deferral D-accounts are transferred to the Plan without alteration. At the discretion of the Plan Administrator, these D-accounts may be consolidated with other accounts made to the Plan by former D-Plan participants after the date of the plan merger.

3. Eligibility. Any participant in the Dimension X 401(k) Plan on May 14, 1997 who on January 1, 1998 is an eligible employee (as defined in Section 1.5 of the Plan) and who has not previously entered the Plan shall begin active participation in the Plan on January 1,

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1998, the date of the merger of the plans. Such participant shall not be required to satisfy the age 18 minimum age requirement set forth in Plan Section 1.5 nor be required to be employed through an entry date. A participant for these purposes shall include a person who maintained an account balance in the Dimension X 401(k) Plan or who was eligible to make deferrals under the Dimension X 401(k) Plan.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their D-accounts which are transferred to the Plan effective January 1, 1998. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (i.e., matching contributions made by Microsoft Corporation after January 1, 1998), participants shall be credited with the whole years of service credited to them under the D-Plan as of their

last computation date prior to January 1, 1998. For the period of time from the last computation date prior to January 1, 1998 until the next computation date following January 1, 1998, the participant shall be credited with the greater of: (1) the period of service that would be credited to the employee under the elapsed time method as set forth in Article V of the Plan for his service during the 12 month period following the participant's last computation date which is prior to January 1, 1998; or (2) a year of service if the participant worked at least 1,000 hours between his/her last computation date before January 1, 1998 and January 1, 1998. For these purposes, a computation date shall be the anniversary date of a participant's first date of employment with Dimension X. Beginning on the last day of the period described in (1) or (2) of the third sentence of this subsection 4, whichever is applicable, a participant shall earn vesting credit under the elapsed time method set forth in Article V of the Plan.

5. Special Provisions Applicable. There are no special provisions applicable to D-accounts.

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6. Plan Loans. Any loans from the D-Plan to a D-Plan participant which are outstanding on January 1, 1998 shall be transferred to the Plan in kind as an asset allocated to the participant's D-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her D-Plan loan documents.

D. Former Accounts and Participants of VXtreme, Inc. 401(k) Retirement Plan

1. History of Corporate Merger. On July 30, 1997, VXtreme, Inc. ("VXtreme") was merged with Microsoft Investments Washington Parent, Inc., a wholly owned subsidiary of Microsoft Corporation with VXtreme being the surviving corporation and becoming a wholly-owned subsidiary of Microsoft Corporation. At the time of the merger, VXtreme sponsored a profit sharing plan with a 401(k) component, the VXtreme, Inc. 401(k) Retirement Plan ("VX-Plan"). Although the VX-Plan continued in existence after the corporate merger, most of the employees of VXtreme after the merger became employees of Microsoft Corporation.

2. Plan Merger. Effective January 1, 1998, the VX-Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document.

The VX-Plan contains only salary deferral contributions, and roll-over contributions ("VX-Accounts"). The VX-Plan does not provide for employer contributions nor employee after-tax contributions, nor has it ever provided for such contributions in the past. The salary deferral contributions and the roll-over contributions to the VX-Plan have always been nonforfeitable. The salary deferral VX-Accounts and the roll-over VX-Accounts are transferred to the Plan without alteration. The salary deferral VX-Accounts and the roll-over VX-Accounts shall be consolidated with each other (hereinafter collectively referred to as VX-Accounts),

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however, they will be kept separate from any contributions made to the Plan by or on behalf of former VX-Plan participants after January 1, 1998.

3. Eligibility. Any employee of VXtreme on January 1, 1998 who is an

eligible employee (as defined in Section 1.5 of the Plan) shall begin active participation in the Plan on January 1, 1998, the date of the merger of the plans. Any participant of the VX-Plan on January 1, 1998 who is not an eligible employee as defined in Plan Section 1.5 (e.g., an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan section 1.5. Such former participant in the VX-Plan shall not be required to be employed through an entry date before he/she can become a participant under the Plan. Any person employed by VXtreme after January 1, 1998 who was not employed by VXtreme at any time on or before January 1, 1998 shall be required to satisfy all of the eligibility conditions of Plan Sections 1.5 and 2.1, and must be employed through an entry date before he/she will become a participant under the Plan.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their VX-Accounts which are transferred to the Plan effective January 1, 1998. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (i.e., matching contributions made by Microsoft Corporation after January 1, 1998), participants shall be credited with vesting service under the elapsed time method as set forth in Article V of the Plan for their service at VXtreme.

5. Special Provisions Applicable. The following special provisions apply only to the VX-Accounts. With respect to the VX-Accounts, the following special provisions shall supersede any other provisions of this Plan which are inconsistent with the following provisions. However, to the extent the Plan is amended subsequent to this amendment in a way which gives

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participants greater benefits or additional options not provided in this section, participants with a VX-Account shall be eligible for those additional benefits or options without violating this section.

6. Form of Benefit Payments. Unless the participant makes an election otherwise, the participant (or beneficiary) shall receive the distribution of his or her VX-Account in the form of a lump-sum. The participant may however, elect to receive distributions from his or her VX-Account in the form of an annuity. There are five different annuity options that a participant may choose. These are: (1) a straight life annuity; (2) a single life annuity with a certain period of 5, 10, or 15 years; (3) a single life annuity with an installment refund; (4) a joint and survivor annuity with an installment refund and survivor percentages of 50, 66 and 2/3, or 100; or (5) a fixed period annuity for any period of whole months which is not less than 60 and does not exceed the joint life expectancies of the participant and the named beneficiary. If a participant chooses a life annuity form of distribution, the provisions of Article XX of the Plan shall apply. If at the time of distribution to a participant or beneficiary the participant's total vested account balance in the Plan (including VX-Account and other accounts) does not exceed $5,000 (and never exceeded $5,000 at the time of a prior distribution), the VX-Account balance will be distributed in an immediate lump-sum cash payment.

7. Plan Loans. Any loans from the VX-Plan to a VX-Plan participant which are outstanding on January 1, 1998 shall be transferred to the Plan in kind as an asset allocated to the participant's VX-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her VX-Plan loan documents. If a participant in the VX-Plan requests a loan after January 1, 1998 of a

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of his or her VX-Account, spousal consent will not be required unless the participant has selected a life annuity form of distribution with respect to his or her VX-Account balance.

E. Former Accounts and Participants of WebTV 401(k) Plan

1. History of Corporate Merger. On August 1, 1997, Microsoft Corporation purchased a controlling interest in WebTV Networks, Inc. ("WebTV"). Through a recapitalization, WebTV became a controlled subsidiary of Microsoft Corporation. WebTV remained in existence after the recapitalization and WebTV employees continued to be employed by WebTV. At the time of the recapitalization, WebTV sponsored the WebTV 401(k) Plan (the "W-Plan"). The W-Plan continued in existence after the recapitalization of WebTV and employees of WebTV continued to participate in the W-Plan.

2. Plan Merger. Effective March 1, 1998, the W-Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document.

The W-Plan contains only employee salary deferral contributions, and roll-over contributions ("W-Accounts"). No employee after-tax, employer matching, or employer discretionary contributions were ever made to the W-Plan. The salary deferral contributions and the roll-over contributions to the W-Plan have always been nonforfeitable. The salary deferral W-Accounts and the roll-over W-Accounts are transferred to the Plan without alteration. The salary deferral W-Accounts and the roll-over W-Accounts shall be consolidated with each other, however, they will be kept separate from any contributions made to the Plan by or on behalf of former W-Plan participants after March 1, 1998.

3. Eligibility. Any employee of WebTV on March 1, 1998 who is an eligible employee (as defined in Section 1.5 of the Plan) and who has not previously entered the Plan

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shall begin active participation in the Plan on March 1, 1998, the date of the merger of the plans. Any participant of the W-Plan on March 1, 1998 who is not an eligible employee as defined in Plan Section 1.5 (e.g., an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan section 1.5. Such former participant in the W-Plan shall not be required to be employed through an entry date before he/she can become a participant in the Plan. Any person employed by WebTV after March 1, 1998 who was not employed by WebTV at any time on or before March 1, 1998 shall be required to satisfy all of the eligibility conditions of Plan Sections 1.5 and 2.1, and must be employed through an entry date before he/she will become a participant under the Plan.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their W-Accounts which are transferred to the Plan effective March 1, 1998. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (i.e., matching contributions made after March 1, 1998), participants shall be credited with the whole years of service credited to them under the W-Plan as of March 31, 1997. For the 12-month period

of time commencing on April 1, 1997, the participant shall be credited with the greater of: (1) the period of service that would be credited to the employee under the elapsed time method as set forth in Article V of the Plan for his service during the 12 month period ending March 31, 1998; or (2) a year of service if the participant worked at least 1,000 hours between April 1, 1997 and March 1, 1998 even if they did not work every day during this period. Beginning March 31, 1998, participants shall earn vesting credit under the elapsed time method set forth in Article V of the Plan.

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5. Special Provisions Applicable. The following special provisions apply only to the W-Accounts. With respect to the W-Accounts, the following special provisions shall supersede any other provisions of this Plan which are inconsistent with the following provisions. However, to the extent the Plan is amended subsequent to this amendment in a way which gives participants greater benefits or additional options not provided in this section, participants with a W-Account shall be eligible for those additional benefits or options without violating this section.

6. Form of Benefit Payments. The participant may elect to have his or her W-Account distributed in a single lump sum payment or in installments, in cash or in kind or in a combination of both. Participants may elect to have their W-Accounts distributed in substantially equal installments over a period which is no longer than the participant's life expectancy or the joint life expectancy of the participant and the participant's designated beneficiary. If at the time of distribution to a participant or beneficiary the participant's total vested account balance in the Plan (including the W-Account and other accounts) does not exceed $5,000 (and never exceeded $5,000 at the time of a prior distribution), then the W-Account balance will be distributed in an immediate lump sum payment, in cash or in kind or a combination of both, as elected by the participant or beneficiary.

7. Plan Loans. Any loans from the W-Plan to a W-Plan participant which are outstanding on March 1, 1998 shall be transferred to the Plan in kind as an asset allocated to the participant's W-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her W-Plan loan documents.

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F. Former Accounts and Participants of Hotmail Corporation 401(k) Plan

1. History of Corporate Merger. On December 30, 1997 Hotmail Corporation was merged with Micro HM Inc., a wholly-owned subsidiary of Microsoft Corporation, with Hotmail Corporation being the surviving corporation and becoming a wholly-owned subsidiary of Microsoft Corporation. At the time of the merger with Micro HM Inc., Hotmail Corporation was the sponsor of the Hotmail Corporation 401(k) Plan ("H-Plan"). The plan remained in existence after Hotmail Corporation was merged into Micro HM Inc.

2. Plan Merger. Effective April 1, 1998, the H-Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document.

The H-Plan contains employee salary deferral contributions and rollover contributions only ("H-Accounts"). No employee after-tax contributions were made, nor were any employer matching or discretionary contributions made. The salary deferral accounts and the rollover accounts have always been nonforfeitable. The salary deferral accounts and the rollover accounts are transferred to the Plan without alteration. At the discretion of the Plan Administrator, these H-Accounts (the salary deferral accounts and the rollover accounts) may be consolidated with each other, however, they will be kept separate from any contributions made to the Plan by or on behalf of former H-Plan participants after April 1, 1998.

3. Eligibility. Any employee of Hotmail Corporation who on April 1, 1998 is a participant in the Hotmail Corporation 401(k) Plan and is an eligible employee (as defined in Section 1.5 of the Plan) shall begin active participation in the Plan on April 1, 1998, the date of the merger of the plans. Such participant shall not be required to be employed through an entry date as set forth in Plan Section 2.4. A participant for these purposes shall include a person who

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maintained an account balance in the Hotmail Corporation 401(k) Plan or who was eligible to make deferrals under the Hotmail Corporation 401(k) Plan. Any participant of the H-Plan on April 1, 1998 who is not an eligible employee as defined in Plan Section 1.5 (e.g., an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan Section 1.5. Such former participant in the H-Plan shall not be required to be employed through an entry date before he/she can become a participant in the Plan. Any person employed by Hotmail Corporation after April 1, 1998 who was not employed by Hotmail Corporation at any time on or before April 1, 1998 shall be required to satisfy all of the eligibility conditions of Plan Sections 1.5 and 2.1, and must be employed through an entry date before he/she will become a participant under the Plan.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their H-Accounts which are transferred to the Plan effective April 1, 1998. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (i.e., matching contributions made by Microsoft Corporation after April 1, 1998), participants shall be credited with vesting service under the elapsed time method as set forth in Article V of the Plan for their service at Hotmail Corporation. The H-Plan did not calculate vesting service because all contributions were 100% vested when made.

5. Special Provisions Applicable. The following special provisions apply only to the H-Accounts. With respect to the H-Accounts, the following special provisions shall supersede any other provisions of this plan which are inconsistent with the following provisions. However, to the extent the Plan is amended subsequent to this amendment in a way which gives participants greater benefits or additional options not provided in this section, participants with

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an H-Account shall be eligible for those additional benefits or options without violating this section.

6. Form of Benefit Payments. Unless the participant makes an election otherwise, the participant (or beneficiary) shall receive the distribution of

his or her H-Account in the form of a lump-sum, either in cash or in kind or in a combination of both. The participant may, however, elect to receive distributions from his or her H-Accounts in the form of installments payable in cash or in kind, or part in cash and part in kind over a period not in excess of that required to comply with Code (S)401(a)(9). If at the time of distribution to the participant or beneficiary the participant's total vested account balance in the Plan (including H-Accounts and all other accounts) does not exceed $5,000 (and never exceeded $5,000 at the time of a prior distribution), then the H-Account balance will be distributed in an immediate lump sum payment, in cash or in kind or a combination of both, as elected by the participant or beneficiary.

7. Plan Loans. Any loans from the H-Plan to an H-Plan participant which are outstanding on April 1, 1998 shall be transferred to the Plan in kind as an asset allocated to the participant's H-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her H-Plan loan documents.

G. Former Accounts and Participants of MSNBC Interactive News 401(k) Plan

1. History of Establishment of MSNBC Interactive News L.L.C. MSNBC Interactive News L.L.C. was established in 1996 as a joint venture between Microsoft Corporation (and certain of its affiliates) and National Broadcast Company (and certain of its affiliates). MSNBC Interactive News L.L.C. sponsors the MSNBC Interactive News 401(k) Plan

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("MSNBC Plan"), and such plan provides service credit for vesting purposes to former employees of National Broadcast Company.

2. Plan Merger. Effective January 1, 1999, the MSNBC Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document.

The MSNBC Plan contains employee salary deferral contributions, employer matching contributions, employee after-tax contributions, and rollover contributions ("MSNBC-Accounts"). The MSNBC-Accounts are hereby made 100% vested, and are transferred without alteration and shall be kept separate from the other Plan accounts. However, the Plan Administrator may, in his discretion, combine certain portions of the MSNBC-Accounts with the other Plan accounts (e.g., MSNBC salary deferrals with Plan salary deferrals, MSNBC after-tax contributions with Plan after-tax contributions) to the extent such combinations comply with the terms of the Plan and applicable laws. Except to the extent permitted by tax regulations (including Treasury Regulation (S)1.411(d)-4), amounts transferred from the MSNBC Plan that are attributable to elective contributions (as defined in Treasury Regulation (S)1.401(k)-1(g)(3)), including amounts treated as elective contributions, shall be subject to the distribution limitations provided for in Treasury Regulation (S)1.401(k)-1(d).

3. Eligibility. Any employee of the MSNBC Interactive News L.L.C. who on December 31, 1998 is a participant in the MSNBC Plan and who on January 1 or 2, 1999 is an eligible employee (as defined in Section 1.5 of the Plan) shall begin active participation in the Plan on January 1, 1999. A participant for these purposes shall include a person who maintained an account balance in the MSNBC Plan or who was eligible to make deferrals under the MSNBC Plan. Any participant of the MSNBC Plan who on January 1 or 2, 1999 is not an eligible

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employee as defined in Plan Section 1.5 (e.g., a temporary employee, an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan Section 1.5. Such former participant in the MSNBC Plan shall not be required to be employed through an entry date before he/she can become a participant in the Plan. Any person employed by the MSNBC Interactive News L.L.C. after January 2, 1999, who was not employed by MSNBC Interactive News L.L.C. at any time on or before January 2, 1999 shall be required to satisfy all of the eligibility conditions of Plan Sections 1.5 and 2.1, and must be employed through an entry date before he/she will become eligible to participate in the Plan.

4. Vesting and Vesting Service Credit. Participants in the MSNBC Plan on December 31, 1998 are 100% vested in their MSNBC-Accounts that are transferred to the Plan effective January 1, 1999, and are 100% vested in their employer matching contribution accounts in the Plan going forward. For purposes of determining the vested percentage in the employer matching contribution account in this Plan (i.e., matching contributions made by MSNBC after January 1, 1999) for employees who are not participants in the MSNBC Plan on December 31, 1998 (e.g., those hired by MSNBC Interactive News L.L.C. after December 31, 1998), such employees shall be credited with vesting service under the elapsed time method as set forth in Article V of the Plan for their service at MSNBC Interactive News L.L.C. and, for employees of MSNBC Interactive News L.L.C., service with National Broadcast Company. Service with National Broadcast Company shall not be counted for those employed by Microsoft Corporation or other affiliates thereof unless the employee worked for MSNBC Interactive News L.L.C. between working for National Broadcast Company and Microsoft Corporation or its affiliates.

5. Special Provisions Applicable. There are no special provisions applicable to the MSNBC-Accounts.

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H. Former Accounts and Participants of Virtual World Entertainment Group, Inc. Employees 401(k) Plan

1. History of Corporate Merger. On January 11, 1999, Virtual World Entertainment Group, Inc. ("VWEG") was merged with a wholly-owned subsidiary of Microsoft Corporation, and VWEG was the surviving corporation. FASA Interactive Technology, Inc. ("FASA") remained a wholly-owned subsidiary of VWEG. Since the corporate merger, neither VWEG nor FASA have had any employees. At the time of the merger, VWEG was the sponsor of the Virtual World Entertainment Group, Inc. Employees 401(k) Plan ("VWEG Plan"), and FASA was a participating employer in the VWEG Plan. The VWEG Plan remained in existence after the corporate merger.

2. Plan Merger and Asset Transfer. Effective July 1, 1999, the VWEG-Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document. Upon the Plan Administrator's receipt of satisfactory evidence that (i) Virtual World Entertainment, LLC ("VWE") has established a defined contribution plan that is tax-qualified under Code Section 401(a), (ii) VWE wants its plan to receive a plan-to-plan transfer, and (iii) VWE's plan has been drafted to receive a plan-to-plan transfer in compliance with Code Sections 414(l) and 411(d)(6) and the treasury regulations thereunder, any assets and liabilities with respect to the VWEG-Accounts of persons currently employed by VWE shall be transferred to VWE's plan.

The VWEG-Plan contains employee salary deferral contributions, employer matching contributions and rollover contributions only ("VWEG-Accounts"). Employee after-tax contributions were not permitted. The salary deferral accounts and the rollover accounts have always been nonforfeitable. The employer matching account has been subject to a vesting

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schedule. Effective July 1, 1999, all assets in the Plan as of such date are hereby made 100% vested. The salary deferral and employer match accounts are transferred to the Plan without alteration. At the discretion of the Plan Administrator, these VWEG-Accounts (the salary deferral and match accounts) may be consolidated with the respective Microsoft salary deferral and match accounts. The rollover accounts shall be kept in a separate acquisition rollover account.

3. Eligibility. Any participant of the VWEG-Plan on July 1, 1999 who is not an eligible employee as defined in Plan Section 1.5 (e.g., an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan Section 1.5. Such former participant in the VWEG-Plan shall not be required to be employed through an entry date before he/she can become a participant in the Plan.

4. Vesting. Participants are 100% vested in their VWEG-Accounts which are transferred to the Plan effective July 1, 1999. In addition, Participants with such VWEG-Accounts shall be 100% vested in future employer matching contributions made to this Plan (the Microsoft Plan).

5. Special Provisions Applicable. The following special provision applies only to the rollover accounts in the VWEG Plan that are transferred to this Plan as part of the VWEG-Accounts. A Participant may request an inservice withdrawal (i.e., withdrawal while still employed) from such rollover accounts once per Plan Year. This special withdrawal provision shall not apply to rollovers made to the Plan after July 1, 1999.

6. Plan Loans. Any loans from the VWEG-Plan to a VWEG-Plan participant which are outstanding on July 1, 1999 shall be transferred to the Plan in kind as an asset allocated to the

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participant's VWEG-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her VWEG-Plan loan documents.

I. Former Accounts and Participants of Compare Net 401(k) Plan

1. History of Corporate Merger. On March 4, 1999, Compare Net, Inc. was merged with MS-Jupiter, Inc., a wholly-owned subsidiary of Microsoft Corporation, with Compare Net, Inc. being the surviving corporation and becoming a wholly-owned subsidiary of Microsoft Corporation. At the time of the merger with MS-Jupiter, Inc., Compare Net, Inc. was the sponsor of the Compare Net 401(k) Plan ("CN-Plan"). The plan remained in existence after Compare Net, Inc. was merged with MS-Jupiter, Inc.

2. Plan Merger. Effective September 1, 1999, the CN-Plan is merged into the Plan, and the plan document for the Plan, as amended previously and by this amendment, is the surviving plan document. The Plan consists only of employee pre-tax deferrals, and rollovers made from prior plans or IRAs ("CN-Accounts"). The CN-Accounts are transferred to the Plan without alteration and shall be kept separate from other accounts held in the Plan by former CN-Plan participants. No discretionary employer contributions were made. Because any prior rollovers are subject to immediate withdrawal, they will be kept in a separate acquisition rollover account from the employee pre-tax deferrals.

3. Eligibility. All former employees of Compare Net, Inc. were terminated from Compare Net, Inc. prior to July 1, 1999. Those employed by Microsoft Corporation as an eligible employee (as defined in Section 1.5 of the Plan) prior to July 1, 1999 entered the Plan on July 1, 1999. Any former participant in the CN-Plan who is not an eligible employee (as defined in Section 1.5 of the Plan) shall enter the Plan immediately upon becoming an eligible employee,

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and shall not be required to be employed through an entry date before he/she will become a participant under the Plan.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their CN-Accounts which are transferred from the CN-Plan effective September 1, 1999. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (i.e., matching contributions made by Microsoft Corporation after July 1, 1999), participants shall be credited with vesting service under the elapsed time method as set forth in Article V of the Plan for their service at Compare Net, Inc.

5. Special Provisions Applicable. The following special provisions apply only to the CN-Accounts. With respect to the CN-Accounts, the following special provisions shall supersede any other provisions of this Plan which are inconsistent with the following provisions. For example, in-kind distributions of Microsoft stock are permitted on lump sum distributions to the extent a CN-Account is invested in Microsoft stock at the time of the distribution, because such distributions are permitted with respect to other Plan accounts and would not be inconsistent with the following special provisions. In addition, to the extent the Plan is amended subsequent to this amendment in a way which gives participants greater benefits or additional options not provided in this section, participants with a CN-Account shall be eligible for those additional benefits or options without violating this section.

6. Form of Benefit Payments. Unless the participant makes an election otherwise, the participant (or beneficiary) shall receive the distribution of his or her CN-Account in the form of a cash lump sum. Participants with vested account balances in excess of $5,000 may elect to receive their distribution in the form of monthly cash installments over a period certain which

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may not exceed the life expectancy of the participant or the joint life expectancy of the participant and his or her designated beneficiary.

7. Inservice Withdrawals of Prior Rollovers. Participants who rolled amounts into the CN-Plan from another plan or IRA may withdraw such amounts and the earnings thereon at any time.

8. Plan Loans. Any loans from the CN-Plan to a CN-Plan participant which are outstanding on September 1, 1999 shall be transferred to the Plan in kind as an asset allocated to the participant's CN-Account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her CN-Plan loan documents.

J. Former Accounts and Participants of Visio Corporation

1. History of Corporate Merger. On January 7, 2000, Visio Corporation became a wholly-owned subsidiary of Microsoft Corporation as a result of a merger between Visio Corporation and a subsidiary of Microsoft Corporation. At the time of the merger with the subsidiary of Microsoft Corporation, Visio Corporation was the sponsor of the Visio 401(k) Plan ("VC-Plan"). The VC-Plan was frozen as of February 1, 2000, and Visio employees stopped making salary deferral contributions to the VC-Plan effective February 1, 2000. The Visio employees will be eligible to enter the Microsoft Savings Plus 401(k) Plan ("Plan") effective March 1, 2000.

2. Plan Merger. Effective July 1, 2000, the VC-Plan is merged into the Plan and this plan document for the Plan, as amended previously and by this Amendment, is the surviving plan document.

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The VC-Plan contains employee salary deferral contributions, employer matching contributions, and rollover contributions ("VC-Accounts"). Employee after-tax contributions were not permitted and discretionary employer contributions were never made. The salary deferral accounts and the rollover accounts have always been nonforfeitable. The employer matching account has been subject to a vesting schedule. Effective February 1, 2000, all accounts in the VC-Plan as of such date were made 100% vested. The salary deferral and employer match accounts are transferred to the Plan without alteration. The rollover accounts containing rollovers that were made to the VC-Plan shall be kept in a separate acquisition rollover account ("Rollover VC-Account").

3. Eligibility. Any participant of the VC-Plan on July 1, 2000, who is not an eligible employee as defined in Plan Section 1.5 (e.g., an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan Section 1.5. Such former participant in the VC-Plan shall renew active participation in the Plan immediately upon becoming an eligible employee as defined in Plan Section 1.5 and attaining age 18. Any person employed by Visio Corporation after July 1, 2000 who was not a participant in the VC-Plan on or before July 1, 2000 shall be required to satisfy all of the eligibility conditions of Plan Section 1.5 and 2.1, and must be employed through an entry date before he/she will become a participant under the Plan.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their VC-Accounts which are transferred to the Plan. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (e.g., matching contributions made by Microsoft Corporation after March 1,

2000), participants shall be credited with vesting service under the elapsed time method as set forth in Article V of the Plan for their service at Visio

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Corporation. Notwithstanding the preceding sentence, employees who are employed by Visio Corporation on any date between March 1, 2000 and July 1, 2000 (inclusive) and who enter the Plan as participants between March 1, 2000 and July 1, 2000 (inclusive) shall be 100% vested in their employer matching contribution accounts in the Plan.

5. Special Provisions Applicable. The following special provisions apply only to the VC-Accounts. With respect to the VC-Accounts, the following special provisions shall supersede any other provisions of this plan which are inconsistent with the following provisions. However, to the extent the Plan is amended subsequent to this amendment in a way which gives participants greater benefits or additional options not provided in this section, participants with a VC-Account shall be eligible for those additional benefits or options without violating this section.

6. Rollover VC-Account. A participant may elect to withdraw from the Rollover VC-Account at any time, any amount up to 100% of the value of the Rollover VC-Account. The participant shall notify the plan administrator of his election to make a withdrawal under this Section. The distribution will be made as soon as reasonably practicable after such notice is given.

7. Form of Benefit Payments. The participant may elect to have his or her VC-Accounts distributed in a single lump sum payment, in cash or in kind.

8. Plan Loans. All loans from the VC-Plan to a VC-Plan participant which are outstanding on July 1, 2000 shall be transferred to the Plan in kind as an asset allocated to the participant's VC-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her VC-Plan loan documents.

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K. Former Accounts and Participants of Entropic Research Laboratory, Inc.

Savings and Investment Plan

1. History of Corporate Merger. On November 4, 1999, Entropic Research Laboratory, Inc. ("Entropic") became a wholly-owned subsidiary of Microsoft Corporation as a result of a merger between Entropic and a subsidiary of Microsoft Corporation. At the time of the merger with the subsidiary of Microsoft Corporation, Entropic was the sponsor of the Entropic Research Laboratory, Inc. Savings & Investment Plan ("ERL-Plan"). Participants in the ERL-Plan who became Microsoft employees on or before March 1, 2000 will be eligible to enter the Microsoft Savings Plus 401(k) Plan ("Plan") effective March 1, 2000.

2. Plan Merger. Effective March 1, 2000, the ERL-Plan is merged into the Plan and this plan document for the Plan, as amended previously and by this Amendment, is the surviving plan document.

The ERL-Plan contains employee salary deferral contributions and rollover contributions ("ERL-Accounts"). Employee after-tax contributions were not permitted and discretionary employer contributions were never made. The salary deferral accounts and the rollover accounts have always been nonforfeitable. The salary deferral accounts are transferred to the Plan without alteration. The rollover accounts containing rollovers that were made to the ERL-Plan shall be kept in a separate acquisition rollover account ("Rollover ERL-Account").

3. Eligibility. Any participant of the ERL-Plan on March 1, 2000, who is not an eligible employee as defined in Plan Section 1.5 (e.g., an intern) shall be an inactive participant in the Plan and shall actively participate in the Plan only if and when they become an eligible employee as defined in Plan Section 1.5. Such former participant in the ERL-Plan shall renew active

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participation in the Plan immediately upon becoming an eligible employee as defined in Plan Section 1.5 and attaining age 18.

4. Vesting and Vesting Service Credit. Participants are 100% vested in their ERL-Accounts which are transferred to the Plan. For purposes of determining their vested percentage in their employer matching contribution account in this Plan (e.g., matching contributions made by Microsoft Corporation), participants shall be credited with vesting service under the elapsed time method as set forth in Article V of the Plan for their service at Entropic.

5. Special Provisions Applicable. The following special provisions apply only to the ERL-Accounts. With respect to the ERL-Accounts, the following special provisions shall supersede any other provisions of this Plan which are inconsistent with the following provisions. However, to the extent the Plan is amended subsequent to this amendment in a way which gives participants greater benefits or additional options not provided in this section, participants with a ERL-Account shall be eligible for those additional benefits or options without violating this section.

6. Rollover ERL-Account. A participant may elect to withdraw from the Rollover ERL-Account as of a valuation date following such election, any amount up to 100% of the value of the Rollover ERL-Account as of such valuation date. The participant shall notify the plan administrator of his election to make a withdrawal under this Section. The distribution will be made as soon as reasonably practicable after such notice is given.

7. Form of Benefit Payments. The participant may elect to have his or her ERL-Accounts distributed in a single lump sum payment, in cash or in kind or in a combination of both. Participants may also elect to have their ERL-Accounts distributed in installments payable in cash or in kind, or in a combination of both over a period not to exceed the participant's life

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expectancy or the joint life expectancy of the participant and spouse. If at the time of distribution to a participant or beneficiary the participant's total vested account balance in the Plan (including ERL-Accounts and other accounts) does not exceed $5,000 (and never exceeded $5,000 at the time of a prior distribution), then the ERL-Account balance will be distributed in an immediate lump sum payment, in cash or in kind or in a combination of both, as elected by the participant or beneficiary, and installment payments will not be a payment option.

8. <u>Timing of Death Benefit Payments</u>. Upon a participant's death, the distribution of the participant's ERL-Account shall be made or commence at the times specified in Section 7.3 of the Plan. The distribution shall be in cash or in kind, or in a combination of both, or in installments payable in cash or in kind, or in a combination of both over a period not to exceed the participant's life expectancy or the joint life expectancy of the participant and spouse, as elected by the participant or beneficiary. Notwithstanding the foregoing, if the participant's total vested account balance in the Plan (including ERL-Accounts and other accounts) does not exceed $5,000, distribution to the beneficiary shall be made in an immediate lump sum payment in cash or in kind, or in a combination of both, as elected by the beneficiary.

If a participant dies prior to the commencement of the distribution of his or her ERL-Account and is survived by a designated beneficiary who is not his or her spouse, the distribution must be made by December 31 of the calendar year in which the fifth anniversary of the participant's death occurs unless the beneficiary elects to have installment payments commence by the end of the first calendar year after the participant's death. If the designated beneficiary is the participant's spouse, the spouse may elect to delay distribution or commencement of installment payments until the end of the calendar year in which the participant would have attained age 65. If the participant dies prior to commencement of the distribution of his or her

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ERL-Account and is not survived by a designated beneficiary, distribution shall be made in an immediate lump sum payment in cash or in kind, or in a combination of both, as elected by the beneficiary.

If the participant died while he was receiving installment payments of his ERL-Account, the remaining portion of the ERL-Account shall be distributed at least as rapidly as under the length and frequency of installment payments which the participant had selected.

9. <u>Plan Loans</u>. All loans from the ERL-Plan to a ERL-Plan participant which are outstanding on March 1, 2000 shall be transferred to the Plan in kind as an asset allocated to the participant's ERL-Plan account. A participant with such a loan outstanding shall have all of the rights and be subject to all of the conditions of his or her loan as set forth in his or her ERL-Plan loan documents.

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APPENDIX VI

Section 2.5

EARLY ENTRY FOR CERTAIN EMPLOYEES OF ACQUIRED COMPANIES

Any eligible employee who immediately following one of the relevant acquisition dates listed below was employed by Microsoft Corporation (or any company which is affiliated with Microsoft, within the meaning of Code Sections 414(b), (c), (m), or (o)), and on the date immediately preceding the relevant acquisition date was employed by the relevant company listed below, shall enter the Plan on the later of (i) the relevant entry dates listed below, or (ii) the first payroll period immediately after becoming an eligible employee and attaining age 18.

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Company	Acquisition Date	Plan Entry Date
<S>	<C>	<C>
NetCarta Corporation	January 31, 1997	March 1, 1997
Interse' Corporation	February 25, 1997	April 1, 1997
Visio Corporation	January 7, 2000	March 1, 2000

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Exhibit 13.1

Quarterly Information
(In millions, except per share data) (Unaudited)

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	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
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1998					
Revenue	$ 3,334	$ 3,792	$ 3,984	$4,152	$15,262
Gross profit	2,800	3,179	3,344	3,479	12,802
Net income	663	1,133	1,337	1,357	4,490
Basic earnings per share	0.14	0.24	0.27	0.27	0.92
Diluted earnings per share	0.13	0.21	0.25	0.25	0.84
Common stock price per share:					
High	37.69	36.66	45.47	54.28	54.28
Low	30.82	29.50	31.10	40.94	29.50
1999					
Revenue	$ 4,193	$ 5,195	$ 4,595	$5,764	$19,747
Gross profit	3,544	4,407	3,887	5,095	16,933
Net income	1,683	1,983	1,917	2,202	7,785
Basic earnings per share	0.34	0.40	0.38	0.43	1.54
Diluted earnings per share	0.31	0.36	0.35	0.40	1.42
Common stock price per share:					
High	59.81	72.00	94.63	95.63	95.63
Low	47.25	43.88	68.00	75.50	43.88
2000					
Revenue	$ 5,384	$ 6,112	$ 5,656	$5,804	$22,956
Gross profit	4,672	5,356	4,904	5,022	19,954
Net income	2,191	2,436	2,385	2,409	9,421
Basic earnings per share	0.43	0.47	0.46	0.46	1.81
Diluted earnings per share	0.40	0.44	0.43	0.44	1.70
Common stock price per share:					
High	100.75	119.94	118.63	96.50	119.94
Low	81.63	84.38	88.13	60.38	60.38

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The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 2000, there were 107,824 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.
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Exhibit 13.2

Financial Highlights
(In millions, except earnings per share)

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Year Ended June 30	1996	1997	1998	1999	2000
<S>	<C>	<C>	<C>	<C>	<C>
Revenue	$ 9,050	$11,936	$15,262	$19,747	$22,956
Net income	2,195	3,454	4,490	7,785	9,421
Diluted earnings per share	0.43	0.66	0.84	1.42	1.70
Cash and short-term investments	6,940	8,966	13,927	17,236	23,798
Total assets	10,093	14,387	22,357	38,625	52,150
Stockholders' equity	6,908	10,777	16,627	28,438	41,368

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Exhibit 13.3

Management's Discussion and Analysis

Results of Operations for 1998, 1999, and 2000

Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for servers, personal computers (PCs), and intelligent devices; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN network of Internet products and services and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells hardware devices; provides consulting services; trains and certifies system integrators and developers; and researches and develops advanced technologies for future software products.

This Management's Discussion and Analysis contains statements that are forward-looking. These statements are based on current expectations that are subject to risks and uncertainties. Actual results will vary because of factors discussed below under "Issues and Uncertainties."

Revenue

The Company's revenue growth rate was 28% in fiscal 1998, 29% in fiscal 1999, and 16% in fiscal 2000. Revenue growth in fiscal 2000 was driven by strong licensing of the Microsoft suite of products including Microsoft Windows NT(R) Workstation, Windows 2000 Professional, Windows NT Server, Windows 2000 Server, Microsoft Office 2000, and SQL Server 7.0. Windows 2000, released during fiscal 2000, is the next version of the Windows NT operating system. Consumer revenue, including Internet access, the online properties, entertainment software, and hardware peripherals also grew strongly. Partially offsetting those items was slower growth from Windows operating systems sold through the original equipment manufacturer (OEM) channel due to slow demand for business PCs throughout a significant portion of fiscal 2000. Revenue growth in fiscal 1998 and 1999 reflected the continued adoption of Windows operating systems and Microsoft Office. Software organizational license increases in 1998, 1999, and 2000 have been a significant factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from OEM licenses and organizational license programs is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. See accompanying notes to financial statements.

The Company's business model continues to evolve from retailing packaged products to licensing organizational licenses and subscriptions. The Company's products are generally delivered to end users through a multi-tiered channel of distributors and resellers, but the distribution model is also changing for selected retail products that are now being shipped straight to resellers and other selected products that are now being shipped straight to end users. Due to these changes in channel mechanics and the business model, the risk of returns of product from distributors and resellers has declined. Accordingly, the estimate for future product returns was reduced by $250 million in the fourth quarter of fiscal 1999.

In fiscal 1999, Microsoft made two changes related to the ratable recognition of revenue for a portion of its revenue for certain products. American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions, requires companies to use the average sales price of each undelivered element of software arrangements to unbundle revenue. Prior authoritative guidance allowed a comparison of the total price differential between a licensed product sold through different channels of distribution to derive the value of undelivered elements offered to customers acquiring product from one channel but not the other. Upon adoption of this new rule in the fourth quarter of fiscal 1999, the percentages of the total arrangement treated as unearned decreased. This change reduced the amount of Microsoft Windows and Microsoft Office sales treated as unearned and increased the amount of revenue recognized upon shipment. Additionally, as part of the Company's long range planning process and a review of product shipment cycles, it was determined that the life cycle of Windows should be extended from two years to three years.

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Business Divisions

Microsoft has three major segments: Productivity Applications and Developer; Windows Platforms; and Consumer and Other.

Productivity Applications and Developer

Productivity Applications and Developer revenue was $7.04 billion, $8.82 billion, and $10.47 billion in 1998, 1999, and 2000. Productivity Applications and Developer products include desktop applications such as Microsoft Office, server applications such as Microsoft SQL Server and Microsoft Exchange Server, and software developer tools.

In fiscal 2000, revenue growth from Microsoft Office integrated suites, including the Premium, Professional, Small Business, and Standard Editions was very solid. Revenue from server applications grew strongly compared to fiscal 1999, largely due to the strong success of SQL Server 7.0. Software developer tools revenue declined, due to increased suite licensing versus stand-alone licenses, and the lack of a release upgrade of the Visual Studio(R) development system.

In fiscal 1999, revenue growth from Microsoft Office integrated suites was strong. Revenue from server applications also grew strongly, reflecting, in part, the release of SQL Server 7.0. The Visual Studio 6.0 development system drove healthy software developer tools revenue growth. In fiscal 1998, revenue from the various Microsoft Office integrated suites increased strongly, while revenue from stand-alone versions of Microsoft Excel, Microsoft Word, Microsoft Access, and Microsoft PowerPoint(R) presentation graphics program decreased.

Windows Platforms

Windows Platforms revenue was $6.28 billion, $8.50 billion, and $9.38 billion in 1998, 1999, and 2000. Windows Platforms products include primarily Windows 98, Windows 2000 Professional, Windows 2000 Server, Windows NT Workstation, and Windows NT Server.

In fiscal 2000, Windows desktop operating systems revenue growth was modest due to soft demand for business PCs during most of the year; a slowdown in shipments in anticipation of the post mid-year availability of Windows 2000 operating systems; and, as expected, a longer business migration cycle for the newest Windows operating system offerings. In addition, Windows desktop operating systems average earned revenue per licensed operating system decreased compared to fiscal 1999. Windows Platform Server revenue growth over fiscal 1999 was particularly strong led by increased adoption by customers of Windows NT Server and Windows 2000 Server.

In fiscal 1999, Windows units licensed through the OEM channel, particularly Windows NT Workstation, increased strongly over the prior year. Organizational licensing of Windows NT Workstation and Windows 98 also contributed to the growth. The revenue growth rate for Windows NT Server was healthy. In fiscal 1998, Windows units licensed through the OEM channel, including Windows 95, Windows 98, and Windows NT Workstation, exhibited robust growth over the prior year.

Consumer and Other

Consumer and Other revenue was $1.94 billion, $2.43 billion, and $3.11 billion in 1998, 1999, and 2000. Consumer and Other products include Internet access and online services; learning and entertainment software; hardware devices; consulting services; and training and certification.

In fiscal 2000, online revenue growth was very strong and reflected higher subscriber totals, offset by lower net prices for Internet access subscriptions compared to the prior year. Additionally, the continued success of the Company's new hardware device offerings and strong sell-through of entertainment software produced robust revenue growth.

In fiscal 1999, online advertising revenue and consulting services rose substantially and Internet access revenue increased moderately, while revenue from hardware devices, consumer software, and Microsoft Press was relatively flat. In fiscal 1998, online revenue increased due to higher Internet access subscriber levels and hardware and learning and entertainment revenue increased.

Distribution Channels

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

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OEM revenue was $4.72 billion in 1998, $6.40 billion in 1999, and $7.01 billion in 2000. The relatively low growth rate in fiscal 2000 was due to lower business PC shipment growth percentages, especially as a result of the soft demand for business PCs and component shortages for part of the year. These issues combined with post mid-year availability of the newest business operating system, Windows 2000 Professional, resulted in lower revenue growth. Average earned revenue per license also declined compared to the prior year, due in part to a mix shift to the lower-priced Windows 98 operating system reflecting the softness in demand for business PCs and lower prices on operating systems licensed through certain OEM channel sectors. In both fiscal 1999 and 1998, PC shipment growth coupled with an increased penetration of higher value 32-bit operating systems drove the OEM revenue increases.

South Pacific and Americas Region revenue was $5.57 billion, $7.25 billion, and $8.33 billion in 1998, 1999, and 2000. In fiscal 2000, Office 2000 integrated suites, Windows 2000 Server, online revenue, and SQL Server sales were the primary drivers of the revenue growth. Strong retail sales of hardware devices and consumer software also contributed to the growth over the prior year. Revenue growth was particularly strong in Latin America and Australia, moderate in Canada, and modest in the United States. In fiscal 1999, server applications, Windows NT Server, Windows NT Workstation, and Microsoft Office all exhibited solid year-over-year growth rates. Organizational licensing activity was strong. Revenue growth was solid in the United States and moderate in Latin America and the South Pacific. In fiscal 1998, revenue growth reflected strong licensing of Microsoft Office.

Europe, Middle East, and Africa Region revenue was $3.50 billion, $4.33 billion, and $5.02 billion in 1998, 1999, and 2000. In fiscal 2000, retail sales of Windows operating systems and Office licensing produced moderate growth in the region. Growth from SQL Server licensing, new hardware device offerings, and entertainment software was exceptionally strong. Revenue growth, measured in constant dollars, was very healthy in Germany and Italy, robust in the Middle East, and low in the United Kingdom. In fiscal 1999, all major products grew strongly over the prior year. Revenue growth was solid in the United Kingdom, Germany, and France, and was particularly high in Sweden, the Netherlands, and Spain. In fiscal 1998, organizational licensing of desktop applications and business systems grew strongly. Revenue growth was particularly high in the United Kingdom.

Asia Region revenue was $1.48 billion in 1998, $1.78 billion in 1999, and $2.60 billion in 2000. In fiscal 2000, the region's growth rate reflected strong performance resulting from improved local economic conditions. Revenue growth was also influenced by robust growth of localized versions of Microsoft Office 2000, especially the Office Personal Edition sold in Japan; Windows platform and server licensing; and strong adoption of SQL Server. Revenue grew strongly in nearly all countries in the Asia region. In fiscal 1999, Japan, Taiwan, China, Hong Kong, and Southeast Asia had moderate revenue growth, while revenue grew very strongly in Korea. In fiscal 1998, revenue was relatively flat in Japan and Southeast Asia due to economic issues and weak currencies.

The Company's operating results are affected by foreign exchange rates. Approximately 32%, 29%, and 30% of the Company's revenue was collected in foreign currencies during 1998, 1999, and 2000. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

Operating Expenses

Cost of Revenue
Cost of revenue as a percent of revenue was 16.1% in 1998, 14.3% in 1999, and 13.1% in 2000. Cost of revenue in fiscal 2000 reflected lower costs associated with WebTV Networks' operations, partially offset by the growth in hardware peripherals costs. The percentage decreases in fiscal 1999 and 1998 resulted primarily from the trend in mix shift to OEM and organizational licenses. The decreases were also due to the shifts in mix to CD-ROMs, which carry lower cost of goods than floppy disks, and higher-margin Windows NT Server, other servers, and client access licenses in the BackOffice(R) product family. Additionally, cost of revenue in 1999 was positively impacted by a reduction in estimates of obsolete inventory and other manufacturing costs of $67 million. As discussed previously, the Company's business model continues to evolve toward licensing from sales of packaged products through distribution channels. Consequently, risks associated with manufacturing and holding physical product have declined.

Research and Development
Microsoft continued to invest heavily in the future by funding research and development (R&D). The increase in fiscal 2000 was driven primarily by higher headcount-related costs. The increase in fiscal 1999 reflected higher development headcount-related costs offset by lower infrastructure and third-party development costs. Fiscal 1998 expenses were driven primarily by higher development headcount-related costs and third-party development costs.

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

Sales and Marketing
In fiscal 2000, sales and marketing expenses as a percentage of revenue increased due to higher relative marketing costs associated with new product releases and online marketing. In fiscal 1999, sales and marketing expense as a percentage of revenue decreased due to lower relative sales expenses and lower relative marketing costs. In fiscal 1998, the sales and marketing expense as a percent of revenue decreased due to lower relative sales expenses.

General and Administrative
Fiscal 2000 general and administrative expenses included a charge for the settlement of a lawsuit with Caldera, Inc. and also reflected increased legal fees and certain employee stock option-related expenses. The increase in fiscal years 1999 and 1998 were attributable to higher legal fees, settlement costs, and headcount-related costs necessary to support the Company's expanding operations.

Other Expenses

Other expenses incorporate miscellaneous items, including certain gains; recognition of Microsoft's share of joint venture activities for the MSNBC entities, TransPoint, and other joint venture activities; and charitable contributions and miscellaneous taxes.

Investment Income, Gain on Sales, and Income Taxes

Investment income increased primarily as a result of a larger investment portfolio generated by cash from operations in 1998, 1999, and 2000, coupled with realized gains from the sale of securities in 1999 and 2000.

In fiscal 2000, Microsoft sold the entertainment city guide portion of MSN Sidewalk to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution arrangement. Microsoft recognized a gain of $156 million on the sale and will recognize revenue amounts related to the distribution arrangement over the terms of the agreement. In fiscal 1999, Microsoft sold its Softimage, Inc. subsidiary to Avid Technology, Inc. for a pretax gain of $160 million.

The effective tax rate for fiscal 2000 was 34.0%. Excluding the impact of the gain on the sale of Softimage, Inc., the effective tax rate for fiscal 1999 was 35.0%. The effective income tax rate for fiscal 1998 was 36.9%, reflecting the nondeductible write-off of WebTV in-process technologies.

Financial Condition

The Company's cash and short-term investment portfolio totaled $23.80 billion at June 30, 2000. The portfolio consists primarily of fixed-income securities, diversified among industries and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in order to diversify financial risk. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft works with many technology companies and often provides investment funding as part of these alliances. During fiscal 2000, the Company purchased approximately $400 million of Rogers Communications Inc. convertible preferred securities and $200 million of Best Buy Co., Inc. common stock. Also, subsequent to fiscal year-end, Microsoft acquired an additional shareholding in Telewest Communications plc for approximately $2.6 billion. During fiscal 1999, the Company purchased $5.0 billion of AT&T convertible preferred securities and warrants, $600 million of Nextel Communications, Inc. common stock, $500 million of NTL, Inc. convertible preferred stock, $330 million of United Pan-Europe Communications common stock, and $200 million of Qwest Communications International Inc. common stock.

Microsoft and National Broadcasting Company (NBC) operate two MSNBC joint ventures: a 24-hour cable news and information channel, and an online news service. Microsoft is paying $220 million over a five-year period that ends in 2001 for its interest in the cable venture and one-half of the operational funding of both joint ventures. Microsoft guarantees a portion of MSNBC debt.

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Microsoft has no material long-term debt and has $164 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at June 30, 2000 was $41.37 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $299 million on June 30, 2000. Cash will also be used to fund ventures and other strategic opportunities.

Since fiscal 1990, Microsoft has repurchased 765 million common shares while 1.99 billion shares were issued under the Company's employee stock option and purchase plans. Microsoft enhanced its repurchase program by selling put warrants. In January 2000, the Company terminated its stock buyback program. Subsequent to fiscal year-end 2000, the Company announced a share repurchase program which will provide shares for issuance to employees under the Company's stock option and stock purchase programs. The market value of all outstanding stock options was $67 billion as of June 30, 2000. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements. The Company's cash and short-term investments are available for strategic investments, mergers and acquisitions, and other potential large-scale cash needs that may arise. Microsoft has not paid cash dividends on its common stock.

Recently Issued Accounting Standards

Statement of Financial Accounting Standards (SFAS) 133, Accounting for Derivative Instruments and Hedging Activities, as amended by SFAS 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133, and SFAS 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, is effective for the Company as of July 1, 2000. SFAS 133 requires that an entity recognize all derivatives as either assets or liabilities measured at fair value. The accounting for changes in the fair value of a derivative depends on the use of the derivative. Adoption of these new accounting standards will result in cumulative after-tax reductions in net income of approximately $350 million and other comprehensive income of approximately $50 million in the first quarter of fiscal 2001. The adoption will also impact assets and liabilities recorded on the balance sheet.

The Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 101, Revenue Recognition in Financial Statements, in December 1999. The SAB summarizes certain of the SEC staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. In June 2000, the SEC issued SAB 101B, which delays the implementation date of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. The Company does not believe that adoption of this SAB will have a material impact on its financial statements.

In March 2000, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) 44, Accounting for Certain Transactions involving Stock Compensation, which clarifies the application of APB 25 for certain issues. The interpretation is effective July 1, 2000, except for the provisions that relate to modifications that directly or indirectly reduce the exercise price of an award and the definition of an employee, which are effective after December 15, 1998. The Company does not believe that adoption of FIN 44 will have a material impact on its financial statements.

Issues and Uncertainties

While Microsoft management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

Rapid Technological Change and Competition

Rapid change, uncertainty due to new and emerging technologies, and fierce competition characterize the software industry, which means that Microsoft's market position is always at risk. Microsoft's ability to maintain its current

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success is dependent upon the Company's ability to develop and introduce new products and enhance existing products to satisfy consumer demand for new computer technologies. This process is challenging because the pace of change continues to accelerate, creating new opportunities for competitors and subjecting business planning to substantial uncertainty. Competitors, working with new technology, may arrive at a technology that creates a new market altogether and renders the Company's product offerings obsolete. "Open source" software, new computing devices, new microprocessor architectures, the Internet, and Web-based computing models are current examples of the rapid pace of change and intensifying competition. If Microsoft does not successfully identify new product opportunities and develop and bring new products to market in a timely and efficient manner, the Company's business growth will suffer and demand for its products will decrease. Competing operating systems, platforms, and products may gain popularity with customers, computer manufacturers, and developers, reducing Microsoft's future revenue.

Future Initiatives

The Company plans to continue significant investments in software research and development including Microsoft .NET, wireless technologies, digital devices, games, television, and small business. Microsoft is also making significant investments in strategic relationships with third parties, and in online products and services such as MSN, CarPoint(TM) online automotive service, and HomeAdvisor(TM) online real estate service, where the Company has the opportunity to establish leadership in new businesses. It is anticipated that these investments in research and development will increase over historical spending levels without corresponding growth in revenue in the near future. Significant revenue from these product opportunities may not be achieved for a number of years, if at all.

PC Growth Rates

The nature of the PC marketplace is changing in ways that may reduce Microsoft's software sales and revenue growth. Recently, manufacturers have sought to reach more consumers by developing and producing lower cost PCs - PCs that come without pre-installed software or contain software with reduced functionality. In addition to the influx of low-cost PCs, a market for handheld computing and communication devices has developed. While these devices are not as powerful or versatile as PCs, they threaten to erode sales growth in the market for PCs with pre-installed software. This may affect Microsoft's revenue growth because manufacturers may choose not to install Microsoft software in these low-cost PCs or consumers may purchase alternative intelligent devices that do not utilize Microsoft software. These lower-priced devices require Microsoft to provide lower-priced software with a subset of the original functionality. As a result, the Company may generate less revenue from the sale of software produced for these devices than from the sale of software for PCs.

Product Ship Schedules

The PC software industry is inherently complex. New products and product enhancements can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could damage Microsoft's business.

Saturation
Product upgrades, which enable users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices and margins than new products. Also, penetration of the Company's desktop applications into large organizations is becoming saturated. These factors are likely to depress future desktop applications revenue growth.

Prices
The competitive factors described above may require Microsoft to lower product prices to meet competition, reducing the Company's net income.

Earnings Process
An increasingly higher percentage of the Company's revenue is subject to ratable recognition, which impacts the timing of revenue and earnings recognition. This policy may be required for additional products, depending on specific license terms and conditions. Also, maintenance and new subscription programs such as the application service provider (ASP) model are increasing in popularity.

Employee Compensation
Microsoft employees currently receive salaries, incentive bonuses, other benefits, and stock options. New government regulations, poor stock price performance, or other factors could diminish the value of the option program to current and prospective employees and force the Company into more of a cash compensation model.

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International Operations
Microsoft develops and sells products throughout the world. The prices of the Company's products in countries outside of the United States are generally higher than the Company's prices in the United States because of the costs incurred in localizing software for non-U.S. markets. The costs of producing and selling the Company's products in these countries are also higher. Pressure to globalize Microsoft's pricing structure might require that the Company reduce the sales price of its software in other countries, even though the costs of the software continue to be higher than in the United States. Negative changes in software "piracy" trade protection laws, policies and measures and other regulatory requirements affecting trade and investment; unexpected changes in regulatory requirements for software; social, political, labor or economic conditions in a specific country or region; difficulties in staffing and managing foreign operations; and potential adverse foreign tax consequences; among other factors, could also have an impact on the Company's business and results of operations outside of the United States.

Market Risk
The Company is exposed to foreign currency, interest rate, and securities price risks. A portion of these risks is hedged, but fluctuations could impact the Company's results of operations and financial position. The Company hedges the exposure of accounts receivable and a portion of anticipated revenue to foreign currency fluctuations, primarily with option contracts. The Company monitors its foreign currency exposures daily to maximize the overall effectiveness of its foreign currency hedge positions. Principal currencies hedged include the Euro, Japanese yen, British pound, and Canadian dollar. Fixed income securities are subject to interest rate risk. The portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. The Company routinely uses options to hedge its exposure to interest rate risk in the event of a catastrophic increase in interest rates. Many securities held in the Company's equity and other investments portfolio are subject to price risk. The Company uses options to hedge its price risk on certain highly volatile equity securities.

The Company uses a value-at-risk (VAR) model to estimate and quantify its market risks. The VAR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. Assumptions applied to the VAR model at June 30, 1999 and 2000 include the following: normal market conditions; Monte Carlo modeling with 10,000 simulated market price paths; a 97.5% confidence interval; and a 20-day estimated loss in fair value for each market risk category. Accordingly, 97.5% of the time the estimated 20-day loss in fair value would be nominal for foreign currency denominated investments and accounts receivable at June 30, 1999 and 2000, and would not exceed $95 million and $211 million at June 30, 1999 and 2000 for interest-sensitive investments or $1.38 billion or $1.02 billion at June 30, 1999 and 2000 for equity securities.

Intellectual Property Rights

Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenue to the Company. While this adversely affects U.S. revenue, revenue loss is even more significant outside of the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenue positively.

Litigation

Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks. The Company is a defendant in a lawsuit filed by the Antitrust Division of the U.S. Department of Justice and a group of nineteen state Attorneys General alleging violations of the Sherman Act and various state antitrust laws. After the trial, the District Court entered Findings of Fact and Conclusions of Law stating that Microsoft had violated sections of the Sherman Act and various state antitrust laws. A Judgment was entered on June 7, 2000 ordering, among other things, the breakup of Microsoft into two companies. On June 20, 2000, the District Court entered an order staying the Judgment of June 7, 2000 in its entirety until the appeal therefrom is heard and decided, unless the stay is earlier vacated by an appellate court. Although Microsoft believes it will obtain ultimate relief from the Judgment, the Company cannot predict with certainty when or the extent to which such relief will be obtained. The failure to obtain relief from certain provisions of the Judgment through the appeal would likely have a material adverse effect on the Company. A large number of antitrust class action lawsuits have been initiated against Microsoft. These cases allege that Microsoft has competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications and seek to recover alleged overcharges that the complaints contend Microsoft charged for these products. Although Microsoft believes the claims are without merit and is vigorously defending the cases, the Company cannot predict with certainty the outcome of these lawsuits.

Future Growth Rate

The revenue growth rate in 2001 may not approach the level attained in prior years. As discussed previously, certain operating expenses are expected to increase in 2001. Because of the fixed nature of a significant portion of operating expenses, coupled with the possibility of slower revenue growth, operating margins in 2001 may decrease from those in 2000.

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Exhibit 13.4

Microsoft Corporation

Financial Statements

Income Statements for the three years ended June 30, 2000

Cash Flows Statements for the three years ended June 30, 2000

Balance Sheets as of June 30, 1999 and 2000

Stockholders' Equity Statements for the three years ended June 30, 2000

Notes to Financial Statements

Independent Auditors' Report

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Income Statements
(In millions, except earnings per share)

<TABLE>
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Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Revenue	$15,262	$19,747	$22,956
Operating expenses:			
Cost of revenue	2,460	2,814	3,002
Research and development	2,601	2,970	3,775
Acquired in-process technology	296	--	--
Sales and marketing	2,828	3,231	4,141
General and administrative	433	689	1,009
Other expenses	230	115	92
Total operating expenses	8,848	9,819	12,019
Operating income	6,414	9,928	10,937
Investment income	703	1,803	3,182
Gain on sales	--	160	156
Income before income taxes	7,117	11,891	14,275
Provision for income taxes	2,627	4,106	4,854
Net income	$ 4,490	$ 7,785	$ 9,421
Earnings per share:			
Basic	$ 0.92	$ 1.54	$ 1.81
Diluted	$ 0.84	$ 1.42	$ 1.70

</TABLE>

See accompanying notes.

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Cash Flows Statements
(In millions)

<TABLE>
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Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Operations			
Net income	$ 4,490	$ 7,785	$ 9,421
Depreciation, amortization, and other noncash items	1,024	926	748
Write-off of acquired in-process technology	296	--	--
Gain on sales	--	(160)	(156)
Stock option income tax benefits	1,553	3,107	5,535
Unearned revenue	3,268	5,877	6,177
Recognition of unearned revenue from prior periods	(1,798)	(4,526)	(5,600)
Other current liabilities	208	1,050	(445)
Accounts receivable	(520)	(687)	(944)
Other current assets	(88)	(235)	(775)
Net cash from operations	8,433	13,137	13,961
Financing			
Common stock issued	959	1,350	2,245
Common stock repurchased	(2,468)	(2,950)	(4,896)
Put warrant proceeds	538	766	472
Preferred stock dividends	(28)	(28)	(13)
Net cash used for financing	(999)	(862)	(2,192)
Investing			
Additions to property and equipment	(656)	(583)	(879)
Cash portion of WebTV purchase price	(190)	--	--
Cash proceeds from sale of Softimage, Inc.	--	79	--
Purchases of investments	(19,114)	(36,441)	(43,158)
Maturities of investments	1,890	4,674	4,025
Sales of investments	10,798	21,080	28,085
Net cash used for investing	(7,272)	(11,191)	(11,927)
Net change in cash and equivalents	162	1,084	(158)
Effect of exchange rates on cash and equivalents	(29)	52	29
Cash and equivalents, beginning of year	3,706	3,839	4,975
Cash and equivalents, end of year	$ 3,839	$ 4,975	$ 4,846

</TABLE>

See accompanying notes.

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Balance Sheets
(In millions)

<TABLE>
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June 30	1999	2000
<S>	<C>	<C>
Assets		
Current assets:		
Cash and equivalents	$ 4,975	$ 4,846
Short-term investments	12,261	18,952
Total cash and short-term investments	17,236	23,798
Accounts receivable	2,245	3,250
Deferred income taxes	1,469	1,708
Other	752	1,552

Total current assets	21,702	30,308
Property and equipment, net	1,611	1,903
Equity and other investments	14,372	17,726
Other assets	940	2,213
Total assets	$38,625	$52,150
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 874	$ 1,083
Accrued compensation	396	557
Income taxes	1,691	585
Unearned revenue	4,239	4,816
Other	1,602	2,714
Total current liabilities	8,802	9,755
Deferred income taxes	1,385	1,027
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock--shares authorized 100; shares issued and outstanding 13 and 0	980	--
Common stock and paid-in capital--shares authorized 12,000; shares issued and outstanding 5,109 and 5,283	13,844	23,195
Retained earnings, including other comprehensive income of $1,787 and $1,527	13,614	18,173
Total stockholders' equity	28,438	41,368
Total liabilities and stockholders' equity	$38,625	$52,150

</TABLE>

See accompanying notes.

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Stockholders' Equity Statements
(In millions)

<TABLE>
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Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Convertible preferred stock			
Balance, beginning of year	$ 980	$ 980	$ 980
Conversion of preferred to common stock	--	--	(980)
Balance, end of year	980	980	--
Common stock and paid-in capital			
Balance, beginning of year	4,509	8,025	13,844
Common stock issued	1,262	2,338	3,554
Common stock repurchased	(165)	(64)	(210)
Structured repurchases price differential	328	(328)	--
Proceeds from sale of put warrants	538	766	472
Stock option income tax benefits	1,553	3,107	5,535
Balance, end of year	8,025	13,844	23,195
Retained earnings			
Balance, beginning of year	5,288	7,622	13,614
Net income	4,490	7,785	9,421
Other comprehensive income:			
Net unrealized investment gains/(losses)	627	1,052	(283)
Translation adjustments and other	(124)	69	23
Comprehensive income	4,993	8,906	9,161
Preferred stock dividends	(28)	(28)	(13)
Immaterial pooling of interests	--	--	97
Common stock repurchased	(2,631)	(2,886)	(4,686)
Balance, end of year	7,622	13,614	18,173

Total stockholders' equity	$16,627	$28,438	$41,368

</TABLE>

See accompanying notes.

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Notes to Financial Statements

Accounting Policies

Accounting Principles
The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States.

Principles of Consolidation
The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated. Investments in unconsolidated joint ventures are accounted for using the equity method; the Company's share of joint ventures' activities is reflected in other expenses.

Estimates and Assumptions
Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns, concessions and bad debts, and the length of product life cycles and buildings' lives. Actual results may differ from these estimates.

Foreign Currencies
Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to other comprehensive income. Revenue and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

Revenue Recognition
Revenue is recognized when earned. The Company's revenue recognition policies are in compliance with all applicable accounting regulations, including American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, With Respect to Certain Transactions. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from certain license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to and through distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. Revenue attributable to undelivered elements, including technical support and Internet browser technologies, is based on the average sales price of those elements and is recognized ratably on a straight-line basis over the product's life cycle. When the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for returns, concessions and bad debts.

Cost of Revenue
Cost of revenue includes direct costs to produce and distribute product and direct costs to provide online services, consulting, product support, and

training and certification of system integrators.

Research and Development
Research and development costs are expensed as incurred. Statement of Financial Accounting Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.

Advertising Costs
Advertising costs are expensed as incurred. Advertising expense was $732 million in 1998, $804 million in 1999, and $1.1 billion in 2000.

Income Taxes
Income tax expense includes U.S. and international income taxes, plus the provision for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes.

Financial Instruments
The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and six years from the purchase date. All cash and short-term investments are classified as available for sale and are recorded at market

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using the specific identification method; unrealized gains and losses are reflected in other comprehensive income. Cost approximates market for all classifications of cash and short-term investments; realized and unrealized gains and losses were not material.

Equity and other investments include debt and equity instruments. Debt securities and publicly traded equity securities are classified as available for sale and are recorded at market using the specific identification method. Unrealized gains and losses are reflected in other comprehensive income. All other investments, excluding joint venture arrangements, are recorded at cost.

Derivative financial instruments are used to hedge certain investments, international revenue, accounts receivable, and interest rate risks, and are, therefore, held primarily for purposes other than trading. These instruments may involve elements of credit and market risk in excess of the amounts recognized in the financial statements. The Company monitors its positions and the credit quality of counter parties, consisting primarily of major financial institutions, and does not anticipate nonperformance by any counter-party.

SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended by SFAS 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133, and SFAS 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, is effective for the Company as of July 1, 2000. SFAS 133 requires that an entity recognize all derivatives as either assets or liabilities measured at fair value. The accounting for changes in the fair value of a derivative depends on the use of the derivative. Adoption of these new accounting standards will result in cumulative after-tax reductions in net income of approximately $350 million and other comprehensive income of approximately $50 million in the first quarter of fiscal 2001. The adoption will also impact assets and liabilities recorded on the balance sheet.

Property and Equipment
Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term,

ranging from one to 15 years. As required by SOP 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use, Microsoft began capitalizing certain computer software developed or obtained for internal use in fiscal 2000. Capitalized computer software is depreciated using the straight-line method over the shorter of the estimated life of the software or three years.

Reclassifications
As required by Emerging Issues Task Force (EITF) Issue 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option, stock option income tax benefits are classified as cash from operations in the cash flows statement. Prior period cash flows statements have been restated to conform with this presentation. Certain other reclassifications have been made for consistent presentation.

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

End users receive certain elements of the Company's products over a period of time. These elements include items such as browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. Upon adoption of SOP 98-9 during the fourth quarter of fiscal 1999, the Company was required to change the methodology of attributing the fair value to undelivered elements. The percentages of undelivered elements in relation to the total arrangement decreased, reducing the amount of Windows and Office revenue treated as unearned, and increasing the amount of revenue recognized upon shipment. The percentage of revenue recognized ratably decreased from a range of 20% to 35% to a range of approximately 15% to 25% of Windows desktop operating systems. For desktop applications, the percentage decreased from approximately 20% to a range of approximately 10% to 20%. The ranges depend on the terms and conditions of the license and prices of the elements. In addition, in the fourth quarter of fiscal 1999, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. Product life cycles are currently estimated at 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organizational license agreements. At June 30, 1999 and 2000, Windows Platforms products unearned revenue was $2.17 billion and $2.61 billion and unearned revenue associated with Productivity Applications and Developer products totaled $1.96 billion and $1.99 billion. Unearned revenue for other miscellaneous programs totaled $116 million and $210 million at June 30, 1999 and 2000.

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Financial Risks

The Company's cash and short-term investment portfolio is diversified and consists primarily of investment grade securities. Investments are held with high-quality financial institutions, government and government agencies, and corporations, thereby reducing credit risk concentrations. Interest rate fluctuations impact the carrying value of the portfolio. The Company routinely hedges the portfolio with options in the event of a catastrophic increase in interest rates. The notional amount of the options outstanding was $4.0 billion and $3.6 billion at June 30, 1999 and 2000. The fair value and premiums paid for the options were not material. Much of the Company's equity security portfolio is highly volatile, so certain positions are hedged.

Finished goods sales to international customers in Europe, Japan, Canada, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. Certain international manufacturing and operational costs are incurred in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Although foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses, the Company hedges a portion of accounts receivable balances denominated in local currencies, primarily with purchased options. The notional amount of options outstanding was $662 million and $1.46 billion at June 30, 1999 and 2000. The fair value and premiums paid for the options were not material.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a portion of planned international revenue with purchased options. The notional amount of the options outstanding was $2.25 billion and $2.08 billion at June 30, 1999 and 2000. The fair value and premiums paid for the options were not material.

At June 30, 1999 and 2000, approximately 50% and 42% of accounts receivable represented amounts due from 10 customers. A single customer accounted for approximately 8%, 11%, and 9% of revenue in 1998, 1999, and 2000.

Microsoft lends certain fixed income and equity securities to enhance investment income. Collateral and/or security interest is determined based upon the underlying security and the credit worthiness of the borrower.

Cash and Short-Term Investments

<TABLE>
<CAPTION>

June 30	1999	2000
<S>	<C>	<C>
Cash and equivalents:		
Cash	$ 635	$ 849
Commercial paper	3,805	1,986
Certificates of deposit	522	1,017
U.S. government and agency securities	--	729
Corporate notes and bonds	--	265
Money market preferreds	13	--
Cash and equivalents	4,975	4,846
Short-term investments:		
Commercial paper	1,026	612
U.S. government and agency securities	3,592	7,104
Corporate notes and bonds	6,996	9,473
Municipal securities	247	1,113
Certificates of deposit	400	650
Short-term investments	12,261	18,952
Cash and short-term investments	$17,236	$23,798

</TABLE>

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Property and Equipment

<TABLE>
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June 30	1999	2000
<S>	<C>	<C>
Land	$ 158	$ 176
Buildings	1,347	1,387
Computer equipment and software	1,433	1,909
Other	578	842
Property and equipment--at cost	3,516	4,314
Accumulated depreciation	(1,905)	(2,411)
Property and equipment--net	$ 1,611	$ 1,903

</TABLE>

During 1998, 1999, and 2000, depreciation expense, of which the majority related to computer equipment, was $528 million, $483 million, and $668 million; disposals were not material.

Equity and Other Investments

<TABLE>
<CAPTION>

June 30, 1999	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
<S>	<C>	<C>	<C>	<C>
Debt securities recorded at market, maturing:				
Within one year	$ 682	$ 8	$ --	$ 690
Between 10 and 15 years	533	30	(33)	530
Beyond 15 years	4,731	347	--	5,078
Debt securities recorded at market	5,946	385	(33)	6,298
Common stock and warrants	3,029	3,598	(799)	5,828
Preferred stock	2,179	--	--	2,179
Other investments	67	--	--	67
Equity and other investments	$11,221	$3,983	$(832)	$14,372

</TABLE>

<TABLE>
<CAPTION>

June 30, 2000	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
<S>	<C>	<C>	<C>	<C>
Debt securities recorded at market, maturing:				
Within one year	$ 498	$ 27	$ --	$ 525
Between 2 and 10 years	388	11	(3)	396
Between 10 and 15 years	775	14	(93)	696
Beyond 15 years	4,745	--	(933)	3,812
Debt securities recorded at market	6,406	52	(1,029)	5,429
Common stock and warrants	5,815	5,655	(1,697)	9,773
Preferred stock	2,319	--	--	2,319
Other investments	205	--	--	205
Equity and other investments	$14,745	$5,707	$(2,726)	$17,726

</TABLE>

Debt securities include corporate and government notes and bonds and derivative securities. Debt securities maturing beyond 15 years are composed entirely of AT&T 5% convertible preferred debt with a contractual maturity of 30 years. The debt is convertible into AT&T common stock on or after December 1, 2000, or may be redeemed by AT&T upon satisfaction of certain conditions on or after June 1,

2002. Equity securities that are restricted for more than one year or not publicly traded are recorded at cost. At June 30, 1999 and 2000, the estimated fair value of these investments in excess of their recorded basis was $2.3 billion and $2.7 billion, based on publicly available market information or other estimates determined by management. The Company hedges the risk of significant market declines on certain highly volatile equity securities with options. The options are recorded at market, consistent with the underlying equity securities. At June 30, 1999 and 2000, the notional amount of the options outstanding was $2.1 billion and $4.0 billion; the fair value represents obligations of $1.0 billion and $1.7 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1998 were not material; realized gains were $623 million and $1.7 billion in 1999 and 2000 and losses were not material in 1999 and 2000.

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Income Taxes

The provision for income taxes consisted of:

<TABLE>
<CAPTION>

Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Current taxes:			
U.S. and state	$2,518	$4,027	$4,744
International	526	281	535
Current taxes	3,044	4,308	5,279
Deferred taxes	(417)	(202)	(425)
Provision for income taxes	$2,627	$4,106	$4,854

</TABLE>

U.S. and international components of income before income taxes were:

<TABLE>
<CAPTION>

Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
U.S.	$5,072	$10,649	$11,860
International	2,045	1,242	2,415
Income before income taxes	$7,117	$11,891	$14,275

</TABLE>

The effective income tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies. In 1999, the effective tax rate was 35.0%, excluding the impact of the gain on the sale of Softimage, Inc. In 2000, the effective tax rate was 34.0%, and included the effect of a 2.5% reduction from the U.S. statutory rate for tax credits and a 1.5% increase for other items. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate in 1998 and 1999 were not significant.

Deferred income taxes as of June 30 were:

<TABLE>

<CAPTION>

	1999	2000
<S>	<C>	<C>
Deferred income tax assets:		
Revenue items	$ 1,145	$ 1,320
Expense items	648	2,122
Deferred income tax assets	1,793	3,442
Deferred income tax liabilities:		
Unrealized gain on investments	(1,046)	(874)
International earnings	(647)	(1,766)
Other	(16)	(121)
Deferred income tax liabilities	$(1,709)	$(2,761)

</TABLE>

The Internal Revenue Service (IRS) has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. Tax Court. Income taxes, except for taxes related to the 1990 and 1991 assessments, have been settled with the IRS for all years through 1994. The IRS is examining the Company's U.S. income tax returns for 1995 and 1996. Management believes any related adjustments that might be required will not be material to the financial statements. Income taxes paid were $1.1 billion in 1998, $874 million in 1999, and $800 million in 2000.

Convertible Preferred Stock

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

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Common Stock

Shares of common stock outstanding were as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Balance, beginning of year	4,816	4,940	5,109
Issued	202	213	229
Repurchased	(78)	(44)	(55)
Balanced, end of year	4,940	5,109	5,283

</TABLE>

Repurchase Program
In January 2000, the Company terminated its stock buyback program. Prior to this termination, the Company periodically repurchased its common shares in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During 1998, the Company executed two forward settlement structured repurchase agreements with an independent third party totaling 42 million shares of stock and paid cash for a portion of the purchase price. In

1999, the Company settled the agreements by returning 28 million shares of stock, based upon the stock price on the date of settlement. The timing and method of settlement were at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the date of the agreement was originally reflected in common stock and paid-in capital.

Put Warrants

Prior to the termination of the stock buyback program, Microsoft enhanced the program by selling put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 2000, warrants to put 157 million shares were outstanding with strike prices ranging from $70 to $78 per share. The put warrants expire between September 2000 and December 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

Other Comprehensive Income

The changes in the components of other comprehensive income are as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Net unrealized investment gains/(losses):			
Unrealized holding gains, net of tax effect of $355 in 1998, $772 in 1999, and $248 in 2000	$ 660	$1,432	$ 531
Reclassification adjustment for gains included in net income, net of tax effect of $(18) in 1998, $(205) in 1999, and $(420) in 2000	(33)	(380)	(814)
Net unrealized investment gains/(losses)	627	1,052	(283)
Translation adjustments and other	(124)	69	23
Other comprehensive income/(loss)	$ 503	$1,121	$(260)

</TABLE>

Employee Stock and Savings Plans

Employee Stock Purchase Plan
The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1998, 1999, and 2000, employees purchased 4.4 million, 2.7 million, and 2.5 million shares at average prices of $27.21, $52.59, and $72.38 per share. At June 30, 2000, 68.4 million shares were reserved for future issuance.

Savings Plan
The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may contribute up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a

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participant's earnings. Matching contributions were $39 million, $49 million, and $65 million in 1998, 1999, and 2000.

Stock Option Plans

The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire after 10 years. At June 30, 2000, options for 341 million shares were vested and 734 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

<TABLE>
<CAPTION>

		Price per Share	
	Shares	Range	Weighted Average
<S>	<C>	<C>	<C>
Balance, June 30, 1997	956	$ 0.56 - $ 29.80	$ 7.86
Granted	138	16.56 - 43.63	31.28
Exercised	(176)	0.56 - 31.24	4.64
Canceled	(25)	4.25 - 41.94	14.69
Balance, June 30, 1998	893	0.56 - 43.63	11.94
Granted	78	45.59 - 83.28	54.62
Exercised	(175)	0.56 - 53.63	6.29
Canceled	(30)	4.25 - 74.28	21.06
Balance, June 30, 1999	766	0.56 - 83.28	23.87
Granted	304	65.56 - 119.13	79.87
Exercised	(198)	0.56 - 82.94	9.54
Canceled	(40)	4.63 - 116.56	36.50
Balance, June 30, 2000	832	0.56 - 119.13	41.23

</TABLE>

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 2000 were as follows:

<TABLE>
<CAPTION>

	Outstanding Options			Exercisable Options	
Range of Exercise Prices	Shares	Remaining Life (Years)	Weighted Average Price	Shares	Weighted Average Price
<S>	<C>	<C>	<C>	<C>	<C>
$0.56-$5.97	133	2.1	$ 4.57	127	$ 4.53
5.98-13.62	104	3.0	10.89	84	10.83
13.63-29.80	135	3.7	14.99	77	14.83
29.81-43.62	96	4.5	32.08	39	31.98
43.63-83.28	198	7.3	63.19	14	54.64
83.29-119.13	166	8.6	89.91	--	--

</TABLE>

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The Company follows Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, to account for stock option and employee stock purchase plans. An alternative method of accounting for stock options is SFAS 123, Accounting for Stock-Based Compensation. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and this compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined as prescribed by SFAS 123, pro forma income statements for 1998, 1999, and 2000 would have been as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1998		1999		2000	
	Reported	Pro Forma	Reported	Pro Forma	Reported	Pro Forma
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Revenue	$15,262	$15,262	$19,747	$19,747	$22,956	$22,956
Operating expenses:						
Cost of revenue	2,460	2,603	2,814	3,013	3,002	3,277
Research and development	2,601	2,963	2,970	3,479	3,775	4,817
Acquired in-process technology	296	296	--	--	--	--
Sales and marketing	2,828	2,977	3,231	3,438	4,141	4,483
General and administrative	433	508	689	815	1,009	1,243
Other expenses	230	230	115	115	92	92
Total operating expenses	8,848	9,577	9,819	10,860	12,019	13,912
Operating income	6,414	5,685	9,928	8,887	10,937	9,044
Investment income	703	703	1,803	1,803	3,182	3,182
Gain on sales	--	--	160	160	156	156
Income before income taxes	7,117	6,388	11,891	10,850	14,275	12,382
Provision for income taxes	2,627	2,369	4,106	3,741	4,854	4,210
Net income	$ 4,490	$ 4,019	$ 7,785	$ 7,109	$ 9,421	$ 8,172
Diluted earnings per share	$ 0.84	$ 0.75	$ 1.42	$ 1.30	$ 1.70	$ 1.48

</TABLE>

The weighted average Black-Scholes value of options granted under the stock option plans during 1998, 1999, and 2000 was $11.81, $20.90, and $36.67. Value was estimated using a weighted average expected life of 5.3 years in 1998, 5.0 years in 1999, and 6.2 years in 2000, no dividends, volatility of .32 in 1998 and 1999 and .33 in 2000, and risk-free interest rates of 5.7%, 4.9%, and 6.2% in 1998, 1999, and 2000.

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Earnings Per Share

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

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

<TABLE>
<CAPTION>

Year Ended June 30	1998	1999	2000
<S>	<C>	<C>	<C>
Net income	$4,490	$7,785	$9,421
Preferred stock dividends	28	28	13
Net income available for common shareholders	$4,462	$7,757	$9,408

Weighted average outstanding shares of common stock	4,864	5,028	5,189
Dilutive effect of:			
Common stock under structured repurchases	6	13	--
Put warrants	--	--	2
Preferred stock	34	16	7
Employee stock options	458	425	338
Common stock and common stock equivalents	5,362	5,482	5,536
Earnings per share:			
Basic	$ 0.92	$ 1.54	$ 1.81
Diluted	$ 0.84	$ 1.42	$ 1.70

</TABLE>

Operational Transactions

In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. A director of the Company owned 10% of WebTV. Microsoft paid $425 million in stock and cash for WebTV. The Company recorded an in-process technologies write-off of $296 million in the first quarter of fiscal 1998.

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. and recorded a pretax gain of $160 million. As part of a transitional service agreement, Microsoft agreed to make certain development tools and management systems available to Avid for use in the Softimage business.

In November 1998, Microsoft acquired LinkExchange, Inc., a leading provider of online marketing services to Web site owners and small and medium-sized businesses. Microsoft paid $265 million in stock.

In September 1999, the Company sold the entertainment city guide portion of MSN Sidewalk to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution agreement. Microsoft recognized a gain of $156 million on the sale and will recognize revenue amounts related to the distribution arrangement over the term of the agreement.

In November 1999, Expedia, Inc. completed an initial public offering of its common stock. Expedia, which is majority-owned by Microsoft, is a leading provider of branded online travel services for leisure and small business travelers. Expedia's financial results and financial condition are consolidated with the operations of Microsoft.

In January 2000, the Company merged with Visio Corporation in a transaction that was accounted for as a pooling of interests. Microsoft issued 14 million shares in the exchange for the outstanding stock of Visio. Visio's assets and liabilities, which were nominal, are included with those of Microsoft as of the merger. Operating results for Visio from periods prior to the merger were not material to the combined results of the two companies. Accordingly, the financial statements for such periods have not been restated.

During fiscal 1999 and 2000, Microsoft also acquired several other entities primarily providing online technologies and services. The Company did not record significant in-process technology write-offs in connection with these transactions.

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Commitments

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $95 million, $135 million, and $201 million in 1998, 1999, and 2000. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2001, $178; 2002, $172; 2003, $160; 2004, $151; 2005, $139; and thereafter, $437.

Microsoft has committed $299 million for constructing new buildings and $200 million for the manufacturing of products. During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

Contingencies

On October 7, 1997, Sun Microsystems, Inc. ("Sun") brought suit against Microsoft in the U.S. District Court for the Northern District of California. Sun's complaint alleges several claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology.

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

On November 17, 1998, the Court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims, because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The Court ordered Microsoft to make certain changes in its products that include Sun's Java technology and to make certain changes in its Java software development tools. The Court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit Court of Appeals on December 16, 1998.

On August 23, 1999 the 9th Circuit Court of Appeals vacated the November 1998 preliminary injunction and remanded the case to the District Court for further proceedings. Sun immediately filed two motions to reinstate and expand the scope of the earlier injunction on the basis of copyright infringement and unfair competition. On January 25, 2000, the Court issued rulings on the two motions, denying Sun's motion to reinstate the preliminary injunction on the basis of copyright infringement and granting, in part, Sun's motion to reinstate the preliminary injunction based on unfair competition. Microsoft is in compliance with the terms of the partially reinstated preliminary injunction and will not need to undertake any further action to comply with the terms of the injunction. No other hearing or trial dates have been set.

The parties have filed multiple summary judgment motions on the interpretation of the Agreement and on Sun's copyright and trademark infringement claims. On February 25, 2000, the Court entered an order denying both parties' motions for summary judgment as to whether the Agreement authorizes Microsoft to distribute independently developed Java Technology. On April 5, 2000, the Trial Court entered an order denying Sun's motion for summary judgment regarding the interpretation of Section 2.7(a), which sets forth certain requirements that Sun must meet when they deliver Java Technology to Microsoft. On May 9, 2000, the Court entered an order granting Microsoft's motion to dismiss Sun's copyright infringement claim and on May 25, 2000, the Court issued a tentative order granting Microsoft's motion to dismiss Sun's claim that it is entitled to liquidated damages based on the alleged improper posting of its source code by Microsoft. The Court has indicated its intention to set a hearing on the remaining motions in September 2000.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-

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Microsoft Internet browsing software (or other software products); taking or threatening "action adverse" in consequence of a person's failure to license or distribute Microsoft Internet browsing software (or other software product) or distributing competing products or cooperating with the government; and restrictions on the screens, boot-up sequence, or functions of Microsoft's operating system products. The state Attorneys General allege largely the same claims and various pendent state claims. The states seek declaratory relief and preliminary and permanent injunctive relief similar to that sought by the DOJ, together with statutory penalties under the state law claims. The foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted Microsoft's motion for summary judgment as to the states' monopoly leverage claim and permitted the remaining claims to proceed to trial. Trial began on October 19, 1998 and ended with closing arguments on September 21, 1999. On November 5, 1999, Judge Jackson issued his Findings of Fact. On April 3, 2000 the Court entered its Conclusions of Law, determining that Microsoft "tied" Internet Explorer and Windows 95/98 in violation of Section 1 of the Sherman Act, that Microsoft violated Section 2 of the Sherman Act by taking actions to maintain its monopoly in the desktop-PC operating system market, and that Microsoft attempted to monopolize the Internet browser market in violation of Section 2 of the Sherman Act. The Court also held that Microsoft did not violate Section 1 of the Sherman Act by entering into a number of contracts challenged by the government. The Court established a schedule for consideration of the remedy to be imposed in a final judgment. On April 28, 2000, the plaintiffs submitted a joint proposed remedy that included a proposed break-up of Microsoft into two companies, an operating systems company, and a company that would own all of Microsoft's other products and businesses. Microsoft submitted its proposed remedy and its proposal for further remedy proceedings on May 10, 2000. On June 7, 2000, Judge Jackson entered the government's proposed order nearly verbatim as his final judgment in the case. That judgment orders a divestiture that will create two separate companies, an "Operating Systems Business" and an "Applications Business," to be implemented one year following a final decision on appeal. It also provides for a broad range of "conduct" remedies that would have gone into effect in 90 days, absent a stay. On June 13, 2000, Microsoft appealed to the United States Court of Appeals. The Court of Appeals immediately entered an order notifying the parties that the Court would hear all matters related to this appeal en banc. The government then asked Judge Jackson to enter an order certifying the case for direct appeal to the Supreme Court. On June 20, 2000, Judge Jackson certified the case for direct appeal to the Supreme Court and simultaneously granted Microsoft's request to stay the entire remedy pending final appeal. The certification divests the Court of Appeals of jurisdiction over the case until the Supreme Court decides whether or not to accept jurisdiction of the case, which is entirely discretionary. The parties have agreed to a briefing schedule on this issue, according to which Microsoft filed its Jurisdictional Statement on July 26, 2000, the government responded on August 15, 2000, and Microsoft replied on August 22, 2000. If the Supreme Court declines to accept jurisdiction, the appeal will return to the Court of Appeals. If the Supreme Court accepts jurisdiction, a schedule will be established for briefing and oral argument on the merits of our appeal.

In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues. In addition, the European Commission has instituted proceedings in which it alleges that Microsoft has failed to disclose information that Sun claims it needs to interoperate fully with Windows 2000 clients and has engaged in discriminatory licensing of such technology. The remedies sought, though not fully defined, include mandatory disclosure of Microsoft intellectual property concerning Windows operating systems and imposition of fines. Microsoft denies the Commission's allegations and intends to contest the proceedings vigorously.

A large number of antitrust class action lawsuits have been initiated against Microsoft. These cases allege that Microsoft has competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications and seek to recover alleged overcharges that the complaints contend Microsoft charged for these products. Microsoft believes the claims are without merit and is vigorously defending the cases.

The Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

Segment Information

Year Ended June 30

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<S>	Windows Platforms <C>	Productivity Applications and Developer <C>	Consumer and Other <C>	Reconciling Amounts <C>	Consolidated <C>
1998					
Revenue	$6,236	$ 7,458	$ 1,765	$ (197)	$15,262
Operating income	3,661	4,824	(1,050)	(1,021)	6,414
1999					
Revenue	$8,570	$ 8,636	$ 1,854	$ 687	$19,747
Operating income	5,476	4,950	(1,241)	743	9,928
2000					
Revenue	$9,265	$10,089	$ 2,718	$ 884	$22,956
Operating income	5,813	4,935	(1,455)	1,644	10,937

</TABLE>

2000 Margin:

63% 49% -54% 48%

The Company's organizational structure and fundamental approach to business reflect the needs of its customers. As such, Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer and Other. Windows Platforms includes the Windows Division, which is primarily responsible for developing and marketing Windows NT Workstation, Windows 2000 Professional, Windows 98, Windows 95, Windows NT Server, and Windows 2000 Server. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and vertical properties. Assets of the segment groups are not relevant for management of the businesses nor for disclosure.

Segment information is presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The Company's financial reporting systems present various data for management to run the business, including internal profit and loss statements (P&Ls) prepared on a basis not consistent with generally accepted accounting principles. Reconciling items include certain elements of unearned revenue, the treatment of certain channel inventory amounts and estimates, and the classification of revenue from product support and consulting. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization. In fiscal 2000, the Company's internal P&Ls included the Black-Scholes value of employee stock option grants, amortized over the remaining months of the fiscal year of the grant, as well as minor changes to the segments' composition due to various internal reorganizations during the year. Fiscal 1999 disclosures have been restated for consistent presentation. It is not practicable to restate fiscal 1998 for these changes.

} - note: restatement ⇒ 1999 Windows figures in 2000 10K ≠ 1999 Windows figures in 1999 10K

Revenue attributable to U.S. operations includes shipments to customers in the United States, licensing to OEMs and certain multinational organizations, and exports of finished goods, primarily to Asia, Latin America, and Canada. Revenue from U.S operations totaled $10.1 billion, $13.7 billion, and $15.7 billion in 1998, 1999, and 2000. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled $5.2 billion, $6.0 billion, and $7.3 billion in 1998, 1999, and 2000.

Long-lived assets totaled $1.5 billion and $1.8 billion in the United States in 1999 and 2000 and $154 million and $126 million in other countries in 1999 and 2000.

<PAGE>

Independent Auditors' Report

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1999 and 2000, and the related consolidated statements of income, cash flows, and stockholders' equity for each of the three years in the period ended June 30, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1999 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2000 in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Seattle, Washington

July 18, 2000

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Exhibit 21

Subsidiaries

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399
Microsoft FSC Corporation. (U.S. VIRGIN ISLANDS)
Microsoft Investments, Inc. (NEVADA)
Microsoft Ireland Operations Limited (IRELAND)
Microsoft Licensing, Inc. (NEVADA)
MSLI, GP (NEVADA)
Microsoft Operations Pte Ltd. (SINGAPORE)
Microsoft Regional Sales Corporation (NEVADA-SINGAPORE BRANCH)
Microsoft Puerto Rico, Inc. (DELAWARE)
The Microsoft Network L.L.C. (DELAWARE)
Microsoft Treasury, Inc (NEVADA)
GraceMac Corporation (NEVADA)
Microsoft de Argentina S.A.
Microsoft Pty. Limited (AUSTRALIA)
Microsoft Gesellschaft m.b.H. (AUSTRIA)
Microsoft B.V.B.A. (BELGIUM)
Microsoft Bolivia S.R.L.
Microsoft Informatica Limitada (BRAZIL)
Microsoft Bulgaria EOOD
Microsoft Canada Co.
Microsoft Chile S.A.
Microsoft Colombia Inc. (DELAWARE)
Microsoft de Centroamerica S.A. (COSTA RICA)
Microsoft Hrvatska d.o.o. (CROATIA)

Microsoft s.r.o. (CZECH REPUBLIC)
Microsoft Danmark ApS (DENMARK)
Microsoft Dominicana, S.A. (DOMINICAN REPUBLIC)
Microsoft Del Ecuador S.A.
Microsoft El Salvador S.A. de C.V.
Microsoft Egypt L.L.C.
Microsoft Oy (FINLAND)
Microsoft France S.A.R.L.
Microsoft G.m.b.H. (GERMANY)
Microsoft Hellas S.A. (GREECE)
Microsoft de Guatemala, S.A.
Microsoft Hong Kong Limited
Microsoft Hungary Kft.
Microsoft Corporation (India) Private Limited
Microsoft India (R&D) Private Limited
PT. Microsoft Indonesia
Microsoft Israel Ltd.
Microsoft SRL (ITALY)
Microsoft Cote d'Ivoire SARL (IVORY COAST)
Microsoft Jamaica, Inc.
Microsoft Company, Limited (JAPAN)
Microsoft Asia Ltd (NEVADA-JAPAN BRANCH)
Microsoft Product Development Ltd. (NEVADA-JAPAN BRANCH)
East Africa Software Limited (KENYA)
Microsoft CH (KOREA)
Microsoft Kuwait Representative Office
SIA Microsoft Latvija
Microsoft Corporation Lebanon Representative Office
Microsoft (Malaysia) Sdn. Bhd.
Microsoft Mexico, S.A. de C.V.
Microsoft Indian Ocean Islands Limited (MAURITIUS)
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Microsoft Maroc S.A.R.L. (MOROCCO)
Microsoft B.V. (THE NETHERLANDS)
Microsoft Manufacturing B.V. (THE NETHERLANDS)
Microsoft International B.V. (THE NETHERLANDS)
Microsoft New Zealand Limited
Microsoft Nigeria Limited
Microsoft Norge AS (NORWAY)
Microsoft Corporation-Pakistan Liaison Office
Microsoft de Panama, S.A.
Microsoft (China) Company Limited (THE PEOPLE'S REPUBLIC OF CHINA)
Microsoft Peru, S.R.L.
Microsoft Philippines, Inc.
Microsoft sp. z.o.o. (POLAND)
MSFT-Software Para Microcomputadores, LDA (PORTUGAL)
Microsoft Caribbean, Inc. (DELAWARE)
Microsoft Romania SRL
Microsoft ZAO (RUSSIA)
Moscow Microsoft Ireland Operations Limited (Representative Office)(RUSSIA)
Microsoft Arabia Limited (SAUDI ARABIA, 60% owned)
Microsoft Singapore Pte Ltd.
Microsoft Slovakia s.r.o.
Microsoft d.o.o., Ljubljana (SLOVENIA)
Microsoft (S.A.) (Proprietary) Limited (SOUTH AFRICA)
Microsoft Iberica S.R.L. (SPAIN)
Microsoft Aktiebolag (SWEDEN)
Microsoft AG (SWITZERLAND)
Microsoft Taiwan Corporation
Microsoft (Thailand) Limited
Microsoft Trinidad & Tobago Limited
Microsoft Tunisie, S.A.R.L. (TUNISIA)

Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (TURKEY)
Microsoft Corporation (UNITED ARAB EMIRATES)
Microsoft Limited (UNITED KINGDOM)
Microsoft Research Limited (UNITED KINGDOM)
Microsoft Uruguay, S.A.
Microsoft Venezuela, S.A.
The Resident Representative Office of MICROSOFT Corporation in Hanoi (VIETNAM)
Microsoft Corporation, Zimbabwe Liaison Office
Microsoft HomeAdvisor, LLC (NEVADA)
WebTV Networks, Inc. (CALIFORNIA)
Expedia, Inc. (WASHINGTON, 75% owned)
Travelscape.com, Inc. (DELAWARE, owned by Expedia, Inc.)
VacationSpot.com, Inc. (DELAWARE, owned by Expedia, Inc.)
CarPoint.com, LLC (DELAWARE, 75% owned)
MSNBC Cable, L.L.C. (DELAWARE, 50% owned)
MSNBC Interactive News, L.L.C. (DELAWARE, 50% owned)
T1-MSN, Inc. (DELAWARE, 50% owned)
Wireless Knowledge L.L.C. (DELAWARE, 50% owned)
Ninemsn Pty. Limited (AUSTRALIA, 50% owned)
WebTV Networks K.K. (JAPAN, 75% owned)
Mobimagic Co. Ltd. (JAPAN, 50% owned)
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Exhibit 23

Independent Auditors' Consent

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981 Stock Option Plan), 33-44302, 33-51583, and 333-06298 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors), 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors), 333-16665 (Microsoft Corporation 1997 Employee Stock Purchase Plan), 333-61729 (Microsoft Corporation 1998 Special Stock Award Program), 333-75243 (Microsoft Corporation Savings Plus 401(k) Plan), 333-91755 (Microsoft Corporation 1999 Stock Option Plan for Non-Employee Directors) and 33-06298 of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, 33-63471, 33-64870, 333-00857, 333-01177, 333-02759, 333-05961, 333-8081, 333-12441, 333-17143, 333-18055, 333-18195, 333-23621, 333-31803, 333-37841, 333-41387, 333-43449, 333-45989, 333-52377, 333-61507, 333-65813, 333-69027, 333-75389, 333-79461, 333-89793, 333-94499, 333-38694, 333-40998, and 333-83873 of Microsoft Corporation on Forms S-3, and 333-26411 and 333-90119 of Microsoft Corporation on Form S-4 of our report dated July 18, 2000 appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 2000.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP

Seattle, Washington

September 27, 2000
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INDEXED
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10-K 1 d10k.htm FORM 10-K FOR THE FISCAL YEAR ENDED JUNE 30, 2002

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United States Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-K

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM ______ TO ______

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION

WASHINGTON (STATE OF INCORPORATION)	91-1144442 (I.R.S. ID)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

(425) 882-8080

Securities registered pursuant to Section 12(b) of the Act:
NONE

Securities registered pursuant to Section 12(g) of the Act:
COMMON STOCK

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

The aggregate market value of common stock held by non-affiliates of the registrant as of July 31, 2002 was $215,553,343,213.

The number of shares outstanding of the registrant's common stock as of July 31, 2002 was 5,378,746,853.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held November 5, 2002 are incorporated by reference into Part III.

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Microsoft Corporation

FORM 10-K

For The Fiscal Year Ended June 30, 2002

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PART I

ITEM 1. BUSINESS

GENERAL

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft's mission is to enable people and businesses throughout the world to realize their full potential, and the Company's vision is empowering people through great software—any time, any place, and on any device. Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software products include scalable operating systems for servers, personal computers (PCs), and intelligent devices; server applications for client/server environments; information worker productivity applications; business solutions applications; and software development tools. During fiscal 2002, Microsoft launched Xbox, the Company's next-generation video game system. The Company's online efforts include the MSN network of Internet products and services and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft licenses consumer software programs; sells hardware devices; provides consulting services; and trains and certifies system integrators and developers.

Microsoft also researches and develops advanced technologies for future software products. A significant portion of the Company's focus is on Microsoft's .NET architecture. Using common industry standards based on XML, a universal language for describing and exchanging data, the Company's goal is to enable seamless sharing of information across many platforms and programming languages, and over the Internet, with XML Web services. In addition, Microsoft has embarked on a long-term initiative called Trustworthy Computing, which aims to bring an enhanced level of security, privacy, reliability, and business integrity to computer systems.

PRODUCTS

During fiscal 2002, Microsoft had four operating segments based on its product and service offerings: Desktop and Enterprise Software and Services; Consumer Software, Services, and Devices; Consumer Commerce Investments; and Other. See Note 20 of the Notes to Financial Statements for financial information regarding segment reporting.

DESKTOP AND ENTERPRISE SOFTWARE AND SERVICES

Desktop and Enterprise Software and Services includes Desktop Applications; Desktop Platforms; and Enterprise Software and Services. For segment reporting purposes, Desktop Applications includes revenue from Microsoft Office; Microsoft Project; Visio; client access licenses (CALs) for Windows NT Server and Windows 2000 Server, Exchange, and BackOffice; Microsoft Great Plains; and bCentral. Desktop Platforms includes revenue from Windows XP Professional and Home; Windows 2000 Professional; Windows NT Workstation; Windows Millennium Edition; Windows 98; and other desktop operating systems. Enterprise Software and Services includes Server Platforms; Server Applications; Developer Tools and Services; and Enterprise Services.

DESKTOP APPLICATIONS

Microsoft Office. Microsoft Office is a software product featuring commonly used desktop functionality. The product is based upon a document-centric concept, with common commands and extensive use of cross-application capabilities. Microsoft Office is available in several versions for the Windows and Macintosh operating systems. Microsoft Office XP, the latest Microsoft Office release, helps users complete common business tasks, including word processing, electronic mail (e-mail), presentations, and data management, with features like smart tags, task panes, integrated e-mail, document recovery, and send for review. The various versions of Microsoft Office include the word processor Microsoft Word, Microsoft Excel spreadsheet, Microsoft Outlook personal information management and e-mail communication client, Microsoft PowerPoint presentation graphics program, and may include Microsoft Access database management application, Microsoft FrontPage Web site creation and management tool, and Microsoft Publisher business desktop publishing program. Most of these applications are also licensed separately.

Other Desktop Application Products. The Company also offers other stand-alone desktop application products. Microsoft Project is a project management program for scheduling, organizing, and analyzing tasks, deadlines, and resources. Visio is a diagramming program that helps people visualize and communicate ideas, information, and systems.

Client Access Licenses. A client access license gives its holder the legal right to access a computer running a Microsoft server product and the services supported by the server using a client computer.

Microsoft Great Plains. Microsoft Great Plains offers a range of integrated business and accounting products, including Dynamics, Solomon, and eEnterprise. Dynamics provides Internet-ready accounting and business management capabilities for small- to mid-sized companies. Solomon offers a full range of e-business and accounting applications for small- to mid-sized companies. eEnterprise supports mid-sized to larger companies by providing a collaborative environment for information management and sharing.

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bCentral. Microsoft's small businesses portal, bCentral, includes Site Manager, a Web site management and hosting service which empowers small businesses to easily create and manage their own Web sites, while allowing for higher-end editing in Microsoft FrontPage, and LinkExchange, which provides services to small businesses and Web site owners to increase their online traffic and sales with free advertising banner ads on their site in exchange for placing ads on other network sites.

DESKTOP PLATFORMS

Windows XP. Microsoft launched Windows XP in October 2001. Windows XP extends the personal computing experience by uniting PCs, devices, and services, while enhancing reliability, security, and performance. Windows XP Home Edition is designed for individuals or families and includes experiences for digital photo, music, video, home networking, and communications. Windows XP Professional includes all the features of Home Edition, plus remote access, security, performance, manageability, and multilingual features to help users improve productivity and connectivity.

Windows 2000 Professional. The successor to Windows NT Workstation, Windows 2000 Professional operating system combines features to create a mainstream operating system for desktop and notebook computing in all organizations. Windows 2000 Professional contains the enhanced business features of Windows 98 such as Plug and Play, easy-to-use user interface, and power management and integrates the strengths of Windows NT Workstation including standards-based security, manageability, and reliability.

Windows NT Workstation. A fully integrated, multitasking 32-bit PC operating system, Windows NT Workstation provides improved security features, robustness, and portability. Windows NT Workstation combines the Windows 98 operating system interface and usability features with the reliability and security of Windows NT for the business environment.

Windows Millennium Edition. Windows Millennium Edition (Me) operating system is designed specifically for home users, including capabilities to manage digital photos and music, work with video, create a home network, and communicate with other consumers.

Windows 98. The successor to Windows 95, Windows 98 is a personal computer operating system that provides a Web-oriented user interface and better system performance along with easier system diagnostics and maintenance. Windows 98 supports graphics, sound, and multimedia technologies and provides the ability to easily add and remove peripheral devices and support for Universal Serial Bus (USB).

ENTERPRISE SOFTWARE AND SERVICES

Windows 2000 Server, Advanced Server, and Datacenter Server. Windows 2000 Server is a multipurpose network operating system for businesses of all sizes. Windows 2000 Advanced Server operating system is ideal for e-commerce and line-of-business applications and provides enhanced performance and scalability through symmetric multiprocessing (SMP) and extended memory support. Windows Datacenter Server operating system is built for large-scale line-of-business and enterprise backend usage and supports server consolidation and enhanced scalability.

Microsoft .NET Enterprise Servers. Microsoft .NET Enterprise Servers include Microsoft SQL Server, Exchange Server, Application Center, BizTalk Server, Commerce Server, Content Management Server, Host Integration Server, Internet Security and Acceleration Server, Microsoft Operations Manager, Mobile Information Server, and SharePoint Portal Server.

SQL Server is a comprehensive data management and analysis platform that enables rapid delivery, dependable performance and secure operation of connected applications.

Exchange Server is a messaging and collaboration server that provides e-mail, group scheduling, task management, contact management and document routing capabilities.

Application Center is Microsoft's deployment and management tool for high-availability Web applications built on the Microsoft Windows 2000 operating system.

BizTalk Server enables companies to rapidly build and deploy integrated business processes within their organizations and with partners.

Commerce Server provides a comprehensive set of features for building scalable, user-centric, business-to-consumer, and business-to-business e-commerce sites.

Content Management Server is the enterprise Web content management system that enables companies to quickly and efficiently build, deploy, and maintain highly dynamic Internet, intranet, and extranet Web sites.

Host Integration Server extends Microsoft Windows applications to other systems by providing application, data, and network integration.

Internet Security and Acceleration Server provides secure, fast, and manageable Internet connectivity. It integrates an extensible, multilayer enterprise firewall and a scalable high-performance Web cache.

Microsoft Operations Manager delivers enterprise-class solutions for operations management of Windows 2000, the Microsoft Active Directory service, and other component services in Windows 2000, as well as other Microsoft .NET Enterprise Server applications such as Exchange and SQL Server.

Mobile Information Server mobile-enables the enterprise, extending the reach of Microsoft .NET Enterprise applications, enterprise data, and intranet content to the mobile user.

SharePoint Portal Server extends the capabilities of Microsoft Windows and Microsoft Office by offering information workers a powerful new way to easily organize, find, and share information. It combines the ability to easily create corporate Web portals with document management, content searching, and team collaboration features.

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Part I
Item 1

Other Servers. Small Business Server is the flexible network solution designed to help businesses with up to 50 computers. Systems Management Server helps centrally manage the distributed environment with integrated features, including hardware inventory, software inventory and metering, software distribution and installation, and remote troubleshooting tools.

Developer Tools and Services. Software development tools and computer languages allow software developers to write programs in a particular computer language and translate programs into a binary machine-readable set of commands that activate and instruct various hardware devices. The Company develops and markets a number of software development environments and language compilers. In February 2002, Microsoft launched Visual Studio .NET, a comprehensive tool for rapidly building and deploying XML Web services and applications. Visual Studio .NET provides software developers with powerful tools to rapidly design broad-reach Web applications for any device and any platform, and to build powerful Windows applications. Microsoft Visual C++ is the Company's development system for Windows-based application development. Microsoft Visual C# offers beginning and intermediate developers with C++ or Java experience a modern language and robust development environment for creating XML Web services and Microsoft .NET-based applications for Windows and the Web. The Microsoft Visual Basic development system provides easy access to a wide variety of data sources by integrating the Microsoft Access database engine and the ability to take advantage of investments in commercial applications. The Microsoft Visual InterDev development system includes integrated, team-based development tools for building Web-based applications based on HTML, Script, and components written in any language. Developers can subscribe to the Microsoft Developer Network (MSDN) information service and receive periodic updates via CD-ROMs, magazines, and several online information services. In addition, Microsoft receives certification fees through the Microsoft Certified Professional (MCP) program, a program that provides credentials for those who have demonstrated in-depth knowledge of at least one Microsoft product.

Enterprise Services. Microsoft Enterprise Services assist organizations with every stage of technology planning, building, deployment, and support. Specializing in IT solutions for the enterprise, Microsoft offers a full range of consulting services for advance technology requirements, including custom solutions services, enterprise application planning, architecture and design services, and proof-of-concept services. The Company provides product support services aligned to customer segments, partner segments, and communities.

CONSUMER SOFTWARE, SERVICES, AND DEVICES

Consumer Software, Services, and Devices includes Xbox video game system, MSN Internet Access, MSN Network Services, PC and Online Games, Learning and Productivity Software, Mobility, and Embedded Systems.

Xbox. Microsoft Xbox, released in fiscal 2002, is Microsoft's next-generation video game console system that delivers high quality graphics and audio gameplay experiences. For information on Xbox manufacturing, see "Manufacturing" below. Games for the Xbox are developed by Microsoft Game Studios, such as Halo and Project Gotham Racing, and by third-party game development partners, such as Tecmo's Dead or Alive 3. Xbox Live, an online service available to owners of Xbox systems, is expected to be launched in the second quarter of fiscal 2003 and will allow online game play among users of online-enabled Xbox games.

MSN Internet Access. MSN Internet access is Microsoft's service for accessing the Web and experiencing a wide range of rich online services and content. MSN Internet access subscribers can access their account from multiple sources, including a computer, television, Internet appliances, and Personal Data Assistants.

MSN Network Services. The MSN network provides services, content and advertising on the Internet, encompassing MSN Search, Messenger, eShop, Hotmail, Money, and Music, as well as other services and content. MSN Search makes Web searches more useful by providing users with the most relevant results for the most popular search queries on the Web. MSN Messenger is a free Internet messaging service that enables users to see when others are online and exchange instant messages with them. MSN eShop is a one-stop online shopping resource. MSN Hotmail is the world's leading free Web-based e-mail service. MSN Money is a complete online personal financial service that combines finance tools and content from Microsoft with exclusive investment news and analysis from CNBC. MSN Music provides consumers with one place online to find old favorites, as well as discover new music, and delivers a high quality listening experience.

PC and Online Games. The Company offers a line of entertainment products from classic software games to online games, simulations, sport products, and strategy games. Microsoft Flight Simulator is a popular aircraft flight simulation product. Other games include Age of Empires, Dungeon Siege, MechWarrior, Microsoft Links, Train Simulator, Zoo Tycoon, and other action and sports titles. Zone.com is a gaming community on the Internet allowing multiplayer gaming competitions of Microsoft's popular CD-ROM games and classic card, board, and puzzle games.

Learning and Productivity Software. Learning titles include Microsoft Encarta Reference Library, a complete research and reference source with a multimedia encyclopedia database with interactive information, an interactive world atlas with three-dimensional maps, a world English dictionary, Encarta Africana, Researcher, and an online version with monthly updates. Titles for children include a series of products based on the popular children's book and television series, Scholastic's The Magic School Bus. Microsoft's productivity offerings include Microsoft Works, an integrated software program that contains basic word processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Microsoft Picture It! brand of products includes Picture It! Photo, with photo editing tools and wizards to easily capture, correct and create photos, and Picture It! Publishing, used to create greeting cards and other print and Web based products. Microsoft Money offers leading tools and resources to conduct a wide range of financial activities. The

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Part I
Item 1

Works Suite provides a comprehensive collection of software, including Microsoft Works, Microsoft Word, Microsoft Money, Microsoft Encarta encyclopedia, Microsoft Picture It! Photo, and Microsoft Streets & Trips.

Mobility and Embedded Systems. Microsoft develops a number of software platforms for mobile computing. Products such as Pocket PC, Pocket PC Phone Edition, and Microsoft Windows Powered Smartphone are designed to enable a variety of mobile scenarios. Microsoft's embedded offerings include two embedded operating systems, Microsoft Windows CE and Microsoft Windows NT Embedded, as well as device specific solutions. Microsoft Windows CE, a robust real-time embedded operating system, is targeted at mobile 32-bit devices. Microsoft Windows NT Embedded, based on the desktop and server versions of Microsoft's operating systems, is targeted at higher-end embedded products and devices. Both embedded operating systems offer integrated tool sets to enable embedded system developers to quickly create sophisticated embedded device and application solutions. Microsoft Mobile Information Server is a scalable and reliable mobile applications server that provides enterprise customers and mobile operators with a rich platform for extending .NET Enterprise application and securely delivering real-time, wireless data to mobile devices.

CONSUMER COMMERCE INVESTMENTS

Consumer Commerce Investments include the HomeAdvisor online real estate service and the CarPoint online automotive service.

HomeAdvisor online real estate service. The HomeAdvisor online real estate service is a complete guide to the home-buying process and provides comprehensive tools for finding homes and loans on the Internet. The service includes customized search features, worksheets and calculators, and editorial content and home-buying advice.

CarPoint online automotive service. The CarPoint online automotive service is the leading online automotive marketplace, visited by more than 7 million consumers each month. With details on more than 10,000 car models and 100,000 used vehicles, users can research and compare cars of virtually every make and model, identify local dealers, and receive instructions for post-purchase service and maintenance.

Expedia, Inc. Expedia was included in the Consumer Commerce Investments segment until Microsoft sold its interest in Expedia to USA Networks, Inc. in February 2002. Expedia, Inc. operates Expedia.com, a leading online travel service. Expedia.com provides air, car, and hotel booking, vacation package and cruise offerings, destination information, and mapping.

OTHER

Hardware. The Hardware Group develops and markets several PC accessories including the Microsoft IntelliMouse family of hand-held pointing devices using the IntelliEye optical technology. Hardware also markets several types of keyboards including the Microsoft Natural Keyboard, an ergonomically designed keyboard, the Internet Keyboard featuring two USB ports and Internet hot keys, and a new Wireless Desktop product including wireless keyboard and mouse. Also included in the Hardware Group's portfolio of devices are SideWinder game controllers and force feedback joysticks with realistic performance technology to use with PC games.

Microsoft Press. Microsoft Press offers comprehensive learning and training resources to help new users, power users, and professionals get the most from Microsoft technology through books, CDs, self-paced training kits, and videos that are created to accommodate different learning styles and preferences. Microsoft Press books are authored by professional and technical writers, both by Microsoft employees and independent authors.

SEGMENT REPORTING

In fiscal 2003, the Company will begin reporting the following operating segments: Client; Information Worker; MSN; Home and Entertainment; CE Mobility; Server and Tools; and Business Solutions. These changes are designed to provide a comprehensive end-to-end financial view of Microsoft's key businesses; promote better alignment of strategies and objectives between development, sales, marketing, and services organizations; provide for more timely and rational allocation of development, sales, and marketing resources within businesses; and focus strategic planning efforts on key objectives and initiatives and give business owners more autonomy in detailed planning.

EQUITY METHOD INVESTMENTS

The Company has entered into joint venture arrangements to take advantage of creative talent and content from other organizations. For example, Microsoft owns 50 percent of MSNBC Cable L.L.C., a 24-hour cable news and information channel, and 50 percent of MSNBC Interactive News L.L.C., an interactive online news service. National Broadcasting Company (NBC) owns the remaining 50 percent of these two joint ventures.

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Item 1

PRODUCT DEVELOPMENT

During fiscal years 2000, 2001, and 2002, research and development expense was $3.77 billion, $4.38 billion, and $4.31 billion, respectively. Those amounts represented 16.4%, 17.3%, and 15.2%, respectively, of revenue in each of those years. In accordance with Statement of Financial Accounting Standards (SFAS) 142, *Goodwill and Other Intangible Assets*, the amortization of goodwill was discontinued in fiscal 2002. The amount of goodwill amortization included in research and development expense in fiscal years 2000 and 2001 was $232 million and $272 million, respectively. The Company plans to continue significant expenditures for research and product development.

Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third-party development and localization of certain products. Internal development allows Microsoft to maintain closer technical control over its products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. Microsoft works on devising innovative solutions to computer science problems, such as making computers easier to use, designing software for the next generation of hardware, improving the software design process, and investigating the mathematical underpinnings of computer science. The Company has created a substantial body of proprietary development tools and has evolved development methodologies for creating and enhancing its products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, or computing devices. Product documentation is generally created internally. The Company strives to become informed at the earliest possible time about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, Microsoft provides to software vendors a range of development, training, testing resources, and guidelines for developing applications.

The software industry is characterized by rapid technological change, which requires constant attention to computing technology trends, shifting consumer demand, and rapid product innovation. The pace of change is accelerating as the computing needs of our customers move beyond the PC toward intelligent devices and appliances, such as the Tablet PC. Tablet PCs extend the power of laptop computers running Windows XP with enhanced capabilities such as handwriting and speech input.

The Company believes that making its products trustworthy is critical to their success and has launched a company-wide effort called Trustworthy Computing. Trustworthy Computing has four pillars: reliability, security, privacy, and business integrity. Reliability means that a computer system is dependable, is available when needed, and performs as expected and at appropriate levels. Security means that a system is resilient to attack, and that the confidentiality, integrity and availability of both the system and its data are protected. Privacy means that individuals have the ability to control data about themselves and that those using such data faithfully adhere to fair information principles. Business integrity, in this context, is about being responsible to customers and helping them find appropriate solutions for their business issues, addressing problems with products or services, and being open in interactions with customers. While the Company is continuing to invest significantly in delivering new capabilities that customers ask for, Microsoft is making security improvements a high priority.

Microsoft .NET is Microsoft's platform for XML Web services. XML Web services allow applications to communicate and share data over the Internet or an intranet, regardless of operating system or programming language. The Microsoft .NET platform includes a comprehensive family of products, built on XML and other Internet industry standards, which provide for each aspect of developing, managing, using, and experiencing XML Web services. There are five areas where Microsoft is building the .NET platform today: Tools, Servers, XML Web Services, Clients, and .NET Experiences. In the Tools area, Visual Studio .NET and the Microsoft .NET framework supply a complete solution for developers to build, deploy, and run XML Web services. They maximize the performance, reliability, and security of XML Web services. The .NET Enterprise Servers, including the Windows 2000 Server family, make up Microsoft .NET's server infrastructure for deploying, managing, and orchestrating XML Web services. Designed with mission-critical performance in mind, they provide enterprises with the agility they need to integrate their systems, applications, and partners through XML Web services, and the flexibility to adapt to changing business requirements. Clients are PCs, laptops, workstations, phones, handheld computers, Tablet PCs, game consoles, and other smart devices. These smart devices use software that supports XML Web services, which enable users to access their data regardless of the location, type, and number of clients used. Smart clients and devices leverage XML Web services to create .NET experiences that allow users to access information across the Internet and from stand-alone applications in an integrated way.

To best serve the needs of users around the world, Microsoft "localizes" many of its products to reflect local languages and conventions and to improve the quality and usability of the product in international markets. Localizing a product might require modifying the user interface, altering dialog boxes, and translating text. In Japanese versions, for example, all user messages and documentation are in Japanese with monetary references in the Japanese yen. Various Microsoft products have been localized into more than 30 languages.

MANUFACTURING

Microsoft contracts out most of its manufacturing activities to third parties. Outside manufacturers produce the Xbox, various retail software packaged products, and hardware. There are other custom manufacturers Microsoft could use in the event outsourced manufacturing becomes unavailable from current vendors. The Company generally has multiple sources for raw materials, supplies, and components and is often able to acquire component parts and materials on a volume discount basis. The graphics processing unit (GPU) for the Xbox was custom designed and is produced by NVIDIA Corporation. Quality control tests are performed on purchased parts, CD-ROMs, and other products.

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Item 1

OPERATIONS

The Company has regional operations centers in Ireland, Singapore, and the Greater Seattle area. The regional centers support all operations, including information processing, vendor management and logistics by geographical regions. The regional center in Dublin, Ireland supports the European, African, and Middle East regions, the center in Singapore supports the Asia Pacific region, and the center in the Greater Seattle area supports North and South America. Microsoft Licensing, Inc. (MSLI), a wholly-owned subsidiary in Reno, Nevada, manages the Company's original equipment manufacturer (OEM) and certain organizational licensing operations.

DISTRIBUTION, SALES AND MARKETING

Microsoft distributes its products primarily through the following channels: OEM; volume licensing; online services and products; and distributors and retailers. In fiscal 2002, Microsoft had three major geographic sales and marketing regions: the South Pacific and Americas Region; the Europe, Middle East, and Africa Region; and the Asia Region. Beginning with fiscal 2003, the Company's geographic sales and marketing organization was modified to remove the South Pacific region from the Americas organization, and combine it with Asia. Sales of volume licenses and packaged software products via these channels are primarily to distributors and resellers.

OEM. Microsoft operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of the Company's products with their computing devices, principally PCs. The Company also markets and licenses certain server operating systems, desktop applications, hardware devices, and consumer software programs to OEMs under similar arrangements. In almost all cases, the products are distributed under Microsoft trademarks. The Company has OEM agreements covering one or more of its products with virtually all of the major PC OEMs, including Acer, Actebis, Dell, eMachines, Fujitsu, Fujitsu Siemens Computers, Gateway, HP, IBM, NEC, Samsung, Sony, and Toshiba. A substantial amount of OEM business is also conducted with system builders, which are low-volume customized PC vendors.

Volume Licensing. The Microsoft Enterprise Agreement program is a licensing program designed to provide a flexible licensing and service solution tailored to customers making a long-term licensing commitment. The agreements are designed to simplify license administration, payment terms, and the contract process. The Microsoft Select program offers flexible software acquisition, licensing, and maintenance options specially customized to meet the needs of large multinational organizations. Marketing efforts and fulfillment are generally coordinated with large account resellers. The Microsoft Open program is a licensing program that is targeted for small- and medium-sized organizations. It is available through the reseller channel and offers discounts based on initial purchase volumes. The Microsoft Enterprise Agreement and Software Assurance under the Select and Open programs provide customers the right to install any new release of products covered in the licensing agreement during the term of their coverage.

Network Service Providers. Microsoft Network Service Providers (NSP) work with a variety of companies worldwide to help them develop and deploy end-to-end network solutions based on Microsoft platforms. NSPs focus on key network service industries including telecommunications and wireless companies and hosts.

Online Services and Products. Microsoft distributes online content and services through MSN Access, MSN Network Services, bCentral small business portal, and other online services. MSN Access delivers simple, personalized Internet access, useful content, services and tools using MSN Internet Explorer. MSN Network Services delivers advertising and other services including online search, shopping, and messaging capabilities to Internet users. bCentral provides the tools and expertise for small-business owners to build, market and manage their businesses online. Other services delivered online include MSDN subscription content and updates, periodic product updates, and online technical and practice readiness resources to support Microsoft partners in developing and selling Microsoft products and solutions.

Distributors and Resellers. The Company distributes products in the finished goods channels primarily to independent non-exclusive distributors and resellers. Distributors and resellers include Ingram Micro, Tech Data, Level 3 Communications, SOFTBANK, Software House International, ASAP Software Express, and Happinet Corporation. Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

CUSTOMERS

The Company's customers include individual consumers, small- and medium-sized organizations, enterprises, educational institutions, Internet Service Providers (ISPs), application developers, and OEMs. Consumers and organizations obtain Microsoft products primarily through resellers and OEMs, which include certain Microsoft products with their computing devices. No single customer accounted for 10% or more of revenue in 2000, 2001, or 2002.

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COMPETITION

The software business is intensely competitive and subject to rapid technological change. As the company pursues its largest strategic initiative, Microsoft .NET, the Company could experience more intense competition during the transition from the traditional core businesses to its new products based on the .NET architecture. The Company continues to face movement from PC-based applications to server-based applications or Web-based application hosting services, from proprietary software to open source software such as the Linux operating system, and from PCs to Internet-based devices. A number of Microsoft's most significant competitors, including IBM, Sun Microsystems, Oracle, and AOL-Time Warner, are collaborating with one another on various initiatives directed at competing with Microsoft. These initiatives relate in part to efforts to move software from individual PCs to centrally managed servers, which would present significant challenges to the Company's historical business model. Other competitive collaborative efforts include the development of new platform technologies that are intended to replicate much of the value of Microsoft Windows operating systems. New computing form factors, including non-PC information devices, are gaining popularity and competing with PCs running Microsoft's software products.

Microsoft faces formidable competition in these new areas and in all areas of its current business activities. The rapid pace of technological change, particularly in the area of Internet platforms and services, continually creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. Global software piracy—the unlawful copying and distribution of Microsoft's copyrighted software products—deprives the Company of large amounts of revenue on an annual basis.

The Company's competitive position may be adversely affected in the future by one or more of the factors described in this section, particularly in view of the fast pace of technological change in the computing industry.

DESKTOP AND ENTERPRISE SOFTWARE AND SERVICES

The Company's competitors include many software application vendors, such as IBM, Oracle, Apple, Sun Microsystems, Corel, Qualcomm, and local application developers in Europe and Asia. IBM and Corel have large installed bases with their spreadsheet and word processor products, respectively, and both have aggressive pricing strategies. Also, IBM and Apple preinstall certain of their application software products on various models of their PCs, competing directly with Microsoft's desktop application software. Sun Microsystems' Star Office is aggressively priced. Additionally, Web-based application hosting services provide an alternative to PC-based applications such as Microsoft Office.

Microsoft's PC and server operating system products face substantial competition from a wide variety of companies. Competitors such as IBM, Apple Computer, Sun Microsystems, and others are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on their own computers. Many of these operating system software products are also licensed to third-party OEMs for preinstallation on their computers. Microsoft's operating system products compete with UNIX-based operating systems from a wide range of companies, including IBM, Hewlett-Packard, Sun Microsystems, and others. Variants of UNIX run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems. The Linux open source operating system has gained increasing acceptance as well. Several computer manufacturers preinstall Linux on PC servers and many leading software developers have written applications that run on Linux. Microsoft Windows operating systems also face competition from alternative platforms such as those based on Internet browsing software and Java technology promoted by AOL-Time Warner and Sun Microsystems.

The Company competes in the business of providing enterprise-wide computing solutions with several competitors who enjoy a larger share of sales and larger installed bases. Many companies offer operating system software for mainframes and midrange computers, including IBM, HP, and Sun Microsystems. Since legacy business systems are typically support-intensive, these competitors also offer substantial support services. Software developers that provide competing server applications for PC-based distributed client/server environments include Oracle, IBM, Computer Associates, Sybase, and Informix. There are also several software vendors who offer connectivity servers. As mentioned above, there are numerous companies and organizations that offer Internet and intranet server software, which compete against the Company's business systems. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with the Company's collaboration and e-mail products.

The Company's developer products compete against offerings from BEA Systems, Borland, IBM, Macromedia, Oracle, Sun Microsystems, Sybase, and other companies.

CONSUMER SOFTWARE, SERVICES, AND DEVICES

Microsoft's online services network, MSN, faces formidable competition from AOL-Time Warner, Yahoo!, and a vast array of Web sites and portals that offer content of all types and e-mail, instant messaging, calendaring, chat, and search and shopping services, among other things.

Xbox competes head-to-head against game systems from Nintendo and Sony, both of which have a large established base of game system users. Game developers like Activision, Capcom, Electronic Arts, Sega, Tecmo, and THQ, to name a few, are both partners and competitors.

Microsoft faces many competitors in the mobile devices space, including Palm, Symbian, Nokia, and Openwave. The embedded operating system market is highly fragmented with many competitive offerings. Key competitors include Wind River and versions of embeddable Linux from commercial Linux vendors such as Red Hat, Lineo, and MontaVista.

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CONSUMER COMMERCE INVESTMENTS

Microsoft faces many competitors in the online real estate and online automotive service spaces, including Homestore, AOL's House and Home channel, Autobytel, AOL autos, and Yahoo! autos.

OTHER

PC input devices face substantial competition from computer manufacturers, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices. Microsoft Press competes in the retail book and eLearning markets with publishers that also create content on Microsoft technologies. A few of the retail competitors are Pearson, WROX, Sybex, and Wiley. The major eLearning competitors are Smartforce and NetG.

EMPLOYEES

As of June 30, 2002, the Company employed approximately 50,500 people on a full-time basis, 34,600 in the United States and 15,900 internationally. Of the total, 20,800 were in product research and development, 23,500 in sales, marketing, and support, 2,200 in manufacturing and distribution, and 4,000 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees are subject to collective bargaining agreements. The Company believes relations with its employees are excellent.

ITEM 2. PROPERTIES

The Company's corporate offices consist of approximately 8.4 million square feet of office building space located in King County, Washington, of which 5.7 million square feet of corporate campus space situated on slightly more than 300 acres of land is owned and approximately 2.7 million square feet is leased. The Company is constructing three buildings with approximately 392,000 square feet of space that will be occupied in the Fall of 2003. To accommodate expansion needs the Company purchased approximately 38 acres, and has an option to purchase approximately 112 additional acres, of land in Issaquah, Washington, which can accommodate 2.95 million square feet of additional office space. The Company leases many sites domestically totaling approximately 3.0 million square feet of office building space.

The Company leases many sites internationally totaling approximately 4.1 million square feet, including the Company's European Operations Center and localization division which leases a 382,000 square-foot campus in Dublin, Ireland, a 45,000 square-foot disk duplication facility in Humacao, Puerto Rico and a 36,000 square-foot facility in Singapore for the Company's Asia Pacific Operations Center. Leased office building space includes the following locations: Tokyo, Japan 343,000 square feet; Unterschleissheim, Germany 253,000 square feet; United Kingdom campus 242,000 square feet; Les Ulis, France 229,000 square feet; and Beijing, China 115,000 square feet.

The Company's facilities are fully used for current operations of all segments and suitable additional space is available to accommodate expansion needs.

ITEM 3. LEGAL PROCEEDINGS

See Note 19—Contingencies of the Notes to Financial Statements (Item 8) for information regarding legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2002.

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Part I
Item 4

EXECUTIVE OFFICERS OF THE REGISTRANT

The executive officers of Microsoft as of July 31, 2002 were as follows:

Name	Age	Position with the Company
William H. Gates, III	46	Chairman of the Board; Chief Software Architect
Steven A. Ballmer	46	Chief Executive Officer
James E. Allchin	50	Group Vice President, Platforms Group
Orlando Ayala	46	Group Vice President, Worldwide Sales, Marketing, and Services Group
Robert J. (Robbie) Bach	40	Senior Vice President, Games Division
Douglas J. Burgum	46	Senior Vice President, Business Solutions
David W. Cole	40	Senior Vice President, MSN and Personal Services Group
John G. Connors	43	Senior Vice President; Chief Financial Officer
Jean-Philippe Courtois	41	Senior Vice President; President, Microsoft Europe, Middle East, and Africa
Jon Stephan DeVaan	41	Senior Vice President, TV Division
Richard P. Emerson	40	Senior Vice President, Corporate Development and Strategy
Paul Flessner	43	Senior Vice President, .NET Enterprise Servers
Kevin R. Johnson	41	Senior Vice President, Microsoft Americas
Robert L. Muglia	42	Senior Vice President, Enterprise Storage Division
Craig J. Mundie	53	Senior Vice President; Chief Technical Officer, Advanced Strategies and Policy
Jeffrey S. Raikes	44	Group Vice President, Productivity and Business Services
Richard F. Rashid	50	Senior Vice President, Research
Eric D. Rudder	35	Senior Vice President, Developer and Platform Evangelism
Steven J. Sinofsky	36	Senior Vice President, Office
Bradford L. Smith	43	Senior Vice President and General Counsel
Brian Valentine	42	Senior Vice President, Windows
David Vaskevitch	49	Senior Vice President; Chief Technical Officer, Business Platform
Deborah N. Willingham	46	Senior Vice President, Human Resources

Mr. Gates co-founded Microsoft in 1975 and served as its Chief Executive Officer from the time the original partnership was incorporated in 1981 until January 2000, when he resigned as Chief Executive Officer and assumed the position of Chief Software Architect. Mr. Gates has served as Chairman of the Board since the Company's incorporation.

Mr. Ballmer was named Chief Executive Officer and a director of the Company in January 2000. He served as President from July 1998 to February 2001. Previously, he had served as Executive Vice President, Sales and Support since February 1992. He joined Microsoft in 1980.

Mr. Allchin was named Group Vice President, Platforms Group in December 1999. He had been Senior Vice President, Platforms since March 1999. He was previously Senior Vice President, Personal and Business Systems since February 1996. Mr. Allchin joined Microsoft in 1990.

Mr. Ayala was named Group Vice President, Worldwide Sales, Marketing, and Services Group in August 2000. He had been Senior Vice President, South Pacific and Americas since February 1998, and before holding that position, was Vice President of the developing markets of Africa, India, the Mediterranean and Middle East, Latin America, Southeast Asia and the South Pacific. He joined Microsoft in 1991 as Senior Director of the Latin America Region.

Mr. Bach was named Senior Vice President, Games Division in March 2000. He had been Vice President, Home and Retail since March 1999. Before holding that position, he had been Vice President, Learning, Entertainment and Productivity since 1996. Mr. Bach joined Microsoft in 1988.

Mr. Burgum joined the Company upon Microsoft's acquisition of Great Plains Software, Inc. in April 2001. Mr. Burgum became Great Plains' first outside investor in March 1983. He was named President of Great Plains in 1984 and subsequently named Chairman and Chief Executive Officer.

Mr. Cole was named Senior Vice President, MSN and Personal Services Group in November 2001. Before holding that position, he had been Senior Vice President, Services Platform Division since August 2000. He had been Senior Vice President, Consumer Services since December 1999 and Vice President, Consumer Windows since March 1999. Previously, he was Vice President, Web Client and Consumer Experience and Vice President, Internet Client and Collaboration. Mr. Cole joined Microsoft in 1986.

Mr. Connors was named Senior Vice President and Chief Financial Officer in December 1999. He had been Vice President, Enterprise since March 1999. Mr. Connors had been Vice President, Information Technology, and Chief Information Officer since July 1996. He joined Microsoft in 1989.

Mr. Courtois was named Senior Vice President and President, Microsoft Europe, Middle East, and Africa in July 2000. He had been Vice President, Customer Marketing since July 1998. Before holding that position, he had been Vice President of Microsoft Europe since 1997 and General Manager for Microsoft France since 1994. Mr. Courtois joined Microsoft in 1984.

Mr. DeVaan was named Senior Vice President, TV Division in December 1999. He had been Senior Vice President, Consumer and Commerce since September 1999. Mr. DeVaan had been Vice President, Consumer and Commerce since March 1999. He had been Vice President, Desktop Applications since 1995. Mr. DeVaan joined Microsoft in 1985.

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Mr. Emerson joined Microsoft in November 2000 as Senior Vice President, Corporate Development and Strategy. Prior to joining Microsoft, he was Managing Director and co-head of Technology and Telecommunications Advisory Services at international investment bank Lazard Freres & Co. LLC. He spent 12 years in San Francisco and New York with Lazard and Morgan Stanley, specializing in advising clients in the technology and telecommunications sectors on mergers, acquisitions, and strategic partnerships.

Mr. Flessner was named Senior Vice President, .NET Enterprise Servers in December 1999. He had been Vice President, Database and Data Access. Since joining the Company, Mr. Flessner's primary responsibilities have been the development of Microsoft's database business. He joined Microsoft in 1994.

Mr. Johnson was named Senior Vice President, Microsoft Americas in February 2002. He had been Senior Vice President, U.S. Sales, Marketing, and Services since August 2001, and before that, Vice President, U.S. Sales, Marketing and Services. Mr. Johnson was named Vice President, Product Support Services in July 1998. He joined Microsoft in 1992.

Mr. Muglia was named Senior Vice President, Enterprise Storage Division in November 2001. Before holding that position, he had been Group Vice President, Personal Services Group since August 2000. He had been Group Vice President, Business Productivity since December 1999. He was named Senior Vice President, Business Productivity in March 1999 and was named Senior Vice President, Applications and Tools in February 1998. He had been Vice President, Server Applications since 1997. He joined Microsoft in 1988.

Mr. Mundie was named Senior Vice President and Chief Technical Officer, Advanced Strategies and Policy in August 2001. He was named Senior Vice President, Consumer Platforms in February 1996. He joined Microsoft as General Manager, Advanced Consumer Technology in 1992.

Mr. Raikes was named Group Vice President, Productivity and Business Services in August 2000. He had been Group Vice President, Sales and Support since July 1998. Before holding that position, he had been Group Vice President, Sales and Marketing since July 1996. Mr. Raikes joined Microsoft in 1981.

Mr. Rashid was named Senior Vice President, Research in May 2000. He had been Vice President, Research since July 1994. He joined Microsoft in 1991.

Mr. Rudder was named Senior Vice President, Developer and Platform Evangelism in October 2001. He had been Vice President, Technical Strategy. Mr. Rudder joined Microsoft in 1988 and has worked in several areas, including networking, operating systems and developer tools, where he previously served as General Manager for the Visual Studio development system.

Mr. Sinofsky was named Senior Vice President, Office in December 1999. He had been Vice President, Office since December 1998. Mr. Sinofsky joined the Office team in 1994, increasing his responsibility with each subsequent release of the desktop suite. He joined Microsoft in 1989.

Mr. Smith was named Senior Vice President and General Counsel in November 2001. He had been Deputy General Counsel for Worldwide Sales and previously was responsible for managing the Company's European Law and Corporate Affairs Group, based in Paris. He joined Microsoft in 1993.

Mr. Valentine was named Senior Vice President, Windows in December 1999. He had been Vice President, Business and Enterprise since March 1999. He had been Vice President, Windows since December 1998. Before managing the Windows group, Mr. Valentine managed the server applications division and had been responsible for the Exchange product unit. He joined Microsoft in 1987.

Mr. Vaskevitch was named Senior Vice President and Chief Technical Officer, Business Platform in August 2001. He was named Senior Vice President, Business Applications in March 2000. He had been Senior Vice President, Developer since December 1999. Before holding that position, he had been Vice President, Distributed Applications Platform. He joined Microsoft in 1986.

Ms. Willingham was named Senior Vice President, Human Resources in February 2001. She had been Vice President, Human Resources since April 2000. Ms. Willingham had been Vice President, Business and Enterprise Division Marketing and was responsible for Windows operating system client and server marketing strategy and training, as well as for providing centralized marketing services for the Consumer Windows Marketing and Streaming Media Marketing teams. She joined Microsoft in 1993.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On June 30, 2002, there were 117,730 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock. The high and low common stock prices per share were as follows:

Quarter Ended	Sept. 30	Dec. 31	Mar. 31	June 30	Year
Fiscal 2001					
Common stock price per share:					
High	$ 82.00	$ 70.88	$ 64.69	$ 73.68	$ 82.00
Low	60.31	41.50	43.38	51.94	41.50
Fiscal 2002					
Common stock price per share:					
High	**$ 72.57**	**$ 69.49**	**$ 69.86**	**$ 60.38**	**$ 72.57**
Low	**49.71**	**51.79**	**57.99**	**48.62**	**48.62**

ITEM 6. SELECTED FINANCIAL DATA

FINANCIAL HIGHLIGHTS

In millions, except earnings per share

Year Ended June 30	1998	1999	2000	2001(1)	2002(2)
Revenue	$ 15,262	$ 19,747	$ 22,956	$ 25,296	**$ 28,365**
Operating income	6,585	10,010	11,006	11,720	**11,910**
Income before accounting change	4,490	7,785	9,421	7,721	**7,829**
Net income	4,490	7,785	9,421	7,346	**7,829**
Diluted earnings per share before accounting change	0.84	1.42	1.70	1.38	**1.41**
Diluted earnings per share	0.84	1.42	1.70	1.32	**1.41**
Cash and short-term investments	13,927	17,236	23,798	31,600	**38,652**
Total assets	22,357	38,321	51,694	58,830	**67,646**
Stockholders' equity	16,627	28,438	41,368	47,289	**52,180**

(1) Fiscal year 2001 includes an unfavorable cumulative effect of accounting change of $375 million or $0.06 per diluted share, reflecting the adoption of SFAS No. 133, and $4.80 billion (pre-tax) in impairments of certain investments, primarily cable and telecommunication investments.

(2) Fiscal year 2002 includes $4.32 billion (pre-tax) in impairments of certain investments, primarily related to the Company's AT&T investment and further declines in the fair values of European cable and telecommunications holdings, and a $1.25 billion (pre-tax) gain on the sale of Expedia, Inc.

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the continued adoption of Microsoft's .NET Enterprise Server offerings. Enterprise Services revenue in fiscal 2001, was up 34% compared to fiscal 2000 and Server Platforms increased 10% while revenue from Developer Tools and Services was flat. In fiscal 2000, Server Platforms revenue growth was particularly strong led by increased adoption by customers of Windows NT Server and Windows 2000 Server. Revenue from Server Applications grew strongly in fiscal 2000, largely due to the strong success of SQL Server 7.0, while Software Developer Tools and Services revenue declined, due to increased suite licensing versus stand-alone licenses, and the lack of a release upgrade of the Visual Studio development system.

Consumer Software, Services, and Devices. Consumer Software, Services, and Devices revenue was $1.63 billion, $1.95 billion, and $3.59 billion in 2000, 2001, and 2002. Consumer Software, Services, and Devices includes the Xbox video game system; MSN Internet access; MSN network service; PC and online games; learning and productivity software; mobility; and embedded systems. The majority of the revenue growth from fiscal 2001 stemmed from sales of the Xbox video game system released in fiscal 2002. MSN Internet access revenue increased as a result of both a higher subscriber base and higher average revenue per subscriber due to a reduction in promotional subscriber programs. Revenue from MSN network services increased despite a declining Internet advertising market. Revenue from embedded systems in fiscal 2002 grew nicely, however learning and productivity software revenue and PC and online games declined compared to fiscal 2001. In fiscal 2001, revenue from MSN network services grew strongly despite a decline in the online advertising market. MSN Internet access revenue also grew solidly from fiscal 2000 as a result of an increased subscriber base, partially offset by a decline in the average revenue per subscriber due to a larger mix of subscribers contracted under rebate programs. Revenue from embedded systems grew strongly from the prior year, while learning and productivity software revenue and PC and online games revenue declined, reflecting softness in the overall consumer market. In fiscal 2000, online revenue growth was very strong and reflected higher subscriber totals, offset by lower net prices for Internet access subscriptions compared to the prior year. Additionally, strong sales of entertainment software in fiscal 2000 produced robust revenue growth in PC and online games.

Consumer Commerce Investments. Consumer Commerce Investments revenue was $182 million, $299 million, and $242 million in 2000, 2001, and 2002. Consumer Commerce Investments include Expedia, Inc., the HomeAdvisor online real estate service, and the CarPoint online automotive service. The decline in revenue compared to fiscal 2001 reflects the sale of Microsoft's majority ownership of Expedia, Inc. to USA Networks, Inc. on February 4, 2002. Acquisitions of Travelscape.com and VacationSpot.com by Expedia, Inc., and increased product offerings from Expedia led to the strong revenue growth in fiscal 2001. The increased overall reach of all properties led to the strong revenue growth in fiscal 2000.

Other. Other revenue, which primarily includes Hardware and Microsoft Press, was $754 million, $630 million, and $530 million in 2000, 2001, and 2002. In fiscal 2002, continued declines in the IT book and consumer market led to a decline in Microsoft Press and Hardware sales. Lower sales of gaming devices and other hardware peripherals as a result of weakness in the consumer market caused the decline in revenue in fiscal 2001. Continued success of the Company's new hardware device offerings led to revenue growth in fiscal 2000.

DISTRIBUTION CHANNELS

Microsoft distributes its products primarily through the following channels: OEM; volume licensing; online services and products; and distributors and retailers. OEM channel revenue represents license fees from original equipment manufacturers who preinstall Microsoft products, primarily on PCs. Microsoft has three major geographic sales and marketing regions: the South Pacific and Americas Region; the Europe, Middle East, and Africa Region; and the Asia Region. Sales of volume licenses and packaged software products via these channels are primarily to distributors and resellers.

OEM revenue was $7.01 billion in 2000, $7.86 billion in 2001, and $9.00 billion in 2002. In fiscal 2002, reported licenses declined compared to fiscal 2001. However, a strong increase in the mix of the higher priced Windows 2000 and Windows XP Professional licenses, and healthy growth in direct and system builder OEMs licenses, led to higher average revenue per license and contributed to the overall OEM revenue growth over fiscal 2001. In fiscal 2001, while total licenses were also impacted by a slowdown in PC shipments, the mix of the higher priced Windows 2000 Professional and Windows NT Workstation increased substantially resulting in higher average revenue per license. A relatively low growth rate in fiscal 2000 was due to lower business PC shipment growth combined with post mid-year availability of Windows 2000 Professional. Average earned revenue per license also declined in fiscal 2000 compared to the prior year, due in part to a mix shift to the lower-priced Windows 98 operating system reflecting the softness in demand for business PCs and lower prices on operating systems licensed through certain OEM channel sectors.

South Pacific and Americas Region revenue was $8.33 billion, $9.52 billion, and $11.41 billion in 2000, 2001, and 2002. In fiscal 2002, the majority of the revenue growth was driven by sales of the Xbox video game system released during the year, as well as strong Windows XP Professional licensing, MSN subscription revenue, and revenue from Microsoft Great Plains. In fiscal 2001, revenue growth was led by strong licensing of Windows 2000 Professional and the family of .NET Enterprise Servers, particularly SQL Server 2000 and Exchange 2000 Server. Revenue from Enterprise services and MSN subscription and services also grew strongly in fiscal 2001. In fiscal 2000, Office 2000 integrated suites, Windows 2000 Server, online revenue, and SQL Server sales were the primary drivers of the revenue growth. Strong retail sales of hardware devices and consumer software also contributed to the growth over the prior year.

Europe, Middle East, and Africa Region revenue was $5.02 billion, $4.86 billion, and $5.13 billion in 2000, 2001, and 2002. In fiscal 2002, the majority of the growth was a result of strong multi-year licensing revenue of Windows XP Home and Professional operating systems and Enterprise Software, as well as the addition of Xbox video game system revenue in the second half of the year. In fiscal 2001, weakening local currencies negatively impacted translated revenue compared to the prior year, while revenue from Windows 2000 Professional and the .NET Enterprise Server family of products was very healthy. In fiscal 2000, retail sales of Windows operating systems and

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Office licensing produced moderate growth in the region. Growth from SQL Server licensing, new hardware device offerings, and entertainment software was especially strong.

Asia Region revenue was $2.60 billion in 2000, $3.06 billion in 2001, and $2.83 billion in 2002. In fiscal 2002, Asia region revenue declined most notably due to lower consumer PC shipments, which hampered revenue from localized versions of Microsoft Office 2000 and Microsoft Office XP, especially the Office Personal Edition. Xbox video game system sales partially offset the decline in Office revenue. In fiscal 2001, the region's growth rate reflected strong revenue from localized versions of Microsoft Office 2000 and Microsoft Office XP, especially the Office Personal Edition. This growth was also attributable to Windows 2000 Professional and .NET Server applications licensing. In fiscal 2000, the region's growth rate reflected strong performance resulting from improved local economic conditions. Revenue growth was also influenced by robust growth of localized versions of Microsoft Office 2000, especially the Office Personal Edition sold in Japan, Windows platform and server licensing, and strong adoption of SQL Server.

The Company's operating results are affected by foreign exchange rates. Approximately 30%, 27%, and 25% of the Company's revenue was collected in foreign currencies during 2000, 2001, and 2002. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

OPERATING EXPENSES

Cost of Revenue. Cost of revenue as a percent of revenue was 13.1% in 2000, 13.7% in 2001, and 18.3% in 2002. Cost of revenue in fiscal 2002 increased primarily due to costs related to Xbox. In fiscal 2001, higher support and service costs associated with the MSN Internet access and MSN network services were partially offset by the lower relative costs associated with organizational licensing and the drop in the mix of packaged product versus the prior year. Cost of revenue in fiscal 2000 reflected lower costs associated with WebTV Networks' operations, partially offset by the growth in hardware peripherals costs.

Research and Development. The discontinuation of goodwill amortization in fiscal 2002 in accordance with Statement of Financial Accounting Standards (SFAS) 142, *Goodwill and Other Intangible Assets*, offset the growth in headcount and development costs. In fiscal 2001, the increase in R&D expense was the result of higher headcount-related costs and investments in new product initiatives. The increase in fiscal 2000 was driven primarily by higher headcount-related costs. Prospectively, increased headcount and increased spending in Server Platforms, Home & Entertainment, Business Solutions and CE are currently expected to be significant factors affecting future research and development expense growth.

Sales and Marketing. Sales and marketing expense as a percentage of revenue was 18.0% in 2000, 19.3% in 2001, and 19.1% in 2002. In fiscal 2002, sales and marketing expense as a percentage of revenue decreased due to lower relative MSN customer acquisition marketing and the large relative increase associated with the onset of Xbox video game system revenue. In fiscal 2001, sales and marketing expenses as a percentage of revenue increased due to higher relative headcount-related costs, higher marketing and sales expenses associated with MSN, the Microsoft Agility advertising campaign, and other new sales initiatives. In fiscal 2000, sales and marketing expenses as a percentage of revenue increased due to higher relative marketing costs associated with new product releases and online marketing. Microsoft expects that it will increase spending on Information Worker, Server Platforms, and Business Solutions sales forces and Windows Client, MSN and Home & Entertainment marketing.

General and Administrative. General and administrative expenses in fiscal 2002 increased due to a charge of approximately $660 million for estimated expenses related to the Company's consumer class action lawsuits and higher legal fees. In fiscal 2001, general and administrative costs decreased due to a charge related to the settlement of the lawsuit with Caldera, Inc. recorded in fiscal 2000. Excluding this charge in fiscal 2000, general and administrative expenses in fiscal 2001 increased from the prior year due to higher headcount-related costs and legal fees. For fiscal 2000, besides the settlement of the lawsuit, general and administrative expenses also reflected increased legal fees and certain employee stock option-related expenses.

NON-OPERATING ITEMS, INVESTMENT INCOME/(LOSS), AND INCOME TAXES

Losses on equity investees and other consists of Microsoft's share of income or loss from investments accounted for using the equity method, and income or loss attributable to minority interests. The decrease in losses on equity investees and other in fiscal 2002 was attributed to the divestiture of certain equity investments in fiscal 2002. The increase in losses on equity investees and other in fiscal 2001 reflects an increase in the number of such investments during the year. In fiscal 2000 losses on equity investees and other decreased reflecting smaller losses from the MSNBC entities.

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The Company recorded net investment income/(loss) in each year as follows:

In Millions

Year Ended June 30	**2000**	**2001**	**2002**
Dividends	$ 363	$ 377	$ 357
Interest	1,231	1,808	1,762
Net recognized gains/(losses) on investments:			
Net gains on the sales of investments	1,780	3,175	2,379
Other-than-temporary impairments	(29)	(4,804)	(4,323)
Net unrealized losses attributable to derivative instruments	(19)	(592)	(480)
Net recognized gains/(losses) on investments	1,732	(2,221)	(2,424)
Investment income/(loss)	$ 3,326	$ (36)	$ (305)

In fiscal 2002, other-than-temporary impairments primarily related to the Company's investment in AT&T and other cable and telecommunication investments. Net gains on the sales of investments included a $1.25 billion gain on the sale of the Company's share of Expedia. Interest and dividend income decreased $66 million from fiscal 2001 as a result of lower interest rates and dividend income.

In fiscal 2001, other-than-temporary impairments primarily related to cable and telecommunication investments. Net gains from the sales of investments in fiscal 2001 included a gain from Microsoft's investment in Titus Communications (which was merged with Jupiter Telecommunications) and the closing of the sale of Transpoint to CheckFree Holdings Corp. Interest and dividend income increased $591 million from fiscal 2000, reflecting a larger investment portfolio. In fiscal year 2000, investment income increased primarily as a result of a larger investment portfolio generated by cash from operations coupled with realized gains from the sale of securities.

At June 30, 2002, unrealized losses on Equity and Other Investments of $623 million were deemed to be temporary in nature. The following, among other factors, could result in some investments being deemed other-than-temporarily impaired in future periods: changes in the duration and extent to which the fair value is less than cost; the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors; and the Company's intent and ability to hold the investment.

In connection with the definitive agreement to combine AT&T Broadband with Comcast in a new company to be called AT&T Comcast Corporation, Microsoft has agreed to exchange its AT&T 5% convertible preferred debt securities for approximately 115 million shares of AT&T Comcast Corporation. It is expected that the transaction will close by December 31, 2002. While it is possible that Microsoft could incur a loss on this exchange transaction up to the carrying value of the AT&T debt securities, management believes that the ultimate loss, if any, will be significantly less. As management is unable to predict whether there will be a gain or loss on the exchange, no loss has been recorded related to this contingent exchange transaction as of June 30, 2002.

The Company's effective tax rate for fiscal 2002 was 32%. The effective tax rate for fiscal 2001 and fiscal 2000 was 33% and 34%, respectively. The decrease in the effective tax rate is due primarily to lower taxes on foreign earnings.

ACCOUNTING CHANGES

Effective July 1, 2001, Microsoft adopted SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 141 requires business combinations to be accounted for using the purchase method of accounting. It also specifies the types of acquired intangible assets that are required to be recognized and reported separate from goodwill. SFAS 142 requires that goodwill and certain intangibles no longer be amortized, but instead tested for impairment at least annually. There was no impairment of goodwill upon adoption of SFAS 142. Goodwill amortization (on a pre-tax basis) was $234 million in fiscal 2000 and $311 million in fiscal 2001.

Effective July 1, 2000, Microsoft adopted SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The adoption of SFAS 133 resulted in a cumulative pre-tax reduction to income of $560 million ($375 million after-tax) and a cumulative pre-tax reduction to other comprehensive income (OCI) of $112 million ($75 million after-tax). The reduction to income was mostly attributable to a loss of approximately $300 million reclassified from OCI for the time value of options and a loss of approximately $250 million reclassified from OCI for derivatives not designated as hedging instruments. The reduction to OCI was mostly attributable to losses of approximately $670 million on cash flow hedges offset by the reclassifications out of OCI of the approximately $300 million loss for the time value of options and the approximately $250 million loss for derivative instruments not designated as hedging instruments.

FINANCIAL CONDITION

The Company's cash and short-term investment portfolio totaled $38.65 billion at June 30, 2002. The portfolio consists primarily of fixed-income securities, diversified among industries and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in order to diversify financial risk. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment for immediate cash needs.

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Cash flow from operations was $14.51 billion for fiscal 2002, an increase of $1.09 billion from fiscal 2001. The increase reflects strong growth in unearned revenue. Cash used for financing was $4.57 billion in fiscal 2002, a decrease of $1.01 billion from the prior year. The decrease reflects the repurchase of put warrants in the prior year. The Company repurchased 122.8 million shares of common stock under its share repurchase program in fiscal 2002, compared to 89.0 million shares repurchased in the prior year. In addition, 5.1 million shares of common stock were acquired in fiscal 2002 under a structured stock repurchase transaction. The Company entered into the structured stock repurchase transaction in fiscal 2001, giving it the right to acquire 5.1 million of its shares in exchange for an up-front net payment of $264 million. Cash used for investing was $10.85 billion in fiscal 2002, an increase of $2.11 billion from fiscal 2001.

Cash flow from operations was $13.42 billion in fiscal 2001, an increase of $2.00 billion from the prior year. The increase was primarily attributable to the growth in revenue and other changes in working capital, partially offset by the decrease in the stock option income tax benefit, reflecting decreased stock option exercises by employees. Cash used for financing was $5.59 billion in fiscal 2001, an increase of $3.39 billion from the prior year. The increase primarily reflects the repurchase of put warrants in fiscal 2001, compared to the sale of put warrants in the prior fiscal year, as well as an increase in common stock repurchased. All outstanding put warrants were either retired or exercised during fiscal 2001. During fiscal 2001, the Company repurchased 89.0 million shares. Cash used for investing was $8.73 billion in fiscal 2001, a decrease of $658 million from the prior year. In fiscal 2000, cash flow from operations was $11.43 billion, a decrease of $720 million from the prior year, reflecting working capital changes partially offset by the increase in the stock option income tax benefit. Cash used for financing was $2.19 billion in fiscal 2000, an increase of $1.33 billion from the prior year, reflecting an increase in common stock repurchased versus the prior year. During fiscal 2000, the Company repurchased 55.2 million shares. Cash used for investing was $9.39 billion in fiscal 2000, a decrease of $808 million from the prior year.

Microsoft has no material long-term debt. Stockholders' equity at June 30, 2002 was $52.18 billion. Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $111 million on June 30, 2002. The Company has not engaged in any transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to affect materially liquidity or the availability of or requirements for capital resources. Since fiscal 1990, Microsoft has repurchased 982 million common shares while 2.23 billion shares were issued under the Company's employee stock option and purchase plans. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet operating requirements. The Company's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale needs and to fund the share repurchase program. Microsoft has not paid cash dividends on its common stock.

SUBSEQUENT EVENT

On July 11, 2002, Microsoft acquired Navision a/s as a result of the successful close of a tender offer. Microsoft purchased Navision's shares for approximately $1.45 billion in stock and cash. Navision is a provider of integrated business software solutions for small and medium-sized companies.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Microsoft's financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for Microsoft include revenue recognition, impairment of investment securities, accounting for research and development costs, accounting for legal contingencies, and accounting for income taxes.

Microsoft accounts for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition.* The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. End users receive certain elements of the Company's products over a period of time. These elements include browser technologies updates and technical support, the fair value of which is recognized over the product's estimated life cycle. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities,* and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 59, *Accounting for Noncurrent Marketable Equity Securities,* provide guidance on determining when an investment is other-than-temporarily impaired, which also requires judgment. In making this judgment, Microsoft evaluates, among other factors, the duration and extent to which the fair value of an investment is less than its cost; the financial health of and business outlook for the investee, including factors such as industry and sector performance, changes in technology, and operational and financing cash flow; and the Company's intent and ability to hold the investment.

Microsoft accounts for research and development costs in accordance with several accounting pronouncements, including SFAS 2, *Accounting for Research and Development Costs,* and SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Other-*

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wise Marketed. SFAS 86 specifies that costs incurred internally in creating a computer software product should be charged to expense when incurred as research and development until technological feasibility has been established for the product. Once technological feasibility is established, all software costs should be capitalized until the product is available for general release to customers. Judgment is required in determining when the technological feasibility of a product is established. Microsoft has determined that technological feasibility for its products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established are not material, and accordingly, the Company expenses all research and development costs when incurred.

Microsoft is subject to various legal proceedings and claims, the outcomes of which are subject to significant uncertainty. SFAS 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. The Company evaluates, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact the Company's financial position or its results of operations.

SFAS 109, *Accounting for Income Taxes*, establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could materially impact the Company's financial position or its results of operations.

ISSUES AND UNCERTAINTIES

The following issues and uncertainties, among others, should be considered in evaluating the Company's financial outlook.

Challenges to the Company's Business Model. Since its inception, the Company's business model has been based upon customers agreeing to pay a fee to license software developed and distributed by Microsoft. Under this commercial software development ("CSD") model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenues received from the distribution of their products. The Company believes that the CSD model has had substantial benefits for users of software, allowing them to rely on the expertise of the Company and other software developers that have powerful incentives to develop innovative software that is useful, reliable and compatible with other software and hardware. In recent years, there has been a growing challenge to the CSD model, often referred to as the Open Source movement. Under the Open Source model, software is produced by global "communities" of programmers, and the resulting software and the intellectual property contained therein is licensed to end users at little or no cost. The Company believes that there are significant problems with the Open Source model, the principal drawback being that no single entity is responsible for the Open Source software, and thus users have no recourse if a product does not work properly or at all. Further, without the market incentives associated with the CSD model, the Company believes that the vigorous innovation and growth of the software industry over the last 25 years would not have occurred. Nonetheless, the popularization of the Open Source movement continues to pose a significant challenge to the Company's business model, including recent efforts by proponents of the Open Source model to convince governments worldwide to mandate the use of Open Source software in their purchase and deployment of software products. To the extent the Open Source model gains increasing market acceptance, sales of the Company's products may decline, the Company may have to reduce the prices it charges for its products, and revenues and operating margins may consequently decline.

New Products and Services. The Company has made significant investments in research and development for new products, services and technologies, including Microsoft .NET, Xbox, business applications, MSN, mobile and wireless technologies, and television. Significant revenue from these investments may not be achieved for a number of years, if at all. Moreover, these products and services may never be profitable, and even if they are profitable, operating margins for these businesses are not expected to be as high as the margins historically experienced in our Desktop and Enterprise Software and Services businesses.

Declines in Demand for Software. If overall market demand for PCs, servers and other computing devices declines significantly, and consumer and corporate spending for such products declines, Microsoft's revenue growth will be adversely affected. Additionally, the Company's revenues would be unfavorably impacted if customers reduce their purchases of new software products or upgrades to existing products if such new offerings are not perceived to add significant new functionality or other value to prospective purchasers.

Product Development Schedule. The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could negatively impact the Company's revenues.

International Operations. Microsoft develops and sells products throughout the world. The prices of the Company's products in countries outside of the United States are generally higher than the Company's prices in the United States because of the cost incurred in localizing software for non-U.S. markets. The costs of producing and selling the Company's products in these countries also are higher. Pressure to globalize Microsoft's pricing structure might require that the Company reduce the sales price of its software in other countries, even though the costs of the software continue to be higher than in the United States. Unfavorable changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment; unexpected changes in regulatory requirements for software; social, political, labor, or economic conditions in a specific country or region, including foreign exchange rates; difficulties in staffing and managing foreign operations; and potential adverse foreign tax consequences, among other factors, could also have a negative effect on the Company's business and results of operations outside of the United States.

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Intellectual Property Rights. Microsoft diligently defends its intellectual property rights, but unlicensed copying and use of software represents a loss of revenue to the Company. While this adversely affects U.S. revenue, revenue loss is even more significant outside the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenue positively and further deterioration in compliance with existing legal protections or reductions in the legal protection for intellectual property rights of software developers could adversely affect revenue.

Taxation of Extraterritorial Income. In August 2001, a World Trade Organization ("WTO") dispute panel determined that the extraterritorial tax ("ETI") provisions of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures Agreement. The U.S. government appealed the panel's decision and lost its appeal. On January 29, 2002, the WTO Dispute Settlement Body adopted the Appellate Body report. President Bush has stated the U.S. will bring its tax laws into compliance with the WTO ruling, but the Administration and Congress have not decided on a solution for this issue. In July 2002, Representative Bill Thomas, Chairman of the House Ways and Means Committee, introduced the American Competitiveness and Corporate Accountability Act of 2002. If enacted, that bill would repeal the ETI regime and introduce broad-based international reform. The proposed reforms would not materially affect the Company. On August 30, 2002, a WTO arbitration panel determined that the European Union may impose up to $4.04 billion per year in countermeasures if the U.S. rules are not brought into compliance. The WTO decision does not repeal the ETI tax benefit and it does not require the European Union to impose trade sanctions, so it is not possible to predict what impact the WTO decision will have on future results pending final resolution of these matters. If the ETI exclusion is repealed and replacement legislation is not enacted, the loss of tax benefit to the Company could be significant.

Litigation. As discussed in Note 19—Contingencies of the Notes to Financial Statements, the Company is subject to a variety of claims and lawsuits. While the Company believes that none of the litigation matters in which the Company is currently involved will have a material adverse impact on the Company's financial position or results of operations, it is possible that one or more of these matters could be resolved in a manner that would ultimately have a material adverse impact on the business of the Company, and could negatively impact its revenues and operating margins.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to foreign currency, interest rate, and equity price risks. A portion of these risks is hedged, but fluctuations could impact the Company's results of operations and financial position. The Company hedges the exposure of accounts receivable and a portion of anticipated revenue to foreign currency fluctuations, primarily with option contracts. The Company monitors its foreign currency exposures daily to maximize the overall effectiveness of its foreign currency hedge positions. Principal currencies hedged include the Euro, Japanese yen, British pound, and Canadian dollar. Fixed income securities are subject to interest rate risk. The portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. The Company routinely uses options to hedge its exposure to interest rate risk in the event of a catastrophic increase in interest rates. Many securities held in the Company's equity and other investments portfolio are subject to price risk. The Company uses options to hedge its price risk on certain highly volatile equity securities.

The Company uses a value-at-risk (VAR) model to estimate and quantify its market risks. VAR is the expected loss, for a given confidence level, in fair value of the Company's portfolio due to adverse market movements over a defined time horizon. The VAR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. The model used for currencies and equities is geometric Brownian motion, which allow incorporation of optionality of these exposures. For interest rates, the mean reverting geometric Brownian motion is used to reflect the principle that fixed-income securities prices over time revert to maturity value.

Value-at-risk is calculated by, first, simulating 10,000 market price paths over 20 days for equities, interest rates and foreign exchange rates, taking into account historical correlations among the different rates and prices. Each resulting unique set of equities prices, interest rates, and foreign exchange rates is applied to substantially all individual holdings to re-price each holding. The 250th worst performance (out of 10,000) represents the value-at-risk over 20 days at the 97.5th percentile. Several risk factors are not captured in the model, including liquidity risk, operational risk, credit risk, and legal risk.

A substantial amount of the Company's equity portfolio is held for strategic purposes. The Company attempts to hedge the value of these securities through the use of derivative contracts such as collars. The Company has incurred substantial impairment charges related to certain of these securities in fiscal 2002 and fiscal 2001. Such impairment charges have been incurred primarily for strategic equity holdings that the Company has not been able to hedge. The VAR amounts disclosed below are not necessarily reflective of potential accounting losses, as they are used as a risk management tool and reflect an estimate of potential reductions in fair value of the Company's portfolio. Losses in fair value over a 20-day holding period can exceed the reported VAR by significant amounts and can also accumulate over a longer time horizon than the 20-day holding period used in the VAR analysis.

The VAR numbers are shown separately for interest rate, currency, and equity risks. These VAR numbers include the underlying portfolio positions and related hedges. Historical data is used to estimate VAR. Given reliance on historical data, VAR is most effective in estimating risk exposures in markets in which there are no fundamental changes or shifts in market conditions. An inherent limitation in VAR is that the distribution of past changes in market risk factors may not produce accurate predictions of future market risk.

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The following table sets forth the VAR calculations for substantially all of the Company's positions:

In Millions

Risk Categories	As of June 30, 2002	As of June 30, 2001	Year ended June 30, 2002 Average	High	Low
Interest rates	$ 472	$ 363	$ 435	$535	$333
Currency rates	310	58	162	310	58
Equity prices	602	520	584	757	488

The total VAR for the combined risk categories is $908 million at June 30, 2002 and $759 million at June 30, 2001. The total VAR is 34% less at June 30, 2002 and 19% less at June, 30 2001 than the sum of the separate risk categories for each of those years in the above table, due to the diversification benefit of the combination of risks. The reasons for the change in risk in portfolios include: larger investment portfolio size, higher foreign exchange exposure due to stronger non-U.S. currencies, and asset allocation shifts.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INCOME STATEMENTS

In millions, except earnings per share

Year Ended June 30	2000	2001	2002
Revenue	$22,956	$25,296	$28,365
Operating expenses:			
Cost of revenue	3,002	3,455	5,191
Research and development	3,772	4,379	4,307
Sales and marketing	4,126	4,885	5,407
General and administrative	1,050	857	1,550
Total operating expenses	11,950	13,576	16,455
Operating income	11,006	11,720	11,910
Losses on equity investees and other	(57)	(159)	(92)
Investment income/(loss)	3,326	(36)	(305)
Income before income taxes	14,275	11,525	11,513
Provision for income taxes	4,854	3,804	3,684
Income before accounting change	9,421	7,721	7,829
Cumulative effect of accounting change (net of income taxes of $185)	–	(375)	–
Net income	$ 9,421	$ 7,346	$ 7,829
Basic earnings per share:			
Before accounting change	$ 1.81	$ 1.45	$ 1.45
Cumulative effect of accounting change	–	(0.07)	–
	$ 1.81	$ 1.38	$ 1.45
Diluted earnings per share:			
Before accounting change	$ 1.70	$ 1.38	$ 1.41
Cumulative effect of accounting change	–	(0.06)	–
	$ 1.70	$ 1.32	$ 1.41

Weighted average shares outstanding:			
Basic	5,189	5,341	**5,406**
Diluted	5,536	5,574	**5,553**

See accompanying notes.

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BALANCE SHEETS

In millions		
June 30	**2001**	**2002**
Assets		
Current assets:		
Cash and equivalents	$ 3,922	$ 3,016
Short-term investments	27,678	35,636
Total cash and short-term investments	31,600	38,652
Accounts receivable, net	3,671	5,129
Inventories	83	673
Deferred income taxes	1,522	2,112
Other	2,334	2,010
Total current assets	39,210	48,576
Property and equipment, net	2,309	2,268
Equity and other investments	14,361	14,191
Goodwill	1,511	1,426
Intangible assets, net	401	243
Other long-term assets	1,038	942
Total assets	$58,830	$67,646
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 1,188	$ 1,208
Accrued compensation	742	1,145
Income taxes	1,468	2,022
Short-term unearned revenue	4,395	5,920
Other	1,461	2,449
Total current liabilities	9,254	12,744
Long-term unearned revenue	1,219	1,823
Deferred income taxes	409	398
Other long-term liabilities	659	501
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital—shares authorized 12,000; Shares issued and outstanding 5,383 and 5,359	28,390	31,647
Retained earnings, including accumulated other comprehensive income of $587 and $583	18,899	20,533
Total stockholders' equity	47,289	52,180
Total liabilities and stockholders' equity	$58,830	$67,646

See accompanying notes.

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CASH FLOWS STATEMENTS

In millions

Year Ended June 30	2000	2001	2002
Operations			
Net income	$ 9,421	$ 7,346	$ 7,829
Cumulative effect of accounting change, net of tax	–	375	–
Depreciation, amortization, and other noncash items	1,250	1,536	1,084
Net recognized (gains)/losses on investments	(1,732)	2,221	2,424
Stock option income tax benefits	5,535	2,066	1,596
Deferred income taxes	(425)	(420)	(416)
Unearned revenue	6,177	6,970	11,152
Recognition of unearned revenue	(5,600)	(6,369)	(8,929)
Accounts receivable	(944)	(418)	(1,623)
Other current assets	(775)	(482)	(264)
Other long-term assets	(864)	(330)	(9)
Other current liabilities	(992)	774	1,449
Other long-term liabilities	375	153	216
Net cash from operations	11,426	13,422	14,509
Financing			
Common stock issued	2,245	1,620	1,497
Common stock repurchased	(4,896)	(6,074)	(6,069)
Sales/(repurchases) of put warrants	472	(1,367)	–
Preferred stock dividends	(13)	–	–
Other, net	–	235	–
Net cash used for financing	(2,192)	(5,586)	(4,572)
Investing			
Additions to property and equipment	(879)	(1,103)	(770)
Purchases of investments	(42,290)	(66,346)	(89,386)
Maturities of investments	4,025	5,867	8.654
Sales of investments	29,752	52,848	70,657
Net cash used for investing	(9,392)	(8,734)	(10,845)
Net change in cash and equivalents	(158)	(898)	(908)
Effect of exchange rates on cash and equivalents	29	(26)	2
Cash and equivalents, beginning of year	4,975	4,846	3,922
Cash and equivalents, end of year	$ 4,846	$ 3,922	$ 3,016

See accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS

In millions

Year Ended June 30	**2000**	**2001**	**2002**
Convertible preferred stock			
Balance, beginning of year	$ 980	$ –	$ –
Conversion of preferred to common stock	(980)	–	–
Balance, end of year	–	–	–
Common stock and paid-in capital			
Balance, beginning of year	13,844	23,195	28,390
Common stock issued	3,554	5,154	1,801
Common stock repurchased	(210)	(394)	(676)
Sales/(repurchases) of put warrants	472	(1,367)	–
Stock option income tax benefits	5,535	2,066	1,596
Other, net	–	(264)	536
Balance, end of year	23,195	28,390	31,647
Retained earnings			
Balance, beginning of year	13,614	18,173	18,899
Net income	9,421	7,346	7,829
Other comprehensive income:			
Cumulative effect of accounting change	–	(75)	–
Net gains/(losses) on derivative instruments	–	634	(91)
Net unrealized investment gains/(losses)	(283)	(1,460)	5
Translation adjustments and other	23	(39)	82
Comprehensive income	9,161	6,406	7,825
Preferred stock dividends	(13)	–	–
Immaterial pooling of interests	97	–	–
Common stock repurchased	(4,686)	(5,680)	(6,191)
Balance, end of year	18,173	18,899	20,533
Total stockholders' equity	$41,368	$47,289	$52,180

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

NOTE 1 ACCOUNTING POLICIES

ACCOUNTING PRINCIPLES

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America.

PRINCIPLES OF CONSOLIDATION

The financial statements include the accounts of Microsoft Corporation and its subsidiaries (Microsoft). Intercompany transactions and balances have been eliminated. Equity investments in which Microsoft owns at least 20% of the voting securities are accounted for using the equity method, except for investments in which the Company is not able to exercise significant influence over the investee, in which case, the cost method of accounting is used. Issuances of shares by a subsidiary are accounted for as capital transactions.

ESTIMATES AND ASSUMPTIONS

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include estimates of loss contingencies and product life cycles, and assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/enhancements and new products; when the Company reaches technological feasibility for its products; the potential outcome of the future tax consequences of events that have been recognized in the Company's financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from these estimates and assumptions.

FOREIGN CURRENCIES

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

REVENUE RECOGNITION

Microsoft accounts for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition.* The Company recognizes revenue when (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the sales price is fixed or determinable; and (iv) collectibility is reasonably assured. For software arrangements with multiple elements, revenue is recognized dependent upon whether vendor-specific objective evidence (VSOE) of fair value exists for each of the elements. When VSOE does not exist for all the elements of a software arrangement and the only undelivered element is postcontract customer support (PCS), the entire licensing fee is recognized ratably over the contract period. Revenue attributable to undelivered elements, including technical support and Internet browser technologies, is based on the average sales price of those elements when sold separately, and is recognized ratably on a straight-line basis over the product's life cycle. PCS and subscription revenue is recognized ratably over the contract period.

Revenue from products licensed to original equipment manufacturers (OEMs) is based on the licensing agreement with an OEM and has historically been recognized when OEMs ship licensed products to their customers. Licensing provisions were modified with the introduction of Windows XP in 2002 and revenue for certain products is recorded upon shipment of the product to OEMs. The effect of this change in licensing provisions was not material. Revenue from packaged product sales to distributors and resellers is usually recorded when related products are shipped. However, when the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Revenue related to the Company's Xbox game console is recognized upon shipment of the product to retailers. Online advertising revenue is recognized as advertisements are displayed. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for estimated returns, concessions, and bad debts.

COST OF REVENUE

Cost of revenue includes direct costs to manufacture and distribute product and direct costs to provide online services, consulting, product support, and training and certification of system integrators.

RESEARCH AND DEVELOPMENT

Technological feasibility for Microsoft's software products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established are not material, and accordingly, the Company expenses all research and development costs when incurred.

ADVERTISING COSTS

Advertising costs are expensed as incurred. Advertising expense was $1.23 billion in 2000, $1.36 billion in 2001, and $1.27 billion in 2002.

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INCOME TAXES

Income tax expense includes U.S. and international income taxes, plus the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes.

FINANCIAL INSTRUMENTS

The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and six years from the purchase date. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash and short-term investments are classified as available for sale and are recorded at market value using the specific identification method; unrealized gains and losses are reflected in OCI.

Equity and other investments include debt and equity instruments. Debt securities and publicly traded equity securities are classified as available for sale and are recorded at market using the specific identification method. Unrealized gains and losses (excluding other-than-temporary impairments) are reflected in OCI. All other investments, excluding those accounted for using the equity method, are recorded at cost.

Microsoft lends certain fixed income and equity securities to enhance investment income. Collateral and/or security interest is determined based upon the underlying security and the creditworthiness of the borrower. The fair value of collateral that Microsoft is permitted to sell or repledge was $499 million at both June 30, 2001 and 2002.

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. The Company employs a systematic methodology that considers available evidence in evaluating potential impairment of its investments. In the event that the cost of an investment exceeds its fair value, the Company evaluates, among other factors, the duration and extent to which the fair value is less than cost; the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors; and the Company's intent and ability to hold the investment. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established. In 2001, the Company recognized $4.80 billion in impairments of certain investments, primarily in the cable and telecommunication industries. In 2002, Microsoft recognized $4 32 billion in impairments of certain investments, primarily related to further declines in the fair values of U.S. and European cable and telecommunications holdings.

The Company uses derivative instruments to manage exposures to foreign currency, security price, and interest rate risks. The Company's objectives for holding derivatives are to minimize these risks using the most effective methods to eliminate or reduce the impact of these exposures.

Foreign Currency Risk. Certain forecasted transactions and assets are exposed to foreign currency risk. The Company monitors its foreign currency exposures daily to maximize the overall effectiveness of its foreign currency hedge positions. Principal currencies hedged include the Euro, Japanese yen, British pound, and Canadian dollar. Options used to hedge a portion of forecasted international revenue for up to three years in the future are designated as cash flow hedging instruments. Options and forwards not designated as hedging instruments under SFAS 133 are also used to hedge the impact of the variability in exchange rates on accounts receivable and collections denominated in certain foreign currencies.

Securities Price Risk. Strategic equity investments are subject to market price risk. From time to time, the Company uses and designates options to hedge fair values and cash flows on certain equity securities. The security, or forecasted sale thereof, selected for hedging is determined by market conditions, up-front costs, and other relevant factors. Once established, the hedges are not dynamically managed or traded, and are generally not removed until maturity.

Interest Rate Risk. Fixed-income securities are subject to interest rate risk. The fixed-income portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. The Company routinely uses options, not designated as hedging instruments, to hedge its exposure to interest rate risk in the event of a catastrophic increase in interest rates.

Other Derivatives. In addition, the Company may invest in warrants to purchase securities of other companies as a strategic investment. Warrants that can be net share settled are deemed derivative financial instruments and are not designated as hedging instruments.

For options designated either as fair value or cash flow hedges, changes in the time value are excluded from the assessment of hedge effectiveness.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The allowance for doubtful accounts reflects management's best estimate of probable losses inherent in the account receivable balance. Management determines the allowance based on known troubled accounts, historical experience, and other currently available evidence. Activity in the allowance for doubtful accounts is as follows:

In Millions

Year Ended June 30	Balance at beginning of period	Charged to costs and expenses	Write-offs and other	Balance at end of period
2002	$ 174	$ 192	$ 157	$ 209
2001	186	157	169	174
2000	204	77	95	186

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INVENTORIES

Inventories are stated at the lower of cost or market, using the average cost method. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories.

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 15 years. Computer software developed or obtained for internal use is depreciated using the straight-line method over the estimated useful life of the software, generally not in excess of three years.

GOODWILL

Beginning in fiscal 2002 with the adoption of SFAS 142, *Goodwill and Other Intangible Assets,* goodwill is no longer amortized, but instead tested for impairment at least annually. Prior to fiscal 2002, goodwill was amortized using the straight-line method over its estimated period of benefit.

INTANGIBLE ASSETS

Intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from three to seven years. The Company periodically evaluates the recoverability of intangible assets and takes into account events or circumstances that warrant revised estimates of useful lives or that indicate that an impairment exists. All of Microsoft's intangible assets are subject to amortization.

RECLASSIFICATIONS

Certain reclassifications have been made for consistent presentation.

NOTE 2 ACCOUNTING CHANGES

Effective July 1, 2000, the Company adopted SFAS 133, *Accounting for Derivative Instruments and Hedging Activities,* which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The adoption of SFAS 133 on July 1, 2000, resulted in a cumulative pre-tax reduction to income of $560 million ($375 million after-tax) and a cumulative pre-tax reduction to OCI of $112 million ($75 million after-tax). The reduction to income was mostly attributable to a loss of approximately $300 million reclassified from OCI for the time value of options and a loss of approximately $250 million reclassified from OCI for derivatives not designated as hedging instruments. The reduction to OCI was mostly attributable to losses of approximately $670 million on cash flow hedges offset by reclassifications out of OCI of the approximately $300 million loss for the time value of options and the approximately $250 million loss for derivative instruments not designated as hedging instruments. The net derivative losses included in OCI as of July 1, 2000 were reclassified into earnings during the twelve months ended June 30, 2001. The change in accounting from the adoption of SFAS 133 did not materially affect net income in 2001.

Effective July 1, 2001, Microsoft adopted SFAS 141, *Business Combinations,* and SFAS 142, *Goodwill and Other Intangible Assets.* SFAS 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting. It also specifies the types of acquired intangible assets that are required to be recognized and reported separate from goodwill. SFAS 142 requires that goodwill and certain intangibles no longer be amortized, but instead tested for impairment at least annually. There was no impairment of goodwill upon adoption of SFAS 142.

Net income and earnings per share for fiscal 2000 and fiscal 2001 adjusted to exclude amortization expense (net of taxes) is as follows:

In Millions, Except Earnings Per Share

Year Ended June 30	2000	2001
Net income:		
Reported net income	$9,421	$7,346
Goodwill amortization	203	252
Equity method goodwill amortization	1	26
Adjusted net income	$9,625	$7,624
Basic earnings per share:		
Reported basic earnings per share	$ 1.81	$ 1.38
Goodwill amortization	0.04	0.05
Equity method goodwill amortization	–	–
Adjusted basic earnings per share	$ 1.85	$ 1.43
Diluted earnings per share:		
Reported diluted earnings per share	$ 1.70	$ 1.32
Goodwill amortization	0.04	0.05
Equity method goodwill amortization	–	–

Adjusted diluted earnings per share	$ 1.74	$ 1.37

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NOTE 3 UNEARNED REVENUE

A portion of Microsoft's revenue under volume licensing programs is earned ratably over the period of the license agreement. Also, revenue attributable to undelivered elements, including technical support and Internet browser technologies, is based on the average sales price of those elements when sold separately, and is recognized ratably on a straight-line basis over the product's life cycle. The percentage of revenue recognized ratably for undelivered elements ranges from approximately 20% to 25% for Windows XP Home, approximately 10% to 15% for Windows XP Professional, and approximately 10% to 15% for desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three years for Windows operating systems and 18 months for desktop applications.

The components of unearned revenue were as follows:

In Millions

June 30	2001	2002
Volume licensing programs	$1,922	$4,158
Undelivered elements	2,818	2,830
Other	874	755
Unearned revenue	$5,614	$7,743

Unearned revenue by product was as follows:

In Millions

June 30	2001	2002
Desktop Applications	$2,189	$3,489
Desktop Platforms	2,586	3,198
Enterprise Software and Services	391	791
Desktop and Enterprise Software and Services	5,166	7,478
Consumer Software, Services, and Devices, and Other	448	265
Unearned revenue	$5,614	$7,743

Of the $7.74 billion of unearned revenue at June 30, 2002, $2.28 billion is expected to be recognized in the first quarter of fiscal 2003, $1.64 billion in the second quarter of fiscal 2003, $1.18 billion in the third quarter of fiscal 2003, $817 million in the fourth quarter of fiscal 2003, and $1.82 billion thereafter.

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NOTE 4 CASH AND SHORT-TERM INVESTMENTS

In Millions

June 30, 2001	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
Cash and equivalents:				
Cash	$ 1,145	$ –	$ –	$ 1,145
Commercial paper	894	–	–	894
Certificates of deposit	286	–	–	286
U.S. government and agency securities	400	–	–	400
Corporate notes and bonds	1,130	–	–	1,130
Municipal securities	67	–	–	67
Cash and equivalents	3,922	–	–	3,922
Short-term investments:				
Commercial paper	635	3	–	638
U.S. government and agency securities	7,355	9	(42)	7,322
Corporate notes and bonds	17,256	214	(149)	17,321
Municipal securities	1,662	41	–	1,703
Certificates of deposit	694	–	–	694
Short-term investments	27,602	267	(191)	27,678
Cash and short-term investments	$31,524	$ 267	$ (191)	$ 31,600

In Millions

June 30, 2002	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
Cash and equivalents:				
Cash	$ 1,114	$ –	$ –	$ 1,114
Commercial paper	260	–	–	260
Certificates of deposit	31	–	–	31
Money market mutual funds	714	–	–	714
Corporate notes and bonds	560	–	–	560
Municipal securities	337	–	–	337
Cash and equivalents	3,016	–	–	3,016
Short-term investments:				
Commercial paper	552	–	–	552
U.S. government and agency securities	10,726	114	(13)	10,827
Corporate notes and bonds	18,822	255	(241)	18,836
Municipal securities	4,462	86	–	4,548
Certificates of deposit	873	–	–	873
Short-term investments	35,435	455	(254)	35,636
Cash and short-term investments	$38,451	$ 455	$ (254)	$ 38,652

Realized gains and (losses) from cash and short-term investments were $80 million and $(226) million in 2000, $541 million and $(369) million in 2001, and $816 million and $(558) million in 2002.

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NOTE 5 INVENTORIES

In Millions		
June 30	2001	2002
Finished goods	$ 78	$ 505
Raw materials and work in process	5	168
Inventories	$ 83	$ 673

NOTE 6 PROPERTY AND EQUIPMENT

In Millions		
June 30	2001	2002
Land	$ 185	$ 197
Buildings	1,584	1,701
Computer equipment and software	2,292	2,621
Other	1,214	1,372
Property and equipment – at cost	5,275	5,891
Accumulated depreciation	(2,966)	(3,623)
Property and equipment – net	$ 2,309	$ 2,268

During 2000, 2001, and 2002, depreciation expense, of which the majority related to computer equipment, was $668 million, $764 million, and $820 million.

NOTE 7 EQUITY AND OTHER INVESTMENTS

In Millions				
June 30, 2001	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
Debt securities recorded at market, maturing:				
Within one year	$ 500	$ –	$ –	$ 500
Between 2 and 10 years	643	12	(3)	652
Between 10 and 15 years	513	–	(9)	504
Beyond 15 years	4,754	–	(829)	3,925
Debt securities recorded at market	6,410	12	(841)	5,581
Common stock and warrants	5,555	2,030	(285)	7,300
Preferred stock	881	–	–	881
Other investments	599	–	–	599
Equity and other investments	$13,445	$ 2,042	$ (1,126)	$ 14,361

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In Millions

June 30, 2002	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
Debt securities recorded at market, maturing:				
Within one year	$ 485	$ 26	$ –	$ 511
Between 2 and 10 years	893	46	(4)	935
Between 10 and 15 years	541	19	(2)	558
Beyond 15 years	3,036	–	–	3,036
Debt securities recorded at market	4,955	91	(6)	5,040
Common stock and warrants	6,930	1,287	(617)	7,600
Preferred stock	1,382	–	–	1,382
Other investments	169	–	–	169
Equity and other investments	$13,436	$ 1,378	$ (623)	$ 14,191

Debt securities include corporate and government notes and bonds and derivative securities. Debt securities maturing beyond 15 years are composed entirely of AT&T 5% convertible preferred debt with a contractual maturity of 30 years. The debt is convertible at the Company's option into AT&T common stock on or after December 1, 2000, or may be redeemed by AT&T upon satisfaction of certain conditions on or after June 1, 2002. In connection with the definitive agreement to combine AT&T Broadband with Comcast in a new company to be called AT&T Comcast Corporation, Microsoft has agreed to exchange its AT&T 5% convertible preferred debt securities for approximately 115 million shares of AT&T Comcast Corporation. It is expected that the transaction will close by December 31, 2002. While it is possible that Microsoft could incur a loss on this exchange transaction up to the carrying value of the AT&T debt securities, management believes that the ultimate loss, if any, will be significantly less. As management is unable to predict whether there will be a gain or loss on the exchange, no loss has been recorded related to this contingent exchange transaction as of June 30, 2002.

Equity securities that are restricted for more than one year or not publicly traded are recorded at cost. At June 30, 2001 the estimated fair value of these investments in excess of their recorded basis was $161 million. At June 30, 2002 the recorded basis of these investments in excess of their estimated fair value was $34 million. This excess of cost over estimated fair value was deemed temporary in nature. The estimate of fair value is based on publicly available market information or other estimates determined by management. Realized gains and (losses) from equity and other investments (excluding impairments discussed previously) were $1.94 billion and $(10) million in 2000, $3.03 billion and $(23) million in 2001, and $2.24 billion and $(121) million in 2002.

NOTE 8 GOODWILL

During fiscal 2002, goodwill was reduced by $85 million, principally in connection with Microsoft's exchange of all of its 33.7 million shares and warrants of Expedia, Inc. to USA Networks, Inc. No goodwill was acquired or impaired during fiscal 2002. As of June 30, 2002, Desktop and Enterprise Software and Services goodwill was $1.1 billion, Consumer Software, Services, and Devices goodwill was $258 million, and Consumer Commerce Investments goodwill was $72 million.

NOTE 9 INTANGIBLE ASSETS

During fiscal 2002, changes in intangible assets primarily relates to the Company's acquisition of $25 million in patents and licenses and $27 million in existing technology, which will be amortized over approximately 3 years. No significant residual value is estimated for these intangible assets. Intangible assets amortization expense was $202 million for fiscal 2001 and $194 million for fiscal 2002. The components of intangible assets were as follows:

In Millions

June 30	2001		2002	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Patents and licenses	$ 407	$ (177)	$ 421	$ (290)
Existing technology	157	(27)	172	(71)
Trademarks, tradenames and other	83	(42)	15	(4)

Intangible assets	$ 647	$ (246)	$ 608	$ (365)

Amortization expense for the net carrying amount of intangible assets at June 30, 2002 is estimated to be $115 million in fiscal 2003, $90 million in fiscal 2004, $36 million in fiscal 2005, and $2 million in fiscal 2006.

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NOTE 10 DERIVATIVES

For fiscal 2001, investment income included a net unrealized loss of $592 million, comprised of a $214 million gain for changes in the time value of options for fair value hedges, $211 million loss for changes in the time value of options for cash flow hedges, and $595 million loss for changes in the fair value of derivative instruments not designated as hedging instruments. For fiscal 2002, investment income included a net unrealized loss of $480 million, comprised of a $30 million gain for changes in the time value of options for fair value hedges, $331 million loss for changes in the time value of options for cash flow hedges, and $179 million net loss for changes in the fair value of derivative instruments not designated as hedging instruments.

Derivative gains and losses included in OCI are reclassified into earnings at the time forecasted revenue or the sale of an equity investment is recognized. During fiscal 2001, $214 million of derivative gains were reclassified to revenue and $416 million of derivative losses were reclassified to investment income/(loss). During fiscal 2002, $234 million of derivative gains were reclassified to revenue and $10 million of derivative losses were reclassified to investment income/(loss). The derivative losses reclassified to investment income/(loss) were offset by gains on the item being hedged. The Company estimates that $63 million of net derivative gains included in other comprehensive income will be reclassified into earnings within the next twelve months.

For instruments designated as hedges, hedge ineffectiveness, determined in accordance with SFAS 133, had no impact on earnings for the fiscal 2001 and 2002. No fair value hedges or cash flow hedges were derecognized or discontinued for fiscal 2001 and 2002.

NOTE 11 INVESTMENT INCOME/(LOSS)

The components of investment income/(loss) are as follows:

In Millions

Year Ended June 30	2000	2001	2002
Dividends	$ 363	$ 377	$ 357
Interest	1,231	1,808	1,762
Net recognized gains/(losses) on investments:			
Net gains on the sales of investments	1,780	3,175	2,379
Other-than-temporary impairments	(29)	(4,804)	(4,323)
Net unrealized losses attributable to derivative instruments	(19)	(592)	(480)
Net recognized gains/(losses) on investments	1,732	(2,221)	(2,424)
Investment income/(loss)	$ 3,326	$ (36)	$ (305)

NOTE 12 INCOME TAXES

The provision for income taxes consisted of:

In Millions

Year Ended June 30	2000	2001	2002
Current taxes:			
U.S. and state	$ 4,744	$ 3,243	$ 3,644
International	535	514	575
Current taxes	5,279	3,757	4,219
Deferred taxes	(425)	47	(535)
Provision for income taxes	$ 4,854	$ 3,804	$ 3,684

U.S. and international components of income before income taxes were:

In Millions

Year Ended June 30	2000	2001	2002
U.S.	$ 11,860	$ 9,189	**$ 8,920**
International	2,415	2,336	**2,593**
Income before income taxes	$ 14,275	$ 11,525	**$ 11,513**

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In 2000, the effective tax rate was 34.0%, and included the effect of a 2.5% reduction from the U.S. statutory rate for tax credits and a 1.5% increase for other items. In 2001, the effective tax rate was 33.0%, and included the effect of a 3.1% reduction from the U.S. statutory rate for tax credits and a 1.1% increase for other items. The effective tax rate in 2002 was 32.0%, and included the effect of a 2.4% reduction from the U.S. statutory rate for the extraterritorial income exclusion tax benefit and a 0.6% reduction for other items.

Deferred income taxes were:

In Millions

June 30	**2001**	**2002**
Deferred income tax assets:		
Revenue items	$ 1,469	**$ 2,261**
Expense items	691	**945**
Impaired investments	1,070	**2,016**
Deferred income tax assets	$ 3,230	**$ 5,222**
Deferred income tax liabilities:		
Unrealized gain on investments	$ (395)	**$ (887)**
International earnings	(1,667)	**(1,818)**
Other	(55)	**(803)**
Deferred income tax liabilities	$(2,117)	**$(3,508)**

Microsoft has not provided for U.S. deferred income taxes or foreign withholding taxes on $780 million of its undistributed earnings for certain non-U.S. subsidiaries, all of which relate to fiscal 2002 earnings, since these earnings are intended to be reinvested indefinitely.

On September 15, 2000, the U.S. Tax Court issued an adverse ruling with respect to Microsoft's claim that the Internal Revenue Service (IRS) incorrectly assessed taxes for 1990 and 1991. The Company has filed an appeal with the Ninth Circuit Court of Appeals on this matter. Income taxes, except for items related to the 1990 and 1991 assessments, have been settled with the IRS for all years through 1996. The IRS is examining the Company's 1997 through 1999 U.S. income tax returns. Management believes any adjustments which may be required will not be material to the financial statements. Income taxes paid were $800 million in 2000, $1.3 billion in 2001, and $1.9 billion in 2002.

NOTE 13 STOCKHOLDERS' EQUITY

Shares of common stock outstanding were as follows:

In Millions

Year Ended June 30	**2000**	**2001**	**2002**
Balance, beginning of year	5,109	5,283	**5,383**
Issued	229	189	**104**
Repurchased	(55)	(89)	**(128)**
Balance, end of year	5,283	5,383	**5,359**

The Company repurchases its common shares in the open market to provide shares for issuance to employees under stock option and stock purchase plans. In 2002, the Company acquired 5.1 million of its shares as a result of a structured stock repurchase transaction entered into in 2001, which gave it the right to acquire such shares in exchange for an up-front net payment of $264 million. To enhance its stock repurchase program, Microsoft has sold put warrants to independent third parties. These put warrants entitled the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. In the third quarter of fiscal 2001, the Company issued 2.8 million shares to settle a portion of the outstanding put warrants. At June 30, 2001 and 2002, there were no outstanding put warrants.

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

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NOTE 14 OTHER COMPREHENSIVE INCOME

In Millions

Year Ended June 30	2000	2001	2002
Cumulative effect of accounting change, net of tax effect of $(37)	$ –	$ (75)	$ –
Net gains/(losses) on derivative instruments:			
Unrealized gains, net of tax effect of $246 in 2001 and $30 in 2002	–	499	55
Reclassification adjustment for (gains)/losses included in net income, net of tax effect of $67 in 2001 and $(79) in 2002	–	135	(146)
Net gains/(losses) on derivative instruments	–	634	(91)
Net unrealized investment gains/(losses):			
Unrealized holding gains/(losses), net of tax effect of $248 in 2000, $(351) in 2001, and $(955) in 2002	531	(1,200)	(1,774)
Reclassification adjustment for (gains)/losses included in net income, net of tax effect of $(420) in 2000, $(128) in 2001, and $958 in 2002	(814)	(260)	1,779
Net unrealized investment gains/(losses)	(283)	(1,460)	5
Translation adjustments and other	23	(39)	82
Other comprehensive income/(loss)	$ (260)	$ (940)	$ (4)

The components of accumulated other comprehensive income were:

In Millions

June 30	2001	2002
Net gains on derivative instruments	$ 177	$ 86
Net unrealized investment gains	598	603
Translation adjustments and other	(188)	(106)
Accumulated other comprehensive income	$ 587	$ 583

NOTE 15 EMPLOYEE STOCK AND SAVINGS PLANS

EMPLOYEE STOCK PURCHASE PLAN

The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 15% of their gross compensation during an offering period. During 2000, 2001, and 2002, employees purchased 2.5 million, 5.7 million, and 5.4 million shares at average prices of $72.38, $36.87, and $50.52 per share. At June 30, 2002, 56.8 million shares were reserved for future issuance.

SAVINGS PLAN

The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may contribute up to 25% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were $47 million, $63 million, and $77 million in 2000, 2001, and 2002.

STOCK OPTION PLANS

The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted between 1995 and 2001 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire after 10 years. Options granted during 2002 vest over four and one-half years and expire 10 years from the date of grant. At June 30, 2002, options for 371 million shares were vested and 543 million shares were available for future grants under the plans.

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Stock options outstanding were as follows:

In Millions, Except Per Share Amounts

	Shares	Price per Share Range	Price per Share Weighted Average
Balance, June 30, 1999	766	$ 0.56 – $ 83.28	$ 23.87
Granted	304	65.56 – 119.13	79.87
Exercised	(198)	0.56 – 82.94	9.54
Canceled	(40)	4.63 – 116.56	36.50
Balance, June 30, 2000	832	0.56 – 119.13	41.23
Granted	224	41.50 – 80.00	60.84
Exercised	(123)	0.59 – 85.81	11.13
Canceled	(35)	13.83 – 119.13	63.57
Balance, June 30, 2001	898	0.56 – 119.13	49.54
Granted	41	48.62 – 72.57	62.50
Exercised	(99)	1.02 – 69.81	12.82
Canceled	(38)	1.15 – 116.56	68.67
Balance, June 30, 2002	802	0.79 – 119.13	53.75

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 2002 were as follows:

In Millions, Except Per Share Amounts

Range of Exercise Prices	Outstanding Options Shares	Outstanding Options Remaining Life (Years)	Outstanding Options Weighted Average Price	Exercisable Options Shares	Exercisable Options Weighted Average Price
$ 0.79 – $ 5.97	36	1.6	$ 4.83	35	$ 4.82
5.98 – 13.62	44	0.5	11.19	42	11.18
13.63 – 29.80	90	2.0	15.02	84	14.97
29.81 – 43.62	73	2.7	32.19	66	32.09
43.63 – 60.00	191	6.9	55.81	41	54.03
60.01 – 69.50	146	6.4	66.24	35	66.53
69.51 – 83.28	80	5.1	71.17	21	71.84
83.29 – 119.13	142	4.2	89.87	47	89.29

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Employee stock options are valued at grant date using the Black-Scholes valuation model, and this compensation cost is recognized ratably over the vesting period.

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Had compensation cost for the Company's stock option and employee stock purchase plans been determined as prescribed by SFAS 123, pro forma income statements for 2000, 2001, and 2002 would have been as follows:

In Millions, Except Per Share Amounts

Year Ended June 30	**2000**		**2001**		**2002**	
	Reported	**Pro Forma**	**Reported**	**Pro Forma**	**Reported**	**Pro Forma**
Revenue	$ 22,956	$ 22,956	$ 25,296	$ 25,296	**$ 28,365**	**$ 28,365**
Operating expenses:						
Cost of revenue	3,002	3,277	3,455	3,775	**5,191**	**5,699**
Research and development	3,772	4,814	4,379	6,106	**4,307**	**6,299**
Sales and marketing	4,126	4,468	4,885	5,888	**5,407**	**6,252**
General and administrative	1,050	1,284	857	1,184	**1,550**	**1,843**
Total operating expenses	11,950	13,843	13,576	16,953	**16,455**	**20,093**
Operating income	11,006	9,113	11,720	8,343	**11,910**	**8,272**
Losses on equity investees and other	(57)	(57)	(159)	(159)	**(92)**	**(92)**
Investment income/(loss)	3,326	3,326	(36)	(36)	**(305)**	**(305)**
Income before income taxes	14,275	12,382	11,525	8,148	**11,513**	**7,875**
Provision for income taxes	4,854	4,210	3,804	2,689	**3,684**	**2,520**
Income before accounting change	9,421	8,172	7,721	5,459	**7,829**	**5,355**
Cumulative effect of accounting change	–	–	(375)	(375)	**–**	**–**
Net income	$ 9,421	$ 8,172	$ 7,346	$ 5,084	**$ 7,829**	**$ 5,355**
Basic earnings per share	$ 1.81	$ 1.57	$ 1.38	$ 0.95	**$ 1.45**	**$ 0.99**
Diluted earnings per share	$ 1.70	$ 1.48	$ 1.32	$ 0.91	**$ 1.41**	**$ 0.98**

The weighted average Black-Scholes value of options granted under the stock option plans during 2000, 2001, and 2002 was $36.67, $29.31, and $31.57. Value was estimated using a weighted average expected life of 6.2 years in 2000, 6.4 years in 2001, and 7.0 years in 2002, no dividends, volatility of .33 in 2000, .39 in 2001, and .39 in 2002, and risk-free interest rates of 6.2%, 5.3%, and 5.4% in 2000, 2001, and 2002.

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NOTE 16 EARNINGS PER SHARE

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

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

In Millions, Except Per Share Amounts

Year Ended June 30	2000	2001	2002
Income before accounting change	$ 9,421	$ 7,721	$ 7,829
Preferred stock dividends	13	–	–
Net income available for common shareholders	$ 9,408	$ 7,721	$ 7,829
Weighted average outstanding shares of common stock	5,189	5,341	5,406
Dilutive effect of:			
Put warrants	2	21	–
Preferred stock	7	–	–
Employee stock options	338	212	147
Common stock and common stock equivalents	5,536	5,574	5,553
Earnings per share before accounting change:			
Basic	$ 1.81	$ 1.45	$ 1.45
Diluted	$ 1.70	$ 1.38	$ 1.41

For the years ended June 30, 2000, 2001 and 2002, 45 million, 351 million, and 373 million shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

NOTE 17 OPERATIONAL TRANSACTIONS

In January 2000, the Company acquired Visio Corporation in a transaction that was accounted for as a pooling of interests. Microsoft issued 14 million shares valued at approximately $1.5 billion in the exchange for the outstanding stock of Visio. Visio's assets and liabilities, which were nominal, are included with those of Microsoft as of the merger. Operating results for Visio from periods prior to the merger were not material to the combined results of the two companies. Accordingly, the financial statements for such periods have not been restated.

In April 2001, the Company acquired Great Plains Software, Inc. for approximately $1.1 billion in stock. Great Plains is a leading supplier of mid-market business applications. The acquisition was accounted for by the purchase method and operating results for Great Plains subsequent to the date of acquisition are included with those of Microsoft. The pro forma impact of Great Plains' operating results prior to the date of acquisition was not material.

NOTE 18 COMMITMENTS

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $201 million, $281 million, and $318 million in 2000, 2001, and 2002. Future minimum rental commitments under noncancellable leases, in millions of dollars, are: 2003, $260; 2004, $219; 2005, $197; 2006, $170; 2007, $135; and thereafter, $302. Microsoft has committed $111 million for constructing new buildings. In addition, the Company has guaranteed $536 million in debt of its equity investees.

NOTE 19 CONTINGENCIES

The Company is a defendant in *U.S. v. Microsoft*, a lawsuit filed by the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of eighteen state Attorneys General alleging violations of the Sherman Act and various state antitrust laws. After the trial, the District Court entered Findings of Fact and Conclusions of Law stating that Microsoft had violated Sections 1 and 2 of the Sherman Act and various state antitrust laws. A Judgment was entered on June 7, 2000 ordering, among other things, the breakup of Microsoft into two companies.

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The Judgment was stayed pending an appeal. On June 28, 2001, the U.S. Court of Appeals for the District of Columbia Circuit affirmed in part, reversed in part, and vacated the Judgment in its entirety and remanded the case to the District Court for a new trial on one Section 1 claim and for entry of a new judgment consistent with its ruling. In its ruling, the Court of Appeals substantially narrowed the bases of liability found by the District Court, but affirmed some of the District Court's conclusions that Microsoft had violated Section 2. On October 12, 2001, the trial court held a status conference and entered orders requiring the parties to engage in settlement discussions until November 2, 2001. Microsoft entered into a settlement with the United States on November 2, 2001. Nine states (New York, Ohio, Illinois, Kentucky, Louisiana, Maryland, Michigan, North Carolina and Wisconsin) agreed to settle on substantially the same terms on November 6, 2001. A hearing on the settlement was held by the Court on March 6, 2002. The Court will now decide whether to approve the settlement as being in the public interest. Nine states and the District of Columbia continue to litigate the remedies phase of *U.S. v. Microsoft*. The non-settling states are seeking imposition of a remedy that would impose much broader restrictions on Microsoft's business than the proposed settlement with the DOJ and nine other states. The Court conducted an evidentiary hearing related to the non-settling states' proposed remedies from March 18 to June 19, 2002. A decision is anticipated later in calendar 2002.

In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues. In addition, the European Commission has instituted proceedings in which it alleges that Microsoft has failed to disclose information that Microsoft competitors claim they need to interoperate fully with Windows 2000 clients and servers and has engaged in discriminatory licensing of such technology, as well as improper bundling of multimedia playback technology in the Windows operating system. The remedies sought, though not fully defined, include mandatory disclosure of Microsoft Windows operating system technology and imposition of fines. Microsoft denies the European Commission's allegations and intends to contest the proceedings vigorously.

A large number of overcharge class action lawsuits have been initiated against Microsoft in various state and Federal courts. These cases allege that Microsoft has competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications and seek to recover alleged overcharges that the complaints contend Microsoft charged for these products. Microsoft believes the claims are without merit and is vigorously defending the cases. To date, Microsoft has won dismissals of all claims for damages by indirect purchasers under Federal law and in 17 separate state court proceedings, of which seven have been affirmed and one has been reversed. Claims on behalf of foreign purchasers have also been dismissed. Appeals of several of these rulings are still pending. No trials or other proceedings have been held concerning any liability issues. Courts in several states have ruled that these cases may proceed as class actions, while two courts have denied class certification status to the claims in that state proceeding and another has ruled that no class action is available for claims in that state. In fiscal 2002, the Company recorded a contingent liability of approximately $660 million representing management's estimate of the costs of resolving the contingency. Management's contingent liability estimate is based upon a proposed settlement between Microsoft and lead counsel for the Federal plaintiffs. While the proposed settlement was not approved by the District Court, management believes that the proposal represents the best estimate of the costs of resolving the contingency based on currently available information. The Company intends to continue vigorously defending these lawsuits.

Netscape Communications Inc., a subsidiary of AOL-Time Warner Inc., filed suit against Microsoft on January 22, 2002 in Federal court in the District of Columbia, alleging violations of antitrust and unfair competition laws and other tort claims relating to Netscape and its Navigator browser. The complaint includes claims of unlawful monopolization or attempted monopolization of alleged markets for operating systems and Web browsers, illegal tying of operating systems and browsers, and tortuous interference with Netscape's business relations. Netscape seeks injunctive relief, unquantified treble damages and its fees and costs. Microsoft denies these allegations and will vigorously defend this action. The case has been transferred for pretrial purposes to the District Court in Baltimore, Maryland and is being coordinated with the overcharge class actions described above.

Be Incorporated, a former software development company whose assets were acquired by Palm Incorporated in August 2001, filed suit against Microsoft on February 18, 2002 in Federal court in San Francisco, alleging violations of Federal and state antitrust and unfair competition laws and other tort claims. Be alleges that Microsoft's license agreements with computer manufacturers, pricing policies, and business practices interfered with Be's relationships with computer manufacturers and discouraged them from adopting Be's own operating system for their products. Be is seeking unquantified treble and punitive damages for its alleged injuries along with its fees and costs. Microsoft denies these allegations and will vigorously defend this action. The case has been transferred for pretrial purposes to the District Court in Baltimore, Maryland and is being coordinated with the overcharge class actions described above.

On March 8, 2002, Sun Microsystems, Inc. filed suit against Microsoft alleging violations of Federal and state antitrust and unfair competition laws as well as claims under the Federal Copyright Act. Sun seeks injunctive relief and unspecified treble damages along with its fees and costs. Microsoft denies these allegations and will vigorously defend this action. The case has been transferred for pretrial purposes to the District Court in Baltimore, Maryland and is being coordinated with the overcharge class actions described above.

On June 3, 2002, Microsoft and the Securities and Exchange Commission entered into an administrative settlement resolving a non-public investigation of certain of Microsoft's accounting and record keeping practices during fiscal years 1995 through 1998 (SEC File No. 3-10789). The settlement provides that Microsoft will not violate securities regulations that require companies to make accurate filings and maintain sufficient records and controls. The settlement has no impact on the Company's financial results.

The Company is also subject to a variety of other claims and suits that arise from time to time in the ordinary course of its business.

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

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NOTE 20 SEGMENT INFORMATION

In Millions

Year Ended June 30	Desktop and Enterprise Software and Services	Consumer Software, Services, and Devices	Consumer Commerce Investments	Other	Reconciling Amounts	Consolidated
2000						
Revenue	$ 20,410	$ 1,654	$ 182	$ 691	$ 19	$ 22,956
Operating income/(loss)	13,210	(1,090)	(60)	86	(1,140)	11,006
2001						
Revenue	$ 22,720	$ 1,961	$ 522	$ 652	$ (559)	$ 25,296
Operating income/(loss)	14,261	(1,666)	(222)	97	(750)	11,720
2002						
Revenue	**$ 23,786**	**$ 3,531**	**$ 245**	**$ 537**	**$ 266**	**$ 28,365**
Operating income/(loss)	**14,671**	**(1,778)**	**23**	**59**	**(1,065)**	**11,910**

Desktop and Enterprise Software and Services Revenue:

In Millions

Year Ended June 30	2000	2001	2002
Desktop Applications	$ 9,013	$ 9,580	**$ 9,327**
Desktop Platforms	7,383	8,265	**9,276**
Desktop Software	16,396	17,845	**18,603**
Enterprise Software and Services	4,014	4,875	**5,183**
Total Desktop and Enterprise Software and Services	$ 20,410	$ 22,720	**$ 23,786**

In fiscal 2002, Microsoft had four segments: Desktop and Enterprise Software and Services; Consumer Software, Services, and Devices; Consumer Commerce Investments; and Other. Desktop and Enterprise Software and Services operating segment includes Desktop Applications, Desktop Platforms, and Enterprise Software and Services. Desktop Applications include Microsoft Office; Microsoft Project; Visio; client access licenses for Windows NT Server and Windows 2000 Server, Exchange, and BackOffice; Microsoft Great Plains; and bCentral. Desktop Platforms include Windows XP Professional and Home, Windows 2000 Professional, Windows NT Workstation, Windows Millennium Edition (Windows Me), Windows 98, and other desktop operating systems. Enterprise Software and Services includes Server Platforms; Server Applications; developer tools and services; and Enterprise services. Consumer Software, Services, and Devices operating segment includes Xbox video game system, MSN Internet access, MSN network services, PC and online games, learning and productivity software, mobility, and embedded systems. Consumer Commerce Investments operating segment includes Expedia, Inc., the HomeAdvisor online real estate service, and the CarPoint online automotive service. Other primarily includes Hardware and Microsoft Press.

Segment information is presented in accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information.* This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The Company's financial reporting systems present various data for management to run the business, including internal profit and loss statements (P&Ls) prepared on a basis not consistent with U.S. generally accepted accounting principles. Assets are not allocated to segments for internal reporting presentations.

Reconciling items for revenue include certain elements of unearned revenue and the treatment of certain channel inventory amounts and estimates. In addition to the reconciling items for revenue, reconciling items for operating income/(loss) include general and administrative expenses ($1.05 billion in 2000, $857 million in 2001, and $1.55 billion in 2002), certain research expenses ($141 million in 2000, $154 million in 2001, and $166 million in 2002), and other corporate level adjustments. The internal P&Ls use accelerated methods of depreciation and amortization. Additionally, losses on equity investees and minority interests are classified in operating income for internal reporting presentations.

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Revenue attributable to U.S. operations includes shipments to customers in the United States, licensing to OEMs and certain multinational organizations, and exports of finished goods, primarily to Asia, Latin America, and Canada. Revenue from U.S. operations totaled $15.7 billion, $17.8 billion, and $20.9 billion in 2000, 2001, and 2002. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled $7.3 billion, $7.5 billion, and $7.5 billion in 2000, 2001, and 2002. No single customer accounted for 10% or more of revenue in 2000, 2001, or 2002.

Long-lived assets (principally property and equipment) totaled $2.2 billion and $2.0 billion in the United States in 2001 and 2002 and $154 million and $220 million in other countries in 2001 and 2002.

NOTE 21 SUBSEQUENT EVENT

On July 11, 2002, Microsoft acquired Navision a/s as a result of the successful close of a tender offer. Microsoft purchased Navision's shares for approximately $1.45 billion in stock and cash. Navision is a provider of integrated business software solutions for small and medium-sized companies. The purchase price allocation is currently being developed for this acquisition.

QUARTERLY INFORMATION

In millions, except per share amounts (Unaudited)

Quarter Ended	Sept. 30	Dec. 31	Mar. 31	June 30	Year
Fiscal 2000					
Revenue	$ 5,384	$ 6,112	$ 5,656	$ 5,804	$ 22,956
Gross profit	4,672	5,356	4,904	5,022	19,954
Net income	2,191	2,436	2,385	2,409	9,421
Basic earnings per share	0.43	0.47	0.46	0.46	1.81
Diluted earnings per share	0.40	0.44	0.43	0.44	1.70
Fiscal 2001					
Revenue	$ 5,766	$ 6,550	$ 6,403	$ 6,577	$ 25,296
Gross profit	4,941	5,686	5,504	5,710	21,841
Net income	2,206(1)	2,624	2,451	65(2)	7,346
Basic earnings per share	0.42(1)	0.49	0.46	0.01	1.38
Diluted earnings per share	0.40(1)	0.47	0.44	0.01	1.32
Fiscal 2002					
Revenue	**$ 6,126**	**$ 7,741**	**$ 7,245**	**$ 7,253**	**$ 28,365**
Gross profit	**5,242**	**6,197**	**5,850**	**5,885**	**23,174**
Net income	**1,283(3)**	**2,283**	**2,738(4)**	**1,525(5)**	**7,829**
Basic earnings per share	**0.24**	**0.42**	**0.51**	**0.28**	**1.45**
Diluted earnings per share	**0.23**	**0.41**	**0.49**	**0.28**	**1.41**

(1) Includes an unfavorable cumulative effect of accounting change of $375 million or $0.07 per basic share and $0.06 per diluted share, reflecting the adoption of SFAS No. 133.
(2) Includes $3.92 billion (pre-tax) in impairments of certain investments.
(3) Includes $1.82 billion (pre-tax) in impairments of certain investments.
(4) Includes $1.25 billion (pre-tax) gain on the sale of Expedia, Inc. and $1.19 billion (pre-tax) in impairments of certain investments.
(5) Includes $1.19 billion (pre-tax) in impairments of certain investments.

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the Company) as of June 30, 2001 and 2002, and the related consolidated statements of income, cash flows, and stockholders' equity for each of the three years in the period ended June 30, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 2001 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2002 in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, effective July 1, 2000, and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, effective July 1, 2001.

/S/ DELOITTE & TOUCHE LLP
Deloitte & Touche LLP
Seattle, Washington
July 18, 2002

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

None.

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PART III

ITEM 10. DIRECTORS OF THE REGISTRANT

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" of the Company's Proxy Statement for the Annual Meeting of Shareholders to be held November 5, 2002 (the "Proxy Statement"). Such information is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" and "Information Regarding the Board and its Committees" is incorporated herein by reference.

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

EQUITY COMPENSATION PLAN INFORMATION

In Millions, Except Per Share Amounts

June 30, 2002 Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	802	$ 53.75	600
Equity compensation plans not approved by security holders	–	–	–
Total	802	$ 53.75	600

The information set forth under the caption "Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management" of the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information set forth under the captions "Certain Relationships and Related Transactions" of the Proxy Statement is incorporated herein by reference.

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PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) Financial Statements and Schedules
The financial statements are set forth under Item 8 of this report on Form 10-K. Financial statement schedules have been omitted since they are either not required, not applicable, or the information is otherwise included.
(b) Reports on Form 8-K
The Company filed no reports on Form 8-K during the quarter ended June 30, 2002.
(c) Exhibit Listing

Exhibit Number	Description
3.1	Restated Articles of Incorporation of Microsoft Corporation (1)
3.2	Bylaws of Microsoft Corporation
10.1	Microsoft Corporation 2001 Stock Plan (2)
10.2	Microsoft Corporation 1991 Stock Option Plan (3)
10.3	Microsoft Corporation 1981 Stock Option Plan (4)
10.4	Microsoft Corporation 1999 Stock Option Plan for Non-Employee Directors (5)
10.5	Microsoft Corporation Stock Option Plan for Consultants and Advisors
10.6	Microsoft Corporation 1997 Employee Stock Purchase Plan (6)
10.7	Microsoft Corporation Savings Plus Plan (7)
10.8	Trust Agreement dated June 1, 1993 between Microsoft Corporation and First Interstate Bank of Washington
10.9	Form of Indemnification Agreement
10.10	Resignation Agreement between Richard Belluzzo and Microsoft Corporation
21.	Subsidiaries of Registrant
23.	Independent Auditors' Consent
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1999.
(2) Incorporated by reference to Registration Statement 333-52-852 on Form S-8.
(3) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1997.
(4) Incorporated by reference to Registration Statement 33-37623 on Form S-8.
(5) Incorporated by reference to Registration Statement 333-91755 on Form S-8.
(6) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 2001.
(7) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 2000.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned; thereunto duly authorized, in the City of Redmond, State of Washington, on September 5, 2002.

MICROSOFT CORPORATION

By /S/ JOHN G. CONNORS

John G. Connors
Senior Vice President; Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on September 5, 2002.

Signature	Title
/S/ WILLIAM H. GATES, III William H. Gates, III	Chairman of the Board of Directors and Chief Software Architect
/S/ STEVEN A. BALLMER Steven A. Ballmer	Chief Executive Officer
/S/ JAMES I. CASH, JR. James I. Cash, Jr.	Director
/S/ RAYMOND V. GILMARTIN Raymond V. Gilmartin	Director
/S/ ANN MCLAUGHLIN KOROLOGOS Ann McLaughlin Korologos	Director
/S/ DAVID F. MARQUARDT David F. Marquardt	Director
/S/ WM. G. REED, JR. Wm. G. Reed, Jr.	Director
/S/ JON A. SHIRLEY Jon A. Shirley	Director
/S/ JOHN G. CONNORS John G. Connors	Senior Vice President; Chief Financial Officer (Principal Financial and Accounting Officer)

CERTIFICATIONS

I, Steven A. Ballmer, certify that:

1. I have reviewed this annual report on Form 10-K of Microsoft Corporation;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report; and

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

Date: September 5, 2002

/S/ STEVEN A. BALLMER

Steven A. Ballmer
Chief Executive Officer

I, John G. Connors, certify that:

1. I have reviewed this annual report on Form 10-K of Microsoft Corporation;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report; and

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

Date: September 5, 2002

/S/ JOHN G. CONNORS

John G. Connors
Chief Financial Officer

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

FOR THE FISCAL YEAR ENDED JUNE 30, 1998

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION

WASHINGTON	91-1144442
(STATE OF INCORPORATION)	(I.R.S. ID)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

(425) 882-8080

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

COMMON STOCK

2 3/4% CONVERTIBLE EXCHANGEABLE PRINCIPAL-PROTECTED PREFERRED STOCK

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [_]

The aggregate market value of common stock held by non-affiliates of the registrant as of September 11, 1998 was $176,181,694,460.

The number of shares outstanding of the registrant's common stock as of September 11, 1998 was 2,484,635,670.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 1998 Annual Report to Shareholders are incorporated by reference into Parts I, II and IV. Portions of the definitive Proxy Statement dated September 25, 1998 to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held November 11, 1998 are incorporated by reference into Part III.

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MICROSOFT CORPORATION

FORM 10-K

FOR THE FISCAL YEAR ENDED JUNE 30, 1998

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PART I

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PART I

ITEM 1. BUSINESS

GENERAL

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, and supports a wide range of software products, including scalable operating systems for intelligent devices, personal computers (PCs) and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company's interactive efforts include entertainment and information software programs, MSN(TM), the Microsoft Network online service; Internet-based services; and alliances with companies involved with other forms of digital interactivity. Microsoft also sells personal computer input devices and books, and researches and develops advanced technologies for future software products.

Microsoft's business strategy emphasizes the development of a broad line of software products for business and personal use, marketed through multiple channels of distribution. The Company is divided into three main areas: the Product Group, the Sales and Support Group, and the Operations Group.

The Platforms and Applications Product Group is comprised of three primary divisions, each responsible for a particular area of platform software development and marketing. The Platforms Group develops PC and server operating systems. The Applications and Tools Group creates server and desktop productivity applications and software development products. The Consumer Platforms Group develops system software for intelligent devices.

The Interactive Media Product Group creates and markets productivity programs, interactive entertainment and information products, desktop finance products, and hardware peripherals. Interactive Media offerings include children's titles, games, reference sources, online informational services, and MSN. The Desktop Finance Division develops personal finance products. The Hardware Division develops PC peripherals such as the keyboard and mouse.

Microsoft has a research lab dedicated to creating new technology in support of the Company's vision for the evolution of personal computing.

The Sales and Support Group is responsible for building long-term business relationships with customers. This group is organized to serve various customer types, including original equipment manufacturers (OEMs), end-users, organizations, enterprises, application developers, Internet content providers (ICPs) and infrastructure owners. Large enterprises are offered tailored license programs, enterprise-wide support, consulting services, and other specialized services. The group manages the channels that serve customers by working with OEMs, distributors, and resellers. In addition to the OEM channel, Microsoft has three major geographic sales organizations: the South Pacific and the Americas; Europe, the Middle East and Africa; and Asia. The group also supports the Company's products with technical support for end-users, developers, and organizations.

The Operations Group is responsible for managing business operations and overall business planning. This includes the process of manufacturing and delivering finished goods and licenses; corporate functions such as finance, administration, human resources, and legal; and the publishing efforts of Microsoft Press.

PRODUCTS

PLATFORMS

The Platforms Group is responsible for development of the Microsoft(R) Windows(R) and Windows NT(R) operating systems including Microsoft Internet Explorer browsing software. PC operating systems perform a variety of software execution, managing information and communication flow among the various PC components, and enabling end-users to access files and information from a variety of sources. The Windows NT operating system for servers is an enterprise-wide

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platform for building and deploying distributed applications for networked PCs. It also provides products for developing, running, and managing Internet and intranet applications and content. Component Object Model (COM) underlies a large majority of the new code developed for Windows and Windows NT operating systems. COM+, an extension of COM, builds on COM's integrated services and features, making it easier for developers to create and use software components in any language, using any tool.

Windows PC Platforms

Windows 98. The successor to Windows 95, Windows 98 is a personal computer operating system which provides a Web-oriented user interface, better system performance along with easier system diagnostics and maintenance. Windows 98 supports current graphics, sound, and multimedia technologies, provides the ability to easily add and remove peripheral devices with support for Universal Serial Bus (USB), and also enables the convergence of the PC and television. Windows 98 was released in June 1998.

Windows 95. The successor to MS-DOS(R) and Windows 3.1, Windows 95 was released in August 1995; periodic service releases, system updates, and new device drivers have been made available to PC OEMs and end-users via the Internet on the Company's web site, http://www.microsoft.com. Windows 95 is a fully integrated, multitasking 32-bit operating system, designed to be compatible with Intel microprocessor-based PCs, most hardware devices, and applications for Windows 3.x and MS-DOS.

Windows 3.x. Microsoft Windows 3.1 provides a graphical user interface and other enhancements for MS-DOS, a single-user, single-tasking operating system. Windows 3.1 supports 16-bit Windows-based applications, and offers ease of use, aesthetic appeal, and straightforward integration into corporate computing environments. Windows for Workgroups 3.11 integrates network and workgroup functionality directly into the Windows operating system.

Windows NT Platforms

Windows NT Workstation. A fully integrated, multitasking 32-bit PC operating system, Windows NT Workstation provides superior security, robustness, and portability. Windows NT Workstation is a multithreaded operating system for mission critical computing which provides the same features and applications programming interfaces (APIs) for Intel and Alpha AXP microprocessors. Microsoft Windows NT Workstation 4.0 features the Windows 95 interface and combines the ease of use of the Windows 95 operating system with the reliability and security of Windows NT.

Windows NT Server. Windows NT Server is a powerful operating system foundation for both server applications and file and print sharing, with extensive network management features, administration tools, security, and high availability. Windows NT Server provides a scalable platform for business critical applications and databases, connectivity, system management, and e-mail servers. The operating system integrates Web services such as Microsoft Internet Information Server, a service used to manage intranet and Internet functionality and Microsoft FrontPage(R) Web site creation and management tool. Windows NT Server, Terminal Server Edition, an extension to the Windows NT Server product line, offers the application support of the Windows

Software development tools and computer languages allow software developers to write programs in a particular computer language and translate programs into a binary machine-readable set of commands that activate and instruct PC hardware. The Company develops and markets a number of software development environments, and language compilers. Microsoft Visual C++(R) is the Company's development system for Windows-based application development. The Microsoft Visual Basic(R) development system provides easy access to a wide variety of data sources by integrating the Microsoft Access database engine and the ability to take advantage of investments in commercial applications through ActiveX controls. The Visual InterDev(TM) Web Development System includes integrated, team-based development tools for building data-driven Web applications based on HTML, Script, and components written in any language. Microsoft Visual J++(TM) development system for Java contains a high productivity Integrated Development Environment and a collection of integrated components to create, test, tune, and deploy Java code on multiple platforms using ActiveX controls. Microsoft Visual Studio(R) development system is a suite of developer tools enabling developers to build components and applications using Visual Basic, Visual C++, Visual FoxPro(R) database development system, Visual InterDev, and Visual J++.

The Company provides third-party software developers with a wide range of technical and support information that assists them in developing software products intended to run on Windows operating systems, taking advantage of key technologies such as ActiveX controls and Windows 32-bit APIs. Developers can subscribe to the Microsoft Developer Network (MSDN(TM)) information service and receive periodic updates via CD-ROMs, magazines, and several on-line information services.

CONSUMER PLATFORMS

The Consumer Platforms Group delivers software and platform technologies that extend the benefits of Windows and Windows-compatible solutions for a broad range of intelligent business and consumer devices, including handheld PCs, Palm-sized PCs, wireless-communication devices such as digital information pagers and cellular smart phones, next-generation entertainment and multimedia consoles including game players, and purpose-built Internet access devices such as Internet TVs, digital set-top boxes and Internet "Web phones."

The Consumer Platforms Group also is responsible for systems integration of products and technologies that public network operators and corporate customers need for a variety of Internet and intranet-based applications.

Windows CE. Microsoft develops Windows CE, a scaleable Windows platform for a broad range of communications, entertainment, and mobile computing devices. The Windows CE operating system is built around an API that is consistent with other 32-bit Windows-based operating systems, which allows developers and programmers to use the same development tools and communication protocols to create applications for Windows CE-powered devices. Windows CE allows information appliances to communicate with each other, share information with Windows-based PCs, and connect to the Internet. Windows CE is developed for PC companions, including handheld PCs, palm-size PCs, and auto PCs, vertical market devices, and home products. Microsoft teams up with hardware companies that build Windows CE-based devices and who understand the needs of vertical markets such as automotive, retail, manufacturing, education, healthcare, telecommunications, or broadcast.

WebTV. In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on WebTV(TM) technologies. WebTV operates the WebTV Network Service and develops the WebTV Internet Terminal and WebTV Plus Receiver, which are available through the company's licensees. Future versions of the set-top terminals will use the Windows CE operating system.

INTERACTIVE MEDIA

The Interactive Media Group develops and markets interactive entertainment and information products across a variety of media, including the Internet, MSN, the Microsoft Network, and CD-ROM.

Learning, Entertainment and Productivity. Reference titles include Microsoft Encarta(R) and Microsoft Bookshelf. The Encarta multimedia encyclopedia database blends text in articles with innovative, interactive information presented through animations, videos, maps, charts, sounds, and pictures. Bookshelf is a multimedia reference library that integrates a dictionary, world atlas, world almanac, thesaurus, concise encyclopedia, and two books of quotations. The Expedia(R) travel series product line offers global positioning system (GPS)-compatible maps and travel planning in an easy-to-use format.

Titles for children include My Personal Tutor, a comprehensive three CD-ROM learning suite, and a series of products based on the popular children's book and television series, Scholastic's The Magic School Bus(TM).

The Company offers a line of entertainment products. Microsoft Flight Simulator is a popular aircraft flight simulation product available for Windows, MS-DOS, and Macintosh operating systems. Other games include Age of Empires(R), Monster Truck Madness(TM), Microsoft Golf, and other sports and action titles. Most games are available for the Windows 32-bit environment. The Microsoft Internet Gaming Zone is a gaming community on the Internet allowing multiplayer gaming competitions of popular CD-ROM games and classic card, board, and puzzle games.

Microsoft's productivity offerings include Microsoft Works, an integrated software program that contains basic word processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Home Essentials, an integrated software program, allows consumers to complete home PC tasks using Microsoft Word, Microsoft Encarta, Microsoft Money, Microsoft Works, Microsoft Greetings Workshop, Microsoft Internet Explorer, and the Microsoft Entertainment Pack-The Puzzle Collection.

Interactive Service Media. The Company is developing an online decision support infrastructure for end-users in such fields as automobiles, retail, entertainment, and travel. Microsoft CarPoint(TM) online automotive service provides current and objective information for new car purchases, including test drive reviews, dealer invoices, and surround videos. Additionally, CarPoint features interactive classifieds for used car purchasing and a new car buying service. Comprised of a national network of dealers, this service refers customers to nearby dealers. Microsoft Sidewalk(TM) online city guide is a personalized city guide to local entertainment. The Sidewalk

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editorial team provides previews, reviews and even customized suggestions about entertainment events in Seattle, New York, Boston, Minneapolis/St. Paul, Washington, D.C., San Diego, Denver, Houston, San Francisco, and Sydney, Australia, with city guides scheduled to launch in additional cities. Microsoft Expedia(TM) travel service is a free service on the Web and MSN, which enables users to find low fares, book flights, make hotel reservations, and rent cars. Expedia also offers a comprehensive source of information for more than 330 destinations including photos, historical information, and local details. Microsoft HomeAdvisor online real estate service is a complete guide to the home-buying process and provides comprehensive tools for finding homes and loans on the Internet. With HomeAdvisor(R), users can find a home, qualify and apply for a loan online, calculate financing options, and gain real estate industry knowledge.

The Microsoft Network. MSN is a Web-based interactive online service. MSN provides easy and inexpensive access for users to a wide range of graphically rich online content. The online service provides access to the Internet, a free Web-based electronic mail account through Hotmail, bulletin boards, and a myriad of additional services offered by Microsoft and by ICPs.

Joint Ventures. The Company has entered into joint venture arrangements to take advantage of creative talent and content from other organizations. Microsoft owns 50 percent of DreamWorks Interactive L.L.C., a software company that develops interactive and multimedia products. DreamWorks SKG owns the remaining 50 percent. Microsoft owns 50 percent of MSNBC Cable L.L.C., a 24-hour cable news and information channel; and 50 percent of MSNBC Interactive News L.L.C., an interactive online news service. National Broadcasting Company (NBC) owns the remaining 50 percent of these two joint ventures. Microsoft is an investor in MSFDC L.L.C., a joint venture between Microsoft and First Data Corp. MSFDC has announced that it is changing its name to TransPoint and Citibank will make an equity investment in the venture. The venture is developing an Internet bill delivery and payment service called TransPoint E-Bills.

Desktop Finance. Desktop Finance develops and markets consumer finance products and manages relationships with financial institutions to develop online deliver systems for customers. Microsoft Money is a financial organization product that allows users to computerize their household finances. Microsoft Money is available for systems running Microsoft Windows 32-bit operating systems and provides online home-banking services with numerous different banks in the U.S.

Microsoft Investor is an online investing site that provides a comprehensive offering of information and services designed to help personal investors make investment decisions, track their securities and understand the market. A blend of free and subscription-based services, Investor provides portfolio tracking and analysis, company and mutual fund research, an investment finder, daily editorial and market summaries, electronic mail notifications and alerts, and access to online trading through leading financial services firms.

Hardware Peripherals. The Company's major PC input device is the Microsoft Mouse, a hand-held pointing device that facilitates use of a PC. The Microsoft IntelliMouse(R) pointing device is a mouse with a center positioned wheel which provides transfer zooming, scrolling and data zooming in Microsoft Windows 32-bit operating systems, Microsoft Internet Explorer, and Microsoft Office 97. Microsoft also offers a mouse designed for the home and a mouse for young children. The Company also markets the Microsoft Natural(R) Keyboard, an ergonomically designed keyboard. Additionally, Microsoft sells various Microsoft Sidewinder(R) Game Controllers and Force Feedback joysticks with realistic performance technology for use with PC games. ActiMates(TM) Interactive Barney is a two-way interactive, talking and moving, wireless plush character peripheral for young children that operates via programming from CD-ROM (PC mode) or a VHS (TV mode) and on-board ROM chip (Standalone mode).

MICROSOFT PRESS

Microsoft Press publishes books about software products from Microsoft and other software developers and about current developments in the industry. Books published by Microsoft Press typically are written and copyrighted by independent authors who submit their manuscripts to the Company for publication and who receive royalties based on revenue generated by the book.

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Microsoft Press contracts with an independent commercial printer for the manufacturing of its books. Publisher's Resources, Inc. acts as the Company's main fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press(R) books. Books are marketed by independent sales representatives and by Microsoft Press sales personnel. Internationally, Microsoft Press has numerous international agreements with publishers for the worldwide distribution of its books. Microsoft Press has granted a publisher in England the right to distribute English language versions of its books in all countries except the United States, Canada, Central and South America, and certain Asian countries. In most cases, Microsoft Press provides each publisher with a book's manuscript, and the publisher arranges for its translation and the printing, marketing, and distribution of the translated version.

PRODUCT DEVELOPMENT

The PC software industry is characterized by extremely rapid technological change, which requires constant attention to software technology trends and shifting consumer demand, and rapid product innovation. The pace of change has recently become even greater due to the surge of interest in the Internet, other forms of online services, PC server-based networking, and new programming languages, such as Java.

Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third-party development and localization of certain products. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved development methodologies for creating and enhancing its products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, or computers. Product documentation is generally created internally.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to new user needs or advances in PCs, servers, peripherals, and the Internet, without compromising product quality. The Company strives to become informed at the earliest possible time about changing usage patterns and hardware advances that may affect software design.

In order to best serve the needs of users around the world, Microsoft "localizes" many of its products to reflect local languages and conventions. In French versions, for example, all user messages and documentation are in French with monetary references in French francs. Various Microsoft products have been localized into more than 30 languages.

During fiscal years 1996, 1997, and 1998, the Company spent $1.43 billion, $1.93 billion, and $2.50 billion, respectively, on product research and development activities. Those amounts represented 16.5%, 16.9%, and 17.3%, respectively, of revenue in each of those years, excluding funding of joint venture activity. The Company is committed to continue high expenditures for research and product development.

MANUFACTURING

Microsoft contracts most of its manufacturing activity with third parties. Outside manufacturers produce various retail software packaged products and hardware such as mouse pointing devices, keyboards, and joysticks. There are other custom manufacturers in the event that outsourced manufacturing becomes unavailable from current sources.

The Company's manufacturing facilities are located in Puerto Rico and Ireland. The Irish facility and the Puerto Rico facilities replicate disks. Microsoft outsources its manufacturing of packaged products. Quality control tests are performed on purchased parts, finished disks and CD-ROMs, and other products. The chief materials and components used in Microsoft products include disks or CD-ROMs, books, and multicolor printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.

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In recent years the Company's sales mix has shifted to OEM and organizational licenses from packaged products. Also, online distribution of software may increase in the future.

OPERATIONS

Microsoft manages all product fulfillment, licensing, and logistic services. The company has regional operation centers in Ireland and the Greater Seattle area. The regional centers support all operations activities, including information processing, vendor management, logistics, and related supporting functions by geographical regions. The regional center in Dublin, Ireland supports the European, African and Middle East regions, and the center in the Greater Seattle area supports North and South America. The company is establishing a regional operations center in Singapore for the Asia Pacific region and plans to consolidate its sales operation. The company established Microsoft Licensing Incorporated (MSLI) in Reno, Nevada, a wholly owned subsidiary, which manages the company's OEM licensing operations.

MARKETING AND DISTRIBUTION

Microsoft aligns its sales and marketing staff with several customer types, including OEMs, end-users, organizations, enterprises, applications developers, educators, and Internet content providers (ICPs) and infrastructure owners. The Company's sales and marketing group seeks to build long-term relationships with customers of Microsoft products. In addition to the OEM channel, Microsoft has three major geographic sales and marketing organizations: the South Pacific and the Americas; Europe, the Middle East and Africa; and Asia.

The OEM customer unit includes the sales force that works with original equipment manufacturers that preinstall Microsoft software on their PCs.

The end-user customer unit has responsibility for activities that target end-users that make individual buying decisions for the PCs they use at work or home. Most sales and marketing activities aimed at end-user customers are performed by this unit, including developing and administering reseller relationships; reseller sales terms and conditions; channel marketing and promotions; end-user marketing programs; and seminars, events, and sales training for resellers. The customer unit's sub-segments include direct marketing resellers and retailers. The key products marketed by the end-user customer unit are the Company's PC operating systems, desktop applications, and interactive media products.

The organization customer unit has responsibility for activities that target groups of users in small and medium organizations. The unit works with channel partners such as distributors, aggregators, value-added resellers, and Solution Providers to provide complete business solutions to this customer segment. The unit's sales and marketing activities include managing technical training programs for Solution Providers (described below) and channel resellers; and supporting and providing seminars, events, and sales training for channel partners. The Company works with the partners to provide software and support to a broad range of small and medium size organizations. The organization customer unit also runs the Microsoft Certified Professional program, which ensures the quality of Microsoft training for individuals and corporations.

The enterprise customer unit has responsibility for sales and marketing activities that target large organizations. The unit works directly with these organizations, and through large account resellers, to create and support enterprise-wide, mission critical solutions for business computing needs. The enterprise customer unit also provides seminars and forums to familiarize enterprises with technology issues and solutions.

The application developers customer unit targets corporate developers and independent software vendors (ISVs) who build business applications with a development platform based on Microsoft Windows and BackOffice architecture. The unit's sales and marketing activities include providing industry specific technical training, seminars, and events for ISVs. The application developers customer unit also focuses on vertical and horizontal industries and their associated software applications. A key focus of the group is Microsoft Developer Tools.

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The education customer unit works with key education groups and other industry partners to provide programs and technology tools that help them expand and enhance learning opportunities for students. The education customer unit has three primary areas, including higher education, K-12, and management of the education channel and resellers.

The Internet customer unit is responsible for introducing the Company's products and technologies to the public infrastructure owners and ICPs. The customer unit also focuses on embedded and dedicated systems. Infrastructure owners include network operators (telephone companies, cable companies, Internet service providers, etc.) who build, own, and operate the public networks and ICPs who provide content for the Web.

FINISHED GOODS CHANNELS

Distributors and Resellers. The Company markets its products in the finished goods channels primarily through independent non-exclusive distributors and resellers. Distributors include CHS Electronics, Computer 2000, Inacom, Ingram Micro, Soft Bank, Tech Data, and Merisel. Resellers include Software Spectrum, Corporate Software & Technology, CompUSA, Software House International, Softmart, ASAP Software Express, and Best Buy. Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

Large Accounts. The Microsoft Select program offers flexible software acquisition, licensing, and maintenance options specially customized to meet the needs of large multinational organizations. Targeted audiences include technology specialists and influential end-users in large enterprises. Marketing efforts and fulfillment are generally coordinated with large account resellers. The Microsoft OPEN program is a licensing program that is targeted for small and medium size organizations. It is available through the reseller channel and offers discounts based on initial purchase volumes.

Solution Providers. Microsoft's Solution Providers program is a comprehensive support relationship with independent organizations that provide network and system integration, custom development, training, and technical support for business computing solutions. The program supports value-added resellers (VARs), system integrators, consultants, custom application developers, solution developers, Internet service and hosting organizations, independent content providers, and sitebuilders (companies that build Web sites for other companies), as well as technical support and training organizations. Under this business partnership strategy, the Company provides sales and product information, development services, early access to Microsoft products, and customer support tools including priority telephone support, education, and business development support. To ensure high-quality technical services for the Company's products, Microsoft Solution Providers are required to have Microsoft-certified professionals on staff. Microsoft Direct Access is a comprehensive and open program that allows independent technology providers to actively engage with Microsoft through the Microsoft Direct Access program online, quarterly briefings, training, and action packs.

Consulting Services. The Company's Consulting Services Division assists customers in deploying and using the Company's computer operating systems, applications, and communications products. The group works with Solution Providers and helps create enterprise-wide computing solutions for large corporate accounts.

International Sales Sites. The Company has established marketing and/or support subsidiaries in more than 60 countries. Product is generally delivered by the Company's owned or outsourced manufacturing operations. They also spend a significant portion of their time working with partners to help them become more proficient at providing these technical services. Notes to Financial Statements--(see Item 8) describe foreign operations and export sales.

The Company's international operations, both OEM and finished goods, are subject to certain risks common to foreign operations in general, such as governmental regulations, import restrictions, and foreign exchange rate fluctuations. Microsoft hedges a portion of its foreign exchange risk.

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OEM CHANNEL

Microsoft operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of the Company's products with their computers. The Company also markets and licenses certain desktop applications, hardware, and interactive media programs to OEMs under similar arrangements. In almost all cases, the products are distributed under Microsoft trademarks. The Company has OEM agreements covering one or more of its products with virtually all of the major PC OEMs, including, Acer, Compaq, Dell, Fujitsu/ICL, Gateway 2000, Hewlett-Packard, IBM, NEC Packard Bell, Samsung, Siemens, Toshiba, and Vobis.

ADVERTISING

The Company works closely with large advertising and direct marketing firms. Advertising, direct marketing, worldwide packaging, and marketing materials are targeted to various end-user segments. The Company utilizes broad consumer media (television, radio, and business publications) and trade publications. Microsoft has programs under which qualifying resellers and OEMs are reimbursed for certain advertising expenditures. The Company maintains a broad advertising campaign emphasizing the Microsoft brand identity.

CUSTOMERS

The Company's customers include end-users, organizations, enterprises, ISPs, application developers, and OEMs. Most end-users of Microsoft products are individuals in businesses, government agencies, educational institutions, and at home. The end-users and organizations obtain Microsoft products primarily through resellers and OEMs, which include certain Microsoft products with their hardware. Notes to Financial Statements (see Item 8) describe customers that represent more than 10% of the Company's revenue. The Company's practice is to ship its products promptly upon receipt of purchase orders from its customers and, consequently, backlog is not significant.

PRODUCT SUPPORT

The Company provides product support coverage options to meet the needs of users of Microsoft products. Support personnel are located in various sites in the U.S. and around the world. Certain support is also supplied by qualified third-party support organizations. The Company hires individuals with product expertise and provides them with productivity tools, continuous product education and training, and consistent processes to deliver quality support for Microsoft products. Coverage options range from standard no-charge toll telephone support to fee-based offerings providing unlimited 800 number telephone and electronic technical support for all Microsoft products 24 hours per day, 7 days per week.

Users have access to troubleshooting "wizards" and Microsoft's KnowledgeBase, a library of thousands of technical articles that is updated regularly with useful information regarding Microsoft products. Microsoft provides access to KnowledgeBase via MSN, America Online, Prodigy, and the Internet. Additionally, several support offerings include Microsoft TechNet and Microsoft Developer Network information subscription services.

As a supplement or alternative to direct support, the Company enhances the third-party support channel by providing Microsoft Solution Providers with education, training, tools, and support. Microsoft Solution Providers include Authorized Training Centers, which offer advanced product education and certification on Microsoft products; and Authorized Support Centers, which provide a wide spectrum of multinational support, multivendor support, and integration services.

COMPETITION

The PC software business is intensely competitive and subject to extremely rapid technological change. Microsoft faces formidable competition in all areas of its business activity, including competition from many

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companies much larger than Microsoft. The rapid pace of technological change continually creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. The Company also faces constant competition from software pirates who unlawfully copy and distribute Microsoft's copyrighted software products.

Operating systems. Microsoft's operating system products face substantial competition from a wide variety of companies. Major competitors such as IBM, Apple Computer, Compaq (Digital Equipment Corporation), Hewlett-Packard, Sun Microsystems and others are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on computers of their own manufacture. Many of these operating system software products are also licensed to third-party OEMs for preinstallation on their machines. Microsoft's operating system products compete with UNIX-based operating systems from a wide range of companies including IBM, AT&T, Hewlett-Packard, Sun Microsystems, The Santa Cruz Operation, and others. Variants of UNIX run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems. Over the past year the Linux operating system has gained increasing acceptance, and leading software developers such as Oracle and Corel have announced that they will develop applications that run on Linux. As PC technology increasingly moves toward connectivity and communications, Microsoft's operating system products will face increased competition from network server operating systems such as Novell's NetWare, Banyan's Vines, the many variants of UNIX, IBM's OS/2, "middleware" products such as IBM's Lotus Notes, and intranet servers from Netscape, IBM, Sun Microsystems, and others.

Business systems. The Company is a fairly recent entrant into the business of providing enterprise-wide computing solutions. Several competitors enjoy a larger share of sales and larger installed bases. Many companies offer operating system software for mainframes and midrange computers, including IBM, Hewlett-Packard, and Sun Microsystems. Since legacy business systems are typically support-intensive, these competitors also offer substantive support services. Software developers that provide competing server applications for PC-based distributed client/server environments include Oracle, IBM, Computer Associates, Sybase, and Informix. There are also several software vendors who offer connectivity servers. As mentioned above, there are numerous companies and organizations that offer Internet and intranet server software which compete against the Company's business systems. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with the Company's collaboration and e-mail products.

Desktop applications. The Company's competitors include many software application vendors, such as IBM (Lotus), Oracle, Apple (Filemaker, Inc.), Corel, and local application developers in Europe and the Far East. IBM and Corel have large installed bases with their spreadsheet and word processor products, respectively, and both have aggressive pricing strategies. Also, IBM and Apple preinstall certain of their software products on various models of their PCs, competing directly with Microsoft desktop application software.

Developer tools. The Company's developer products compete against offerings from Borland, Macromedia, Oracle, Sun Microsystems, Sybase, Symantec, and other companies.

News services. The Company's MSNBC joint ventures face formidable competition from other 24-hour cable and Internet news organizations such as CNN, CNN Headline News, and Fox News Network. MSNBC also competes with traditional news media such as newspapers and broadcast TV and Internet news services.

Consumer platforms. A wide variety of companies develop operating systems for information appliances, including Apple, Motorola, 3Com, Psion Software, and others. The Company's nascent WebTV offerings and other multimedia consumer products face competitors such as Sun Microsystems, Oracle, NetChannel, and others. An enormous range of companies, including media conglomerates, telephone companies, cable companies, retailers, hardware manufacturers, and software developers, are competing to make interactive services widely available to the home.

Internet platforms and services. The advent of the Internet as a computing, communication, and collaboration platform as well as a low cost and efficient distribution vehicle increases competition and creates uncertainty as to future technology directions. The Company faces intense competition in the development and

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marketing of Internet (and intranet) software from a wide variety of companies and organizations including IBM, Netscape, Novell, Oracle, Real Networks, Sun Microsystems', and many others. In addition, the very low barriers to entry on the Internet have allowed numerous Web-based service companies to build significant businesses in areas such as electronic mail, electronic commerce, Web search engines, directories, and information of numerous types. Competitors include Netscape, Lycos, Yahoo, Excite, Infoseek, CitySearch, and many others.

Online services. Microsoft's online services network, MSN, faces formidable competition from America Online and other traditional online services as well as a vast array of sites on the World Wide Web that offer content of all types and email, chat, search and shopping services, among other things.

Interactive media. The Company's Interactive Media division faces many smaller but focused and branded competitors, particularly in the areas of entertainment and education. Consolidation in this area of software development has made certain competitors even stronger. Competitors include Intuit, Electronic Arts, The Learning Company (including Softkey, MECC, Broderbund, and Compton's), Voyager, Cendant (including Sierra On Line, Knowledge Adventures, and Davidson Associates), and Dorling Kindersley. Still other competitors own branded content, such as Disney and Lucas Arts.

Additionally, PC-based games are increasingly competing head-to-head against games created for proprietary systems such as Nintendo, Sony PlayStation, and Sega. Input devices face substantial competition from computer manufacturers, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices.

A number of Microsoft's most significant competitors, including IBM, Sun Microsystems, Oracle, and Netscape, are collaborating with one another on various initiatives directed at competition with Microsoft. These initiatives relate in part to efforts to move software from individual PCs to centrally-managed servers. While the likely technological and business success of such "thin client" strategies is currently unknown, widespread adoption of such computing systems would present significant challenges to the Company's historical business model.

The Company's competitive position may be adversely affected by one or more of these factors in the future, particularly in view of the fast pace of technological change in the software industry.

EMPLOYEES

As of June 30, 1998, the Company employed 27,055 people on a full-time basis, 18,425 in the U.S. and 8,630 internationally. Of the total, 10,019 were in product research and development, 13,547 in sales, marketing, and support, 1,142 in manufacturing and distribution, and 2,347 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees are subject to collective bargaining agreements. The Company believes relations with its employees are excellent.

ITEM 2. PROPERTIES

The Company's corporate offices consist of approximately 5.2 million square feet of office building space located in King County, Washington. There are two sites that total approximately 300 acres of land. The Company recently completed the construction of three office buildings comprising approximately 565,000 square feet of space and is constructing a set of office buildings with approximately 418,000 square feet of space. This site will be occupied in the winter of 1999. The Company owns all of its corporate campus.

The Company entered into a build to suit lease agreement in the San Francisco, CA, Bay Area. This campus when complete will be approximately 515,000 square feet. It is scheduled to open in the spring of 1999.

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The Company leases a 45,000 square foot disk duplication facility in Humacao, Puerto Rico. The Puerto Rico facility, which began operation in April 1990, is leased under a 10-year lease, with an option to renew for an additional 10 years. The Company's European manufacturing operation consists of a 161,000 square foot facility situated on 12 acres in Dublin, Ireland. The Ireland site also includes office buildings with 157,000 square feet for international localization. The Ireland facilities are fully owned by the Company. In Les Ulis, France, the Company owns a 199,000 square foot office building on four acres of land. In the United Kingdom, the Company owns 3 building that total 230,000 square feet. The Company is going to execute a sale lease back on this property during the next fiscal year.

In addition, the Company leases office space in numerous locations in the United States and many other countries.

The Company's facilities are fully utilized for current operations and suitable additional space is available to accommodate expansion needs.

ITEM 3. LEGAL PROCEEDINGS

The information set forth in Notes to Financial Statements--Contingencies on page 45-46 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 1998.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The information set forth on page 48 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.1.

ITEM 6. SELECTED FINANCIAL DATA

The information set forth on page 1 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.2.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The information set forth on pages 27-33 of the 1998 Annual Report to

Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information set forth on pages 27-33 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following financial statements and supplement data for the Company and independent auditors' report set forth on pages 26 and 34-49 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

. Income Statements for the three years ended June 30, 1998

. Cash Flows Statements for the three years ended June 30, 1998

. Balance Sheets as of June 30, 1997 and 1998

. Stockholders' Equity Statements for the three years ended June 30, 1998

. Notes to Financial Statements

. Independent Auditors' Report

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

None.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" on pages 1 and 2 of the Company's Proxy Statement dated September 25, 1998, for the Annual Meeting of Shareholders to be held November 11, 1998 (the "Proxy Statement"). Such information is incorporated herein by reference.

The executive officers of Microsoft as of September 11, 1998 were as follows:

<TABLE>
<CAPTION>

NAME	AGE	POSITION WITH THE COMPANY
<C>	<C>	<S>
William H. Gates............	42	Chairman of the Board; Chief Executive Officer
Steven A. Ballmer...........	42	President
Robert J. Herbold...........	56	Executive Vice President; Chief Operating Officer
Frank M. (Pete) Higgins.....	40	Group Vice President, Interactive Media
Paul A. Maritz..............	43	Group Vice President, Platforms and Applications
Nathan P. Myhrvold..........	39	Group Vice President, Chief Technology

		Officer
Jeffrey S. Raikes..........	40	Group Vice President, Sales and Support
James E. Allchin...........	46	Senior Vice President, Personal and Business Systems
Orlando Ayala Lozano........	42	Senior Vice President, South Pacific and Americas Region
Joachim Kempin..............	56	Senior Vice President, OEM, Internet Customer Unit, Embedded Systems
Michel Lacombe..............	47	Senior Vice President, Europe, Middle East, and Africa Region; President, Microsoft Europe
Robert L. Muglia............	38	Senior Vice President, Applications and Tools Division
Craig Mundie................	49	Senior Vice President, Consumer Platforms Division
William H. Neukom...........	56	Senior Vice President, Law and Corporate Affairs; Secretary
Bernard P. Vergnes..........	53	Senior Vice President, Microsoft; Chairman, Microsoft Europe
Gregory B. Maffei...........	38	Vice President, Finance; Chief Financial Officer

</TABLE>

Mr. Gates co-founded Microsoft in 1975 and has been its Chairman of the Board and Chief Executive Officer since the original partnership was incorporated in 1981.

Mr. Ballmer was named President in July 1998 and had been Executive Vice President, Sales and Support since February 1992. He had been Senior Vice President, Systems Software since 1989. From 1984 until 1989, Mr. Ballmer served as Vice President, Systems Software. He joined Microsoft in 1980.

Mr. Herbold joined Microsoft as Executive Vice President and Chief Operating Officer in November 1994. Mr. Herbold had been with The Procter & Gamble Company since 1968, with experience in information services, advertising and market research. Most recently, he was P&G's Senior Vice President, Information Services and Advertising.

Mr. Higgins was named Group Vice President, Interactive Media Group in October 1996. He was named Group Vice President, Applications and Content in May 1995 and Senior Vice President, Desktop Applications Division in March 1993. He had been Vice President, Desktop Applications Division since 1992. Mr. Higgins joined Microsoft in 1983.

Mr. Maritz was named Group Vice President, Platforms and Applications in October 1996 and had been Group Vice President, Platforms since May 1995. He had been Senior Vice President, Product and Technology Strategy in November 1994 and had been Senior Vice President, Systems Division since February 1992. He had been Vice President, Advanced Operating Systems since 1989. Mr. Maritz joined Microsoft in 1986.

Mr. Myhrvold was named Group Vice President and Chief Technology Officer in October 1996. He was named Group Vice President, Applications and Content in May 1995 and had been Senior Vice President,

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Advanced Technology since July 1993. He had been Vice President, Advanced Technology and Business Development since 1989. Mr. Myhrvold joined Microsoft in 1986.

Mr. Raikes was named Group Vice President, Sales and Support in July 1998.

He had been Group Vice President, Sales and Marketing since July 1996. He was named Senior Vice President, Microsoft North America in January 1992 and had been Vice President, Office Systems since 1990. Mr. Raikes joined Microsoft in 1981.

Mr. Allchin was named Senior Vice President, Personal and Business Systems in February 1996. He was named Senior Vice President, Business Systems Division in November 1994 and had been Vice President, Business Systems Division, since July 1991. Mr. Allchin joined Microsoft in 1991.

Mr. Ayala was named Senior Vice President of South Pacific and Americas Region in February 1998. He had been Vice President of the developing markets of Africa, India, the Mediterranean and Middle East, Latin America, Southeast Asia and the South Pacific. He joined Microsoft in May 1991 as Senior Director of the Latin America Region.

Mr. Kempin was named Senior Vice President, OEM, Internet Customer Unit, Embedded Systems in February 1998. He had been Senior Vice President, OEM Sales since August 1993. He had been Vice President, OEM Sales since 1987. Mr. Kempin joined Microsoft in 1983.

Mr. Lacombe is President, Microsoft Europe. He was named Senior Vice President, Europe, Middle East, and Africa Region in February 1998. He had been President, Microsoft Europe and Senior Vice President, Microsoft since July 1997. He had been Vice President, Europe since September 1995 and Vice President, End User Customer Unit, Europe since April 1994. Mr. Lacombe had been Regional Director of Southern Europe from May 1991. Mr. Lacombe joined Microsoft in 1983.

Mr. Muglia was named Senior Vice President, Applications and Tools Division in February 1998. He had been Vice President of the Server Applications Division since 1997 and was Vice President of Developer Tools since 1995. He joined Microsoft in January 1988.

Mr. Mundie was named Senior Vice President, Consumer Platforms Division in February 1996. He was named Senior Vice President, Consumer Systems in May 1995 and had been Vice President, Advanced Consumer Technology since July 1993. He joined Microsoft as General Manager, Advanced Consumer Technology in December 1992.

Mr. Neukom was named Senior Vice President, Law and Corporate Affairs in February 1994. He joined Microsoft in 1985 as Vice President, Law and Corporate Affairs.

Mr. Vergnes is a Senior Vice President and Chairman, Microsoft Europe. He was named President, Microsoft Europe in April 1992. He had been Vice President, Europe since 1989. Mr. Vergnes joined Microsoft in 1983.

Mr. Maffei was named Vice President, Finance and Chief Financial Officer in July 1997. He was named Vice President, Corporate Development in July 1996 and Treasurer in April 1994. He joined Microsoft in April 1993 as Director, Business Development & Investments.

ITEM 11. EXECUTIVE COMPENSATION

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" on pages 4 through 6 and "Information Regarding the Board and its Committees" on page 2 is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information set forth under the caption "Information Regarding

Beneficial Ownership of Principal Shareholders, Directors, and Management" on page 3 of the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information set forth in Notes to Financial Statements -- Acquisition on page 44 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

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PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Financial Statements and Schedules

The financial statements as set forth under Item 8 of this report on Form 10-K are incorporated herein by reference.

Financial statement schedules have been omitted since they are either not required, not applicable, or the information is otherwise included.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the last quarter of fiscal 1998.

(c) Exhibit Listing

<TABLE>
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EXHIBIT NUMBER	DESCRIPTION
<C>	<S>
3.1	Restated Articles of Incorporation (1)
3.2	Bylaws (1)
10.1	Microsoft Corporation 1991 Stock Option Plan (2)
10.2	Microsoft Corporation 1981 Stock Option Plan (3)
10.3	Microsoft Corporation Stock Option Plan for Non-Employee Directors (1)
10.4	Microsoft Corporation Stock Option Plan for Consultants and Advisors (1)
10.5	Microsoft Corporation 1997 Employee Stock Purchase Plan (2)
10.6	Microsoft Corporation Savings Plus Plan (1)
10.7	Trust Agreement dated June 1, 1993 between Microsoft Corporation and First Interstate Bank of Washington (4)
10.8	Form of Indemnification Agreement (4)
11.	Computation of Earnings Per Share (5)
13.1	Quarterly and Market Information Incorporated by Reference to Page 48 of 1998 Annual Report to Shareholders ("1998 Annual Report")
13.2	Selected Financial Data Incorporated by Reference to Page 1 of 1998 Annual Report
13.3	Management's Discussion and Analysis of Results of Operations and Financial Condition Incorporated by Reference to Pages 27-33 of 1998 Annual Report
13.4	Financial Statements Incorporated by Reference to Pages 26 and 34-49 of 1998 Annual Report
21.	Subsidiaries of Registrant Incorporated by Reference to Page 50 of 1998 Annual Report
23.	Independent Auditors' Consent
27.	Financial Data Schedule

</TABLE>

- --------

(1) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1994.
(2) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1997.
(3) Incorporated by reference to Registration Statement 33-37623 on Form S-8.
(4) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.
(5) Incorporated by reference to Exhibit 13.4 filed herein.

<PAGE>

SIGNATURES

PURSUANT TO THE REQUIREMENTS OF SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934, THE REGISTRANT HAS DULY CAUSED THIS REPORT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE CITY OF REDMOND, STATE OF WASHINGTON, ON SEPTEMBER 23, 1998.

MICROSOFT CORPORATION

By /s/ Gregory B. Maffei

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

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THIS REPORT HAS BEEN SIGNED BELOW BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT AND IN THE CAPACITIES INDICATED ON SEPTEMBER 23, 1998.

<TABLE>
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SIGNATURE	TITLE
<S>	<C>
/s/ William H. Gates William H. Gates	Chairman of the Board of Directors and Chief Executive Officer
/s/ Paul G. Allen Paul G. Allen	Director
/s/ Jill E. Barad Jill E. Barad	Director
/s/ Richard A. Hackborn Richard A. Hackborn	Director
/s/ David F. Marquardt David F. Marquardt	Director
/s/ Robert D. O'Brien Robert D. O'Brien	Director

/s/ Wm. G. Reed, Jr.	Director
Wm. G. Reed, Jr.	
/s/ Jon A. Shirley	Director
Jon A. Shirley	
/s/ Gregory B. Maffei	Vice President, Finance; Chief Financial Officer (Principal Financial and Accounting Officer)
Gregory B. Maffei	

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EXHIBIT INDEX

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(4) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.
(5) Incorporated by reference to Exhibit 13.4 filed herein.

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EXHIBIT 13.1

QUARTERLY INFORMATION
(In millions, except per share amounts) (Unaudited)

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	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
<S>	<C>	<C>	<C>	<C>	<C>
1996					
Revenue	$2,016	$2,195	$2,205	$ 2,255	$ 8,671
Operating income	704	809	778	768	3,059
Net income	499	575	562	559	2,195
Basic earnings per share	0.21	0.24	0.24	0.23	0.93
Diluted earnings per share	0.19	0.23	0.22	0.22	0.86
Common stock price per share:					
High	27.32	25.85	26.77	31.47	31.47
Low	21.25	20.10	19.97	24.91	19.97
1997					
Revenue	$2,295	$2,680	$3,208	$ 3,175	$11,358
Operating income	853	1,035	1,484	1,499	4,871
Net income	614	741	1,042	1,057	3,454
Basic earnings per share	0.26	0.31	0.43	0.44	1.44
Diluted earnings per share	0.24	0.28	0.40	0.40	1.32
Common stock price per share:					
High	34.66	43.07	51.75	67.47	67.47
Low	26.88	32.72	40.38	44.88	26.88
1998					
Revenue	$3,130	$3,585	$3,774	$ 3,995	$14,484
Operating income	1,060	1,613	1,867	1,874	6,414
Net income	663	1,133	1,337	1,357	4,490
Basic earnings per share	0.27	0.47	0.55	0.55	1.83
Diluted earnings per share	0.25	0.42	0.50	0.50	1.67
Common stock price per share:					
High	75.38	73.31	90.94	108.56	108.56
Low	61.63	59.00	62.19	81.88	59.00

</TABLE>
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The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1998, there were 70,491 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.
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EXHIBIT 13.2

FINANCIAL HIGHLIGHTS
(In millions, except earnings per share)

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Year Ended June 30	1994	1995	1996	1997	1998
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Revenue	$4,649	$5,937	$ 8,671	$11,358	$14,484
Net income	1,146	1,453	2,195	3,454	4,490
Diluted earnings per share (1)	0.47	0.58	0.86	1.32	1.67
Cash and short-term investments	3,614	4,750	6,940	8,966	13,927
Total assets	5,363	7,210	10,093	14,387	22,357
Stockholders' equity	4,450	5,333	6,908	10,777	16,627

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(1) Diluted earnings per share have been restated to reflect a two-for-one stock split in February 1998.

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EXHIBIT 13.3

MANAGEMENT'S DISCUSSION AND ANALYSIS
RESULTS OF OPERATIONS FOR 1996, 1997, AND 1998

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

REVENUE

The Company's revenue growth rate continued to slow, from 46% in the fiscal year ended June 30, 1996 and 31% in fiscal 1997 to 28% in fiscal 1998. Revenue growth was particularly strong in 1996 due to the retail introduction of the Microsoft Windows 95 operating system. The 1997 and 1998 growth rates, although slower than that of 1996, reflected the continued adoption of Windows 32-bit operating systems and Microsoft Office 97, particularly as Microsoft software is deployed across entire corporate, academic, and governmental organizations. Software license volume increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and organization license programs is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices

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than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. During each of the three years an increased percentage of products and programs included elements which were billed but unearned and recognized ratably, such as Windows operating systems, Office 97, maintenance, and other subscription models. See accompanying notes.

PRODUCT GROUPS. Platform product revenue was $4.11 billion, $5.97 billion, and $7.64 billion in 1996, 1997, and 1998. Platform revenue is primarily licenses of PC operating systems; business systems with client/server, Internet, and intranet architectures; and software development tools.

The Company's principal desktop platform products are its 32-bit operating systems: Windows 95, Windows 98, and Windows NT Workstation. Released in August 1995, Windows 95 was a successor to the MS-DOS(R) and Microsoft Windows 3.x operating systems. Windows NT Workstation version 4.0 was released in fiscal 1997. Windows 98 became available at the end of fiscal 1998. Although the growth rate of new PC shipments slowed, desktop operating systems contributed to revenue growth as shipments of new PCs preinstalled with such systems increased during the three-year period. Additionally, increased penetration of higher value 32-bit operating systems, particularly Windows NT Workstation, led to growth in 1996, 1997, and 1998. In 1996, retail license sales of Windows 95 were a major factor in the Platform revenue increase, reflecting the typical sales pattern for major operating system upgrades. Also in 1996, a portion of Windows operating system revenue became subject to ratable recognition.

Business systems products offer an enterprise-wide distributed client/server, Internet, and intranet environment based on the Microsoft Windows NT Server operating system, Microsoft Exchange Server, Microsoft SQL Server, and other server applications in the Microsoft BackOffice (R) family of products. Revenue from these products increased strongly due to greater corporate demand, particularly for intranet solutions, although the growth rate slowed in 1998.

Although revenue was not significant, sales of WebTV terminals and service and preinstallations of Windows CE by OEMs on intelligent devices were strong in 1998.

Independent software vendors, corporate developers, and solutions developers license tools such as the Microsoft Visual Basic(R) development system to develop software for Windows operating systems and the Internet. Revenue from developer products increased steadily in 1996 and 1997 and was flat in 1998.

Applications and Content revenue was $4.56 billion, $5.39 billion, and $6.84 billion in 1996, 1997, and 1998. Applications and Content revenue includes primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Microsoft Office for Windows 95 was released in fiscal 1996 and Microsoft Office 97 was released in fiscal 1997. Applications and Content revenue grew 27% in 1996, 18% in 1997, and 27% in 1998. The lower growth rate in 1997 was due primarily to the application of the ratable revenue recognition model for Office 97.

Absolute increases in desktop applications revenue during the three-year period were led by the various Microsoft Office integrated suites, including Standard, Professional, and Small Business Editions. The primary programs in Microsoft Office are the word processor Microsoft Word, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for the 32-bit version of Windows, the 16-bit version of Windows, and Macintosh operating systems, also include Microsoft Access database management program, Microsoft Outlook(TM) messaging and collaboration client, or other programs. Revenue from stand-alone versions of Microsoft Excel, Word, and PowerPoint continued to decrease as the sales mix shifted to integrated product suites. Microsoft Project scheduling and project management program revenue increased during the three-year period.

Microsoft offers a broad range of interactive media products, which also showed moderate growth. Products include CD-ROM multimedia reference titles and programs for home and small office productivity, children's creativity, and entertainment. In addition to the Microsoft Network, online Internet services include travel information and reservations, local event information, and car buying information.

The Company also markets input devices. Mouse and gaming device sales increased while keyboard revenue was steady during the three-year period.

SALES CHANNELS. The Company distributes its products primarily through OEM licenses, organization licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers. Microsoft has three major sales and marketing geographies: the United States and Canada, Europe, and elsewhere in the world (Other International). Sales of organization licenses and packaged products in these channels are primarily to distributors and resellers. The trend has continued toward a higher percentage of organization licensing versus packaged products.

OEM channel revenue was $2.50 billion in 1996, $3.48 billion in 1997, and $4.72 billion in 1998. The primary source of OEM revenue is the licensing of desktop operating systems, and OEM revenue is highly dependent on PC shipment volume.

U.S. and Canadian channel revenue was $2.68 billion, $3.41 billion, and $4.36 billion in 1996, 1997, and 1998. Revenue in Europe was $2.02 billion, $2.54 billion, and $3.15 billion in 1996, 1997, and 1998. Growth rates have been lower in Europe than in other geographic areas due to higher existing market shares and a more dramatic shift to licensing programs. Other International channel revenue was $1.47 billion in 1996, $1.93 billion in 1997, and $2.26 billion in 1998. Growth rates were higher in the Other International channel in 1996 and 1997 due to customers accepting newly localized products, particularly in Japan, and penetration in emerging markets. However, revenue was relatively flat in Japan and Southeast Asia in 1998 due to economic issues and weak currencies.

The Company's operating results are affected by foreign exchange rates. Approximately 34%, 32%, and 34% of the Company's revenue was collected in foreign currencies during 1996, 1997, and 1998. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

OPERATING EXPENSES

COST OF REVENUE. As a percentage of revenue, cost of revenue was 13.7% in 1996, 9.6% in 1997, and 8.3% in 1998. The decrease was due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks), licenses to OEMs and organizations, and higher-margin Windows NT Server, other servers, and client access licenses in the BackOffice product family. In 1998, the decrease was offset somewhat by costs of WebTV.

RESEARCH AND DEVELOPMENT. Microsoft continued to invest heavily in the future by funding research and development (R&D). Expense increases of 67% in 1996, 34% in 1997, and 30% in 1998 resulted primarily from development staff headcount growth and higher levels of third-party development costs in many areas, particularly Windows-based platforms, including desktop operating systems, server systems, and

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consumer appliances, along with Internet and intranet technologies. R&D costs also increased for desktop and server applications, development tools, and interactive media initiatives such as MSN and other online services.

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

SALES AND MARKETING. The increase in the absolute dollar amount of sales and marketing expenses in the three-year period was due primarily to expanded product-specific marketing programs, such as Windows 95 in 1996, Office 97 in 1997, and Windows 98 in 1998. Sales and marketing costs as a percentage of revenue decreased due to moderate headcount growth. Microsoft brand advertising and product support expenses declined in 1997, but rose slightly in 1998.

GENERAL AND ADMINISTRATIVE. Increases in general and administrative expenses were attributable to higher legal costs and growth in the number of people and computer systems necessary to support overall increases in the scope of the Company's operations.

OTHER EXPENSES. Other expenses increased due to recognition of Microsoft's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities.

INTEREST INCOME AND INCOME TAXES

Interest income increased primarily as a result of a larger investment portfolio generated by cash from operations. The effective income tax rate was 35.0% in 1996 and 1997. The effective income tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies.

NET INCOME

Net income as a percent of revenue increased in 1996, 1997, and 1998 due to the lower relative cost of revenue, sales and marketing expenses, and general and administrative expenses, partially offset by investments in research and development, joint ventures, and WebTV.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $13.93 billion at June 30, 1998. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, including financial investments and strategic technology companies in many areas. During 1997, Microsoft invested $1.0 billion in Comcast Corporation, a cable television and diversified telecommunications company. Comcast Special Class A common stock and convertible preferred stock are included in equity investments at fair market value on the balance sheet.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of

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operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at June 30, 1998 was $16.63 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $420 million on June 30, 1998.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 347 million common shares while 807 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $48 billion as of June 30, 1998. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

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

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

ISSUES AND UNCERTAINTIES

Microsoft does not provide forecasts of future financial performance. While Microsoft management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

RAPID TECHNOLOGICAL CHANGE AND COMPETITION. Rapid change, uncertainty due to new and emerging technologies, and fierce competition characterize the PC software industry. The pace of change has recently accelerated due to the Internet and new programming languages, such as Java.

FUTURE INITIATIVES. The Company is expanding its efforts to provide and support mission-critical systems to large enterprises. Scalability of BackOffice server and application products, total cost of ownership of Windows- and Office-based systems, information storage unification, user interface simplification, and Internet and intranet integration are also major focus areas. Additionally, Microsoft is committed to providing technologies, operating systems, and interactive content for the future convergence of PCs, televisions, and the Internet. Future revenue from these initiatives may not duplicate historical revenue growth rates.

PC GROWTH RATES. The underlying PC unit growth rate and percentage of new PCs acquired as replacement units directly impact the Company's software revenue growth. The PC shipment growth rate may continue to decrease and the replacement rate may continue to increase, reducing future software revenue opportunity.

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PRODUCT SHIP SCHEDULES. Delays in new-product releases dampen revenue growth rates and can cause operational inefficiencies that impact manufacturing and distribution logistics, independent software vendor (ISV) and OEM relationships, and customer support expenses.

CUSTOMER ACCEPTANCE. While the Company performs extensive usability and beta testing of new products, user acceptance and corporate penetration rates ultimately dictate the success of development and marketing efforts.

PRICES. Future product prices may decrease from historical levels, depending on competitive market and cost factors. European and Asian software prices vary by country and are generally higher than in the United States to cover localization costs and higher costs of distribution. Increased global license agreements, European monetary unification, or other factors could erode such price uplifts in the future.

EARNINGS PROCESS. An increasingly higher percentage of the Company's revenue is subject to ratable recognition. Subsequent product support and delivery of unspecified enhancements require the applicable portion of revenue for certain products to be recognized over the product's life cycle. This policy may be required for additional products, depending on specific license terms and conditions. Also, maintenance and other subscription programs may continue to increase in popularity, particularly with organizations.

SATURATION. Product upgrades, which enable users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices and margins than new products. As the desktop applications market has become saturated, the sales mix has shifted from standard products to upgrade products. This trend is likely to continue.

ORGANIZATION LICENSES. Average revenue per unit from organization license programs is lower than average revenue per unit from retail versions shipped through the finished goods channels. Unit sales under licensing programs may continue to increase.

CHANNEL MIX. Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenue was achieved through the OEM channel during 1997 and 1998.

COST OF REVENUE. Although cost of revenue as a percentage of revenue decreased in 1997 and 1998, it varies with channel mix, product mix within channels, and usage of online operations. The trend of declining cost of revenue as a percentage of revenue is unlikely to continue in 1999.

PAY AND PARTICIPATION MODEL. Microsoft employees currently receive salaries, incentive bonuses, other fringe benefits, and stock options. New government regulations, poor stock price performance, or other factors could diminish the value of the option program to current and prospective employees and force the Company into more of a cash compensation model. Had the Company paid employees in cash the grant date Black-Scholes value of options vested in 1996, 1997, and 1998, the pretax expense would have been approximately $450 million, $620 million, and $850 million.

LONG-TERM RESEARCH AND DEVELOPMENT INVESTMENT CYCLE. Developing and localizing software is expensive and the investment in product development often involves a long payback cycle. The Company plans to continue significant investments in software research and development and related product opportunities from which significant revenue is not anticipated for a number of years. Management expects total spending for research and development in 1999 to increase over spending in 1998.

SALES, MARKETING, AND SUPPORT INVESTMENTS. The Company's plans for 1999 include accelerated investments in its sales, marketing, and support groups.

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FOREIGN EXCHANGE. A large percentage of the Company's sales, costs of manufacturing, and marketing is transacted in local currencies. As a result, the Company's international results of operations are subject to foreign exchange rate fluctuations.

INVESTMENTS VALUE SENSITIVITY. The Company's investment portfolio is subject to interest rate and market price risk. A 10% increase in treasury security yields would reduce the carrying value of interest-sensitive securities at June 30, 1998 by $128 million, and a 10% decrease in market values would reduce the carrying value of the Company's publicly traded equity securities by $300 million. Many of these equity securities are highly volatile stocks.

INTELLECTUAL PROPERTY RIGHTS. Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenue to the Company. While this adversely affects U.S. revenue, revenue loss is even more significant outside of the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenue positively.

FUTURE GROWTH RATE. The revenue growth rate in 1999 may not approach the level attained in prior years. As discussed previously, operating expenses are expected to increase in 1999. Because of the fixed nature of a significant portion of such expenses, coupled with the possibility of slower revenue growth, operating margins in 1999 may decrease from those in 1998.

LITIGATION. Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks.

YEAR 2000. The Year 2000 presents potential concerns for business and consumer computing. The consequences of this issue may include systems failures and business process interruption. It may also include additional business and competitive differentiation. Aside from the well-known calculation problems with the use of 2-digit date formats as the year changes from 1999 to 2000, the Year 2000 is a special case leap year and in many organizations using older technology, dates were used for special programmatic functions.

The problem exists for many kinds of software and hardware, including mainframes, mini computers, PCs, and embedded systems. Microsoft is in the process of gathering, testing, and producing information about Microsoft technologies impacted by the Year 2000 transition. First, Microsoft classified its core products into categories of compliance: compliant, compliant with minor issues, and not compliant. Second, if a product is stated to be non-compliant, Microsoft will provide information as to how an organization could bring that product into compliance. Microsoft is issuing patches and/or workarounds at no additional charge for most issues. Third, Microsoft is working to help organizations find solutions to Year 2000 problems. The technologies and services offered by Microsoft and companies it works with can be components in overall Year 2000 solutions. Microsoft is assisting companies with the task of recognizing how disparate technologies can fit together to create a viable solution set.

Current information about the Company's product, business, and technical concerns is available at the Microsoft Year 2000 Resource Center Web site (www.microsoft.com/year2000). The Web site also contains information about obtaining software patches to resolve various Year 2000 issues in certain

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

The Year 2000 issue also affects the Company's internal systems, including information technology (IT) and non-IT systems. Microsoft is assessing the readiness of its systems for handling the Year 2000. Although the assessment is still underway, management currently believes that all material systems will be compliant by the Year 2000 and that the cost to address the issues is not material. Nevertheless, Microsoft is creating contingency plans for certain internal systems.

All organizations dealing with the Year 2000 must address the effect this issue will have on their third-party supply chain. Microsoft is undertaking steps to identify its vendors and to formulate a system of working with key third-parties to understand their ability to continue providing services and products through the change to 2000. Microsoft will work directly with its key vendors, distributors, and resellers, and partner with them if necessary, to avoid any business interruptions in 2000. For these key third-parties, contingency plans will be developed.

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

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EXHIBIT 13.4

MICROSOFT CORPORATION

FINANCIAL STATEMENTS

Income Statements for the three years ended June 30, 1998

Cash Flows Statements for the three years ended June 30, 1998

Balance Sheets as of June 30, 1997 and 1998

Stockholders' Equity Statements for the three years ended June 30, 1998

Notes to Financial Statements

Independent Auditors' Report

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INCOME STATEMENTS
(In millions, except earnings per share)

<TABLE>
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Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
Revenue	$8,671	$11,358	$14,484
Operating expenses:			
Cost of revenue	1,188	1,085	1,197
Research and development	1,432	1,925	2,502
Acquired in-process technology	--	--	296
Sales and marketing	2,657	2,856	3,412
General and administrative	316	362	433
Other expenses	19	259	230
Total operating expenses	5,612	6,487	8,070
Operating income	3,059	4,871	6,414
Interest income	320	443	703
Income before income taxes	3,379	5,314	7,117
Provision for income taxes	1,184	1,860	2,627
Net income	2,195	3,454	4,490
Preferred stock dividends	--	15	28
Net income available for common shareholders	$2,195	$ 3,439	$ 4,462
Earnings per share (1):			
Basic	$ 0.93	$ 1.44	$ 1.83
Diluted	$ 0.86	$ 1.32	$ 1.67

</TABLE>

(1) Earnings per share have been restated to reflect a two-for-one stock split in February 1998.

See accompanying notes.

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CASH FLOWS STATEMENTS
(In millions)

<TABLE>
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Year Ended June 30	1996	1997	1998
Operations			
<S>	<C>	<C>	<C>
Net income	$ 2,195	$ 3,454	$ 4,490
Depreciation and amortization	480	557	1,024
Write-off of acquired in-process technology	--	--	296
Unearned revenue	983	1,601	3,268
Recognition of unearned revenue from prior periods	(477)	(743)	(1,798)
Other current liabilities	584	321	208
Accounts receivable	(71)	(336)	(520)
Other current assets	25	(165)	(88)
Net cash from operations	3,719	4,689	6,880
Financing			
Common stock issued	504	744	959
Common stock repurchased	(1,385)	(3,101)	(2,468)
Put warrant proceeds	124	95	538
Preferred stock issued	--	980	--
Preferred stock dividends	--	(15)	(28)
Stock option income tax benefits	352	796	1,553
Net cash from (used for) financing	(405)	(501)	554
Investments			
Additions to property and equipment	(494)	(499)	(656)
Cash portion of WebTV purchase price	--	--	(190)
Equity investments and other	(625)	(1,669)	(1,598)
Short-term investments	(1,551)	(921)	(4,828)
Net cash used for investments	(2,670)	(3,089)	(7,272)
Net change in cash and equivalents	644	1,099	162
Effect of exchange rates on cash and equivalents	(5)	6	(29)
Cash and equivalents, beginning of year	1,962	2,601	3,706
Cash and equivalents, end of year	2,601	3,706	3,839
Short-term investments	4,339	5,260	10,088
Cash and short-term investments	$ 6,940	$ 8,966	$13,927

</TABLE>

See accompanying notes.

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BALANCE SHEETS
(In millions)

<TABLE>
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June 30	1997	1998
<S>	<C>	<C>

ASSETS	97	98
Current assets:		
Cash and short-term investments	$ 8,966	$13,927
Accounts receivable	980	1,460
Other	427	502
Total current assets	10,373	15,889
Property and equipment	1,465	1,505
Equity investments	2,346	4,703
Other assets	203	260
Total assets	$14,387	$22,357
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 721	$ 759
Accrued compensation	336	359
Income taxes payable	466	915
Unearned revenue	1,418	2,888
Other	669	809
Total current liabilities	3,610	5,730
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock--shares authorized 100; shares issued and outstanding 13	980	980
Common stock and paid-in capital--shares authorized 8,000; shares issued and outstanding 2,408 and 2,470	4,509	8,025
Retained earnings	5,288	7,622
Total stockholders' equity	10,777	16,627
Total liabilities and stockholders' equity	$14,387	$22,357

</TABLE>

See accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS
(In millions)

<TABLE>
<CAPTION>

Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
CONVERTIBLE PREFERRED STOCK			
Balance, beginning of year	--	--	$ 980
Convertible preferred stock issued	--	$ 980	--
Balance, end of year	--	980	980
COMMON STOCK AND PAID-IN CAPITAL			
Balance, beginning of year	$ 2,005	2,924	4,509
Common stock issued	504	744	1,262
Common stock repurchased	(41)	(91)	(165)
Structured repurchases price differential	--	--	328
Proceeds from sale of put warrants	124	95	538
Reclassification of put warrant obligation	(20)	45	--
Stock option income tax benefits	352	792	1,553
Balance, end of year	2,924	4,509	8,025
RETAINED EARNINGS			
Balance, beginning of year	3,328	3,984	5,288
Net income	2,195	3,454	4,490
Preferred stock dividends	--	(15)	(28)
Common stock repurchased	(1,344)	(3,010)	(2,631)
Reclassification of put warrant obligation	(210)	590	--

Net unrealized investment gains and other	15	285	503
Balance, end of year	3,984	5,288	7,622
Total stockholders' equity	$ 6,908	$10,777	$16,627

</TABLE>

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION. The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated. Investments in 50% owned joint ventures are accounted for using the equity method; the Company's share of joint ventures' activities is reflected in other expenses.

ESTIMATES AND ASSUMPTIONS. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates.

FOREIGN CURRENCIES. Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenue, costs, and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

REVENUE RECOGNITION. Revenue is recognized when earned. The Company's revenue recognition policies are in compliance with American Institute of Certified Public Accountants Statements of Position 97-2 and 98-4, Software Revenue Recognition. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from organization license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. Revenue attributable to significant support (technical support and unspecified enhancements such as service packs and Internet browser updates) is based on the price charged or derived value of the undelivered elements and is recognized ratably on a straight-line basis over the product's life cycle. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for returns and bad debts.

RESEARCH AND DEVELOPMENT. Research and development costs are expensed as incurred. Statement of Financial Accounting Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.

TELEPHONE SUPPORT. Telephone support costs are included in sales and marketing.

INCOME TAXES. Income tax expense includes U.S. and international income taxes, plus an accrual for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

STOCK SPLIT. In February 1998, outstanding shares of common stock were split two-for-one. All share and per share amounts have been restated.

FINANCIAL INSTRUMENTS. The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and five years from the purchase date. All cash and short-term investments are classified as available for sale and are recorded at market. Cost approximates market for all classifications of cash and short-term investments; realized and unrealized gains and losses were not material.

Publicly tradeable equity securities are recorded at market; unrealized gains and losses are reflected in stockholders' equity. The pretax unrealized gain was $1.4 billion at June 30, 1998.

PROPERTY AND EQUIPMENT. Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 30 years.

RECLASSIFICATIONS. Certain reclassifications have been made for consistent presentation.

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UNEARNED REVENUE

Microsoft believes that Internet technologies are integral to its products and has committed to integrating these technologies, such as its browser software, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating systems OEM revenue and approximately 35% of retail versions revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was $860 million and $1.19 billion at June 30, 1997 and 1998.

Since Office 97 is also tightly integrated with the Internet, and in the view of subsequent delivery of new Internet technologies, enhancements, and other support, a ratable revenue recognition policy was implemented for Office 97. Approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled $300 million and $770 million at June 30, 1997 and 1998.

Unearned revenue also includes maintenance and other subscription contracts, including organization license agreements.

FINANCIAL RISKS

The Company's investment portfolio is diversified and consists primarily of short-term investment grade securities. Interest rate fluctuations impact the carrying value of the portfolio. While no hedge was in place on June 30, 1998, the Company routinely hedges the portfolio in case of a catastrophic increase in interest rates. At June 30, 1997 and 1998, approximately 31% and 40% of accounts receivable represented amounts due from ten customers. One customer accounted for approximately 13%, 12%, and 8% of revenue in 1996, 1997, and 1998.

Finished goods sales to international customers in Europe, Japan, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. European manufacturing costs and international selling, distribution, and support costs are generally disbursed in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Therefore, foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses. As a result, Microsoft's hedging activities for balance sheet exposures have been minimal.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a percentage of planned international revenue with purchased options. The notional amount of the options outstanding at June 30, 1998 was $2.1 billion. At June 30, 1998, the fair value and premiums paid for the options were not material.

CASH AND SHORT-TERM INVESTMENTS

<TABLE>
<CAPTION>

June 30	1997	1998
<S>	<C>	<C>
Cash and equivalents:		
Cash	$ 246	$ 195
Commercial paper	1,660	2,771
Money market preferreds	946	454
Certificates of deposit	854	419
Cash and equivalents	3,706	3,839
Short-term investments:		
Commercial paper	261	868
Municipal securities	571	1,361
Corporate notes and bonds	1,907	3,998
U.S. government and agency securities	1,513	3,511
Certificates of deposit	1,008	350
Short-term investments	5,260	10,088
Cash and short-term investments	$8,966	$13,927

</TABLE>

<PAGE>

PROPERTY AND EQUIPMENT

<TABLE>
<CAPTION>

June 30	1997	1998
<S>	<C>	<C>
Land	$ 183	$ 183
Buildings	1,027	1,259
Computer equipment	1,064	1,182
Other	503	428
Property and equipment--at cost	2,777	3,052

Accumulated depreciation	(1,312)	(1,547)
Property and equipment--net	$ 1,465	$ 1,505

</TABLE>

During 1997 and 1998, depreciation expense, of which the majority related to computer equipment, was $353 million and $528 million; disposals were immaterial.

INCOME TAXES

The provision for income taxes consisted of:

<TABLE>
<CAPTION>

Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
Current taxes:			
U.S. and state	$1,139	$1,710	$2,518
International	285	412	526
Current taxes	1,424	2,122	3,044
Deferred taxes	(240)	(262)	(417)
Provision for income taxes	$1,184	$1,860	$2,627

</TABLE>

U.S. and international components of income before income taxes were:

<TABLE>
<CAPTION>

Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
U.S.	$2,356	$3,775	$5,072
International	1,023	1,539	2,045
Income before income taxes	$3,379	$5,314	$7,117

</TABLE>

The effective income tax rate was 35.0% in 1996 and 1997. The effective tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies.

Income taxes payable were:

<TABLE>
<CAPTION>

June 30	1997	1998
<S>	<C>	<C>
Deferred income tax assets:		
Revenue items	$ 474	$ 713
Expense items	505	613
Deferred income tax assets	979	1,326

Deferred income tax liabilities:		
Unrealized gain on investments		(479)
International earnings	(465)	(373)
Other	(4)	(26)
Deferred income tax liabilities	(469)	(878)
Current income tax liabilities	(976)	(1,363)
Income taxes payable	$(466)	$ (915)

</TABLE>

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991 which the Company is contesting in Tax Court. The IRS is examining the Company's U.S. income tax returns for 1992 through 1994. Management believes any related adjustments that might be required will not be material to the financial statements. Income taxes paid were $758 million in 1996, $1.1 billion in 1997, and $1.1 billion in 1998.

CONVERTIBLE PREFERRED STOCK

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

COMMON STOCK

ISSUED AND OUTSTANDING Shares of common stock outstanding were as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
Balance, beginning of year	2,352	2,388	2,408
Issued	88	94	101
Repurchased	(52)	(74)	(39)
Balance, end of year	2,388	2,408	2,470

</TABLE>

REPURCHASE PROGRAM The Company repurchases its common stock in the open market to provide shares for issuing to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 1999.

In addition, under structured repurchases with an independent third-party, the Company executed two forward purchases totaling 21 million shares of stock. Under these arrangements, a portion of the purchase price will be paid in the next five or six years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net share or cash) is at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the two dates of agreement is reflected in common stock and paid-in capital.

PUT WARRANTS

To enhance its stock repurchase program, the Company sells put warrants to independent third-parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 1998, 60 million warrants were outstanding. The outstanding put warrants at June 30, 1998 expire between November 1998 and June 2000 and have strike prices ranging from \$72 to \$77 per share. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

EMPLOYEE STOCK AND SAVINGS PLANS

EMPLOYEE STOCK PURCHASE PLAN The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1996, 1997, and 1998, employees purchased 3.6 million, 2.8 million, and 2.2 million shares at average prices of \$18.86, \$29.82, and \$54.42 per share. At June 30, 1998, 36.8 million shares were reserved for future issuance.

SAVINGS PLAN The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may defer up to 15% of pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were \$15 million, \$28 million, and \$39 million in 1996, 1997, and 1998.

STOCK OPTION PLANS The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. The option exercise price is the fair market value at the date of grant. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after 10 years. At June 30, 1998, options for 222 million shares were vested and 523 million shares were available for future grants under the plans.

Stock options outstanding were as follows:
<TABLE>
<CAPTION>

		Price per Share	
	Shares	Range	Weighted Average
<S>	<C>	<C>	<C>
Balance, June 30, 1995	456	\$ 0.39 - \$20.79	\$ 7.28

</TABLE>

<PAGE>

<TABLE>

<S>	<C>	<C>	<C>
Granted	114	20.05 - 29.47	22.50
Exercised	(80)	0.39 - 22.63	5.38
Canceled	(14)	1.30 - 27.72	13.93

Balance, June 30, 1996	476	0.55 - 29.47	11.04
Granted	110	27.66 - 59.60	29.15
Exercised	(90)	0.55 - 29.47	6.64
Canceled	(18)	8.50 - 48.57	19.42

Balance, June 30, 1997	478	1.12 - 59.60	15.72
GRANTED	69	33.12 - 87.25	62.56
EXERCISED	(88)	1.12 - 62.47	9.27
CANCELED	(13)	1.32 - 83.88	29.37

BALANCE, JUNE 30, 1998	446	1.12 - 87.25	23.87

</TABLE>

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1998 were as follows:

<TABLE>
<CAPTION>

	Outstanding options			Exercisable options	
Range of exercise prices	Shares	Remaining life (years)	Weighted average price	Shares	Weighted average price
<S>	<C>	<C>	<C>	<C>	<C>
$1.12-$8.50	85	2.7	$ 5.06	84	$ 5.07
8.51-11.94	100	4.4	10.47	83	10.19
11.95-27.25	97	4.9	21.62	38	21.14
27.26-59.60	100	5.6	29.81	17	28.99
59.61-87.25	64	6.5	64.00	--	--

</TABLE>

The Company follows Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, to account for stock option and employee stock purchase plans. No compensation cost is recognized because the option exercise price is equal to the market price of the underlying stock on the date of grant.

An alternative method of accounting for stock options is SFAS 123, Accounting for Stock-Based Compensation. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards as prescribed by SFAS 123, pro forma income statements for 1996, 1997, and 1998 would have been as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1996		1997		1998	
	Reported	Pro forma	Reported	Pro forma	REPORTED	PRO FORMA
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Revenue	$8,671	$8,671	$11,358	$11,358	$14,484	$14,484

Operating expenses:						
Cost of revenue	1,188	1,204	1,085	1,107	1,197	1,227
Research and development	1,432	1,655	1,925	2,230	2,502	2,924
Acquired in-process technology	--	--	--	--	296	296
Sales and marketing	2,657	2,823	2,856	3,082	3,412	3,725
General and administrative	316	362	362	424	433	520
Other expenses	19	19	259	259	230	230
Total operating expenses	5,612	6,063	6,487	7,102	8,070	8,922
Operating income	3,059	2,608	4,871	4,256	6,414	5,562
Interest income	320	320	443	443	703	703
Income before income taxes	3,379	2,928	5,314	4,699	7,117	6,265
Provision for income taxes	1,184	1,026	1,860	1,646	2,627	2,325
Net income	2,195	1,902	3,454	3,053	4,490	3,940
Preferred stock dividends	--	--	15	15	28	28
Net income available for common shareholders	$2,195	$1,902	$ 3,439	$ 3,038	$ 4,462	$ 3,912
Diluted earnings per share	$ 0.86	$ 0.74	$ 1.32	$ 1.16	$ 1.67	$ 1.47

</TABLE>

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The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1996, 1997, and 1998, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been $2,073 million, $3,179 million, and $4,019 million, and earnings per share would have been $0.81, $1.21, and $1.50 for 1996, 1997, and 1998.

The weighted average Black-Scholes value of options granted under the stock option plans during 1996, 1997, and 1998 was $8.86, $11.72, and $23.62. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1998 and .30 in prior years, and risk-free interest rates of 6.0%, 6.5%, and 5.7% in 1996, 1997, and 1998.

EARNINGS PER SHARE

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

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

<TABLE>
<CAPTION>

Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
Net income	$2,195	$3,454	$4,490
Preferred stock dividends	--	15	28
Net income available for common shareholders	$2,195	$3,439	$4,462
Average outstanding shares of common stock	2,368	2,391	2,432
Dilutive effect of:			
Common stock under structured repurchases	--	--	3

Preferred stock	--	13	17
Employee stock options	193	218	229
Common stock and common stock equivalents	2,561	2,622	2,681
Earnings per share:			
Basic	$ 0.93	$ 1.44	$ 1.83
Diluted	$ 0.86	$ 1.32	$ 1.67

</TABLE>

ACQUISITION

In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. A director of the Company owned 10% of WebTV. Microsoft paid $425 million in stock and cash for WebTV. The Company recorded an in-process technologies write-off of $296 million in the first quarter of 1998.

SUBSEQUENT SALE

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

COMMITMENTS

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $92 million, $92 million, and $95 million in 1996, 1997, and 1998. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1999, $85; 2000, $72; 2001, $52; 2002, $25; 2003, $17; and thereafter, $17.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 1999, $184; 2000, $100; and

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2001, $30. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed $420 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

CONTINGENCIES

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

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

On May 12, 1998, Sun filed companion motions seeking a preliminary injunction based on allegations of copyright infringement and unfair competition. Sun requested an order enjoining Microsoft from distributing any Java-based technology in any operating system, browser, or developers tools, including Windows 98, Internet Explorer 4.0 software, and the Visual J++(TM) 6.0 development system for Java, unless and until Microsoft includes with each such product an implementation of the Java run-time environment that passes Sun's compatibility test suite or an operable implementation of Sun's current Java run-time environment. The hearing for these motions is set for September 4, 1998.

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

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

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

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

On May 18, 1998, the DOJ and a group of 20 state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-Microsoft Internet browsing software (or other software products); taking or threatening "action adverse" in consequence of a person's failure to license or distribute Microsoft Internet browsing software (or other software product) or distributing competing

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products or cooperating with the government; and restrictions on the screens, boot-up sequence, or functions of Microsoft's operating system products. The state Attorneys General allege largely the same claims, and various pendent state claims. The states seek declaratory relief, and preliminary and permanent injunctive relief similar to that sought by the DOJ, together with statutory penalties under the state law claims. The foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. Hearings for the plaintiffs' motion for a preliminary injunction, Microsoft's motion for summary judgment, and a trial on the merits are scheduled to begin in September 1998. Microsoft believes that the claims are without merit and intends to defend against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of MS-DOS and Windows in the late 80's and early 90's--essentially the same complaints that resulted in the 1994 consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Fact discovery is scheduled to end in October 1998, and trial is scheduled for June 1999. Microsoft is vigorously defending the case.

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

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

GEOGRAPHIC INFORMATION
<TABLE>
<CAPTION>

Year Ended June 30	1996	1997	1998
<S>	<C>	<C>	<C>
REVENUE			
U.S. operations	$ 6,739	$ 8,877	$11,331
European operations	2,215	2,770	3,719
Other international operations	1,267	1,757	1,776
Eliminations	(1,550)	(2,046)	(2,342)
Total revenue	$ 8,671	$11,358	$14,484
OPERATING INCOME			
U.S. operations	$ 2,118	$ 3,474	$ 4,591
European operations	649	1,013	1,470
Other international operations	297	469	423
Eliminations	(5)	(85)	(70)
Total operating income	$ 3,059	$ 4,871	$ 6,414
IDENTIFIABLE ASSETS			
U.S. operations	$ 8,193	$11,630	$18,294
European operations	2,280	3,395	5,052
Other international operations	1,042	705	1,113
Eliminations	(1,422)	(1,343)	(2,102)
Total identifiable assets	$10,093	$14,387	$22,357

</TABLE>

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the United States, licensing to OEMs, and exports of finished goods directly to international customers, primarily in Asia, South America, and Canada. Exports and international OEM transactions are primarily in U.S. dollars and totaled $2.1 billion, $2.3 billion, and $2.9 billion in 1996, 1997, and 1998.

"Other international operations" primarily include subsidiaries in Japan, Canada, Australia, and Brazil. International revenue, which includes European operations, other international operations, exports, and OEM distribution, was 56%, 56%, and 53% of total revenue in 1996, 1997, and 1998. Most international identifiable assets are U.S. dollar denominated investment securities.

<PAGE>

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1997 and 1998, and the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1997 and 1998, and the results of their operations and their cash flows for each of the three years ended June 30, 1998 in conformity with generally accepted accounting principles.

/s/ DELOITTE & TOUCHE LLP

DELOITTE & TOUCHE LLP
Seattle, Washington
July 16, 1998
(August 3, 1998 as to Subsequent Sale Note)

</TEXT>
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<TYPE>EX-21
<SEQUENCE>6
<DESCRIPTION>SUBSIDIARIES OF REGISTRANT
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EXHIBIT 21

SUBSIDIARIES

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399

Microsoft FSC Corp. (U.S. VIRGIN ISLANDS)

Microsoft Investments, Inc. (NEVADA)

Microsoft Ireland Operations Limited (IRELAND)

Microsoft Licensing, Inc. (NEVADA)

Microsoft Puerto Rico, Inc. (Manufacturing) (DELAWARE)

The Microsoft Network L.L.C. (DELAWARE)

GraceMac Corporation (NEVADA)

Microsoft de Argentina S.A.

Microsoft Pty. Limited (AUSTRALIA)

Microsoft Gesellschaft m.b.H. (AUSTRIA)

Microsoft N.V. (BELGIUM)

Microsoft Informatica Limitada (BRAZIL)

Microsoft Canada Co.

SOFTIMAGE, Inc. (CANADA)

Microsoft Chile S.A.

Microsoft Colombia Inc. (DELAWARE)

Microsoft de Centroamerica S.A. (COSTA RICA)

Microsoft Hrvatska d.o.o. (CROATIA)

Microsoft s.r.o. (CZECH REPUBLIC)

Microsoft Danmark ApS (DENMARK)

Microsoft Dominicana, S.A. (DOMINICAN REPUBLIC)

Microsoft Del Ecuador S.A.

Microsoft El Salvador S.A. de C.V.

Microsoft Corporation (Representative Office) (EGYPT)

Microsoft Oy (FINLAND)

Microsoft France S.A.R.L.

Microsoft G.m.b.H. (GERMANY)

Microsoft Hellas S.A. (GREECE)

Microsoft de Guatemala, S.A.

Microsoft Hong Kong Limited

Microsoft Hungary Kft.

Microsoft Corporation (India) Private Limited

Microsoft India (R&D) Private Limited

PT. Microsoft Indonesia

Microsoft Israel Ltd.

Microsoft S.p.A. (ITALY)

Microsoft Cote d'Ivoire (IVORY COAST)

Microsoft Company, Limited (JAPAN)

East Africa Software Limited (KENYA)

Microsoft CH (KOREA)

Microsoft (Malaysia) Sdn. Bhd.

Microsoft Mexico, S.A. de C.V.
<PAGE>

Microsoft Indian Ocean Islands Limited (MAURITIUS)

Microsoft Maroc S.A.R.L. (MOROCCO)

Microsoft B.V. (THE NETHERLANDS)

Microsoft International B.V. (THE NETHERLANDS)

Microsoft New Zealand Limited

Microsoft Norge AS (NORWAY)

Microsoft de Panama, S.A.

Microsoft (China) Company Limited (THE PEOPLE'S REPUBLIC OF CHINA)

Microsoft Peru, S.A.

Microsoft Philippines, Inc.

Microsoft sp. z.o.o. (POLAND)

MSFT-Software Para Microcomputadores, LDA (PORTUGAL)

Microsoft Caribbean, Inc. (PUERTO RICO) (DELAWARE)

Microsoft Romania SRL

Microsoft ZAO (RUSSIA)

Microsoft Manufacturing B.V. (Representative Office)(RUSSIA)

Microsoft Singapore Pte Ltd.

Microsoft Slovakia s.r.o.

Microsoft d.o.o., Ljubljana (SLOVENIA)

Microsoft (S.A.) (Proprietary) Limited (SOUTH AFRICA)

Microsoft Iberica S.R.L. (SPAIN)

Microsoft Aktiebolag (SWEDEN)

Microsoft AG (SWITZERLAND)

Microsoft Taiwan Corporation

Microsoft (Thailand) Limited

Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (TURKEY)

Microsoft Corporation (UNITED ARAB EMIRATES)

Microsoft Limited (UNITED KINGDOM)

Microsoft Research Limited (UNITED KINGDOM)

Microsoft Uruguay, S.A.

Microsoft Venezuela, S.A.

The Resident Representative Office of MICROSOFT Corporation in Hanoi (VIETNAM)

Microsoft Corporation (Representative Office)(ZIMBABWE)

WebTV Networks, Inc. (California)

DreamWorks Interactive L.L.C. (WASHINGTON, 50% owned)

MSBET L.L.C. (DELAWARE, 50% owned)

MSFDC L.L.C. (DELAWARE, 50% owned)

MSNBC Cable, L.L.C. (DELAWARE, 50% owned)

MSNBC Interactive News, L.L.C. (DELAWARE, 50% owned)

Ninemsn Pty. Limited (AUSTRALIA)

WebTV Networks K.K. (JAPAN)
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EXHIBIT 23

INDEPENDENT AUDITORS' CONSENT

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981 Stock Option Plan), 33-44302 and 33-51583 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors), 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors), 333-16665 (Microsoft Corporation 1997 Employee Stock Purchase Plan), 333-61729 (Microsoft Corporation 1998 Special Stock Award Program), and 33-06298 of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, 33-63471, 33-64870, 333-857, 333-1177, 333-2759, 333-5961, 333-8081, 333-12441, 333-17143, 333-18055, 333-18195, 333-23621, 333-31803,333-37841, 333-41387, 333-43449, 333-45989, 333-52377, and 333-61507 of Microsoft Corporation on Forms S-3, and 333-26411 of Microsoft Corporation on Form S-4 of our report dated July 17, 1997 (August 1, 1997 as to Acquisition Note) appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 1998.

/s/ Deloitte & Touche LLP
Deloitte & Touche LLP
Seattle, Washington
September 23, 1998
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PUBLIC DOCUMENT COUNT: 10
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FILED AS OF DATE: 19970929
SROS: NASD

FILER:

COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWARE [7372]
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-K
SEC ACT:
SEC FILE NUMBER: 000-14278
FILM NUMBER: 97687694

BUSINESS ADDRESS:
STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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STREET 2: NORTH OFFICE 2211
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

For The Fiscal Year Ended June 30, 1997

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION

Washington (State of incorporation)	91-1144442 (I.R.S. ID)

One Microsoft Way, Redmond, Washington 98052-6399

(425) 882-8080

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock

2 3/4% Convertible Exchangeable Principal-Protected Preferred Stock.

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [_]

The aggregate market value of common stock held by non-affiliates of the registrant as of September 12, 1997 was $106,179,466,860.

The number of shares outstanding of the registrant's common stock as of September 12, 1997 was 1,212,567,717.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 1997 Annual Report to Shareholders are incorporated by reference into Parts I, II and IV.

Portions of the definitive Proxy Statement dated September 26, 1997 to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held November 14, 1997 are incorporated by reference into Part III.

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<PAGE>

MICROSOFT CORPORATION

FORM 10-K

For The Fiscal Year Ended June 30, 1997

INDEX

<TABLE>
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PART I

Item 1. Business

GENERAL

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including scalable operating systems for information appliances, personal computers (PCs) and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company has recently expanded its interactive content efforts, including entertainment and information software programs, MSN(TM), The Microsoft(R) Network online service, Internet-based services, and alliances with companies involved with other forms of digital interactivity. Microsoft also sells personal computer input devices and books, and researches and develops advanced technologies for future software products.

Microsoft's business strategy emphasizes the development of a broad line of software products for business and personal use, marketed through multiple channels of distribution. The Company is divided into three main groups: the Product Group, the Sales and Support Group, and the Operations Group.

The Platforms Product Group is comprised of five primary divisions, each responsible for a particular area of platform software development and marketing. The Personal Systems Division develops PC operating systems. The Business Systems Division develops server operating systems and server applications. The Internet Client and Collaboration Division develops Web browser technologies and e-mail, editing, and collaboration products. The Developer Tools Division creates software development tools. The Consumer Platforms Division develops system software for non-PC devices, multimedia devices, and digital authoring environments.

The Applications and Content Product Group creates and markets productivity programs, interactive entertainment and information products, desktop finance products, and PC input devices. The Desktop Applications Division creates business productivity applications and products designed for the home, school, and the small business market. Interactive Media offerings include children's titles, games, reference sources, online informational services, and MSN. The Desktop Finance Division develops personal finance products. The Input Device Division creates PC peripherals.

Microsoft has a research lab dedicated to creating new technology in support of the Company's vision for the evolution of personal computing.

The Sales and Support Group is responsible for building long-term business relationships with customers. This group is organized to serve various customer types, including original equipment manufacturers (OEMs), end-users, organizations, enterprises, application developers, and Internet content providers (ICPs) and infrastructure owners. Large enterprises are offered tailored license programs, enterprisewide support, consulting services, and other specialized services. The group manages the channels that serve customers by working with OEMs, distributors, and resellers. In addition to the OEM channel, Microsoft has three major geographic sales organizations: U.S. and Canada, Europe, and Other International. The group supports the Company's products with technical support for end-users, developers, and organizations.

The Operations Group is responsible for managing business operations and overall business planning. This includes the process of manufacturing and delivering finished goods and licenses; corporate functions such as finance, administration, human resources, and legal; and the publishing efforts of Microsoft Press.

PRODUCTS
PERSONAL SYSTEMS
- ---

The Personal Systems Division has overall responsibility for the Microsoft Windows(R) PC operating systems. Operating system software performs a variety of functions, such as allocating computer memory, scheduling applications software execution, managing information and communication flow among the various PC components, and enabling end-users to access files and information.

WINDOWS 95. Microsoft's primary personal operating system, the successor to MS-DOS(R) and Windows 3.1, was released commercially in August 1995; periodic service releases, system updates, and new device drivers have been made available to PC OEMs and to end-users via the Internet on the Company's web site, http://www.microsoft.com. Windows 95 is a fully integrated, multitasking 32-bit operating system, designed to be
<PAGE>

compatible with Intel microprocessor-based PCs, most hardware devices, and Windows 3.1 and MS-DOS applications.

WINDOWS NT WORKSTATION. Also a fully integrated, multitasking 32-bit operating system, Windows NT(R) Workstation provides greater security, robustness and portability. Windows NT Workstation is a multithreaded operating system for mission critical computing which provides the same features and applications programming interfaces (APIs) for Intel and Alpha AXP microprocessors.

MS-DOS. MS-DOS is a single-user, single-tasking operating system designed for Intel microprocessor-based PCs. MS-DOS was introduced in 1981 and was preinstalled by OEMs on most PCs shipped prior to the release of Windows 95.

WINDOWS 3.1. Microsoft Windows 3.1 provides a graphical user interface and other enhancements for MS-DOS-based PCs. Windows 3.1 supports 16-bit Windows-based applications, and offers ease of use, aesthetic appeal, and straightforward integration into corporate computing environments. Windows for Workgroups 3.11 integrates network and workgroup functionality directly into the Windows operating system.

BUSINESS SYSTEMS
- ---

The Business Systems Division develops and markets Windows NT Server and related Microsoft BackOffice(R) and Internet server-based applications. Server operating systems are enterprise-wide platforms for building and deploying distributed applications for networked PCs.

WINDOWS NT SERVER. Windows NT Server is a powerful operating system foundation for both server applications and file and print sharing, with extensive network management features, administration tools, security, and high availability. Windows NT Server provides a platform for business critical applications and databases, connectivity, system management, and e-mail servers. The operating system integrates Web services such as Microsoft Internet Information Server, a server used to manage intranet and Internet functionality and Microsoft FrontPage(R) Web site creation and management tool.

MICROSOFT BACKOFFICE. Based on Windows NT Server, the Microsoft BackOffice family of server applications is an integrated series of software products that include services for file and print, applications, database, messaging, groupware, desktop management, Internet access, transaction processing, and host connectivity. BackOffice enables organizations to share information, collaborate, and manage and deploy business-critical applications. Microsoft Exchange Server provides e-mail, group scheduling, and integrated groupware capabilities; Microsoft SQL Server(TM) manages and stores data; Microsoft Proxy Server creates a single, secure gateway to the Internet; Microsoft SNA Server provides connectivity to host data and applications; and Microsoft Systems Management Server centrally manages this distributed environment.

INTERNET SERVER TOOLS. The Company also offers Internet servers based on Windows NT Server. In addition to the Web services technologies included in Windows NT Server, the Company also offers Microsoft Site Server, which allows a comprehensive management of sophisticated web sites and their content. Microsoft Transaction Server is a component-based transaction processing system for developing, deploying, and managing scalable enterprise, Internet, and intranet server applications.

INTERNET CLIENT AND COLLABORATION

The Internet Client and Collaboration Division develops Internet browser technology and e-mail and group collaboration products.

INTERNET SOFTWARE. The division has overall development and marketing responsibility for Microsoft Internet Explorer, the Company's Internet browser. It also provides products for developing, running, and managing Internet and intranet applications and content, including ActiveX(TM) controls. Formerly known as object linking and embedding (OLE) controls, ActiveX controls are components (or objects) that can be inserted into a Web page or another application which allow packaged functionality programmed elsewhere to be reused and enables real-time, interactive content.

DEVELOPER TOOLS

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The Developer Tools Division provides software development tools and technical information to Windows and Internet applications developers. These products and services empower independent software developers, corporate developers, solutions developers, and Webmasters to create a broad spectrum of applications, primarily for Windows 95 and Windows NT, but also for the platform-independent Internet and intranets.

SOFTWARE DEVELOPMENT TOOLS AND COMPUTER LANGUAGES. Software development tools and computer languages allow software developers to write programs in a particular computer language and translate programs into a binary machine-readable set of commands that activate and instruct PC hardware. The Company develops and markets a number of software development environments, and language compilers. Microsoft Visual C++(R) is the Company's development system for Windows application development. The Microsoft Visual Basic(R) programming system provides easy access to a wide variety of data sources by integrating the Microsoft Access database engine and the ability to take advantage of investments in commercial applications through ActiveX controls. Microsoft Visual J++(TM), a development environment for Java applications and Internet applets, contains a high productivity Integrated Development Environment and a collection of integrated components to create, test, tune, and deploy Java code on multiple platforms using ActiveX controls.

DEVELOPER INFORMATION. The Company provides third party software developers with a wide range of technical and support information that assists them in developing software products intended to run on Windows operating systems, taking advantage of key technologies such as ActiveX controls and Windows 32-bit APIs. Developers can subscribe to the Microsoft Developer Network (MSDN) information service and receive periodic updates via CD-ROMs, magazines, and several on-line information services.

CONSUMER PLATFORMS

The Consumer Platforms Division is developing software for non-PC devices, the Broadcast PC, multimedia devices, and network multimedia.

NON-PC DEVICES. The division develops Windows CE, a scaleable Windows platform for a broad range of communications, entertainment, and mobile computing devices. The Windows CE operating system enables information appliances to communicate with each other, share information with Windows PCs, and connect to the Internet. Handheld PCs based on Windows CE are manufactured and sold by various hardware OEMs and are designed to be companions to Windows-based PCs.

MULTIMEDIA DEVICES. In August 1997 Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on WebTV technologies. Future versions of the set-top terminals will use the Windows CE operating system.

The Consumer Platforms Division is also responsible for Softimage, which develops, markets, and supports a family of interactive software products enabling digital media producers to create and edit two- and three-dimensional content for digital media productions. Softimage supplies 3D visualization software for broadcast, film production, and other high-end animation applications. In addition, Softimage has a product line of 2D visualization software for use on high-end applications, including postproduction editing and the integration of visual images, text, sound, and special effects technology. These products are designed for the Windows NT and IRIX operating systems.

SOFTIMAGE 3D. Softimage(R) 3D provides three-dimensional animation software for film and video professionals, animators, and artists who create and produce high-end three-dimensional imagery for traditional and new media.

SOFTIMAGE DS. Softimage DS is a digital authoring environment blending 2D and 3D graphics, digital video, and digital audio. The digital studio environment accommodates many types of projects for digital multimedia such as high-end advertising, entertainment, games, and integrated interactive multimedia.

DESKTOP APPLICATIONS

The Desktop Applications Division develops applications software, which provides the PC with instructions for the performance of productivity tasks such as manipulating text, numbers, or graphics. The Company's desktop applications software is designed for use by a broad class of end-users, regardless of business, industry, or market segment. Primary examples of desktop applications software are word processing, spreadsheet, and presentation graphics programs. The Company's desktop applications programs are developed principally for Windows and Macintosh operating systems.

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MICROSOFT OFFICE. Microsoft Office is a suite of software programs featuring seamless integration of the most commonly used desktop applications. Microsoft Office is based upon a document-centric concept, with common commands and extensive use of cross-application capabilities. Microsoft Office is available in several versions, with certain combinations of products available for the various operating system platforms. The most recent version for Windows, Microsoft Office 97, has enhanced Internet features such as integration with Microsoft Internet Explorer, a Web toolbar, the ability to save as an HTML format, connectivity to other Office documents or web sites via hyperlinks, and support for ActiveX controls. Products offered in the various versions include Microsoft Word, Microsoft Excel, the Microsoft PowerPoint(R) presentation graphics program, Microsoft Outlook(TM), the Microsoft Access database, Microsoft Bookshelf(R), and others. The Microsoft Home Essentials(TM) suite is marketed primarily toward users in the home.

MICROSOFT WORD. The Company's principal word processing program is Microsoft Word. Versions of Microsoft Word provide graphical word processing features, plus the ability to handle graphics, tables, spreadsheet data, charts, and images imported from other software programs.

MICROSOFT EXCEL. The Company's spreadsheet program is Microsoft Excel. It is an integrated spreadsheet with pivot table, database, and business graphics capabilities. Microsoft Excel allows full linking and embedding of objects that permits users to view and edit graphics or charts from other programs in the worksheet in which the object is stored. Microsoft Excel graphics capabilities can be linked to its spreadsheets to allow simultaneous changes to charts as changes are made to the spreadsheets.

MICROSOFT POWERPOINT. Microsoft PowerPoint is a presentation graphics program for producing transparencies, slides, overheads, and prints.

MICROSOFT ACCESS. Microsoft Access is a relational database management application that provides access to structured business data. Database products control the maintenance and utilization of structured data organized into a set of records or files.

MICROSOFT OUTLOOK. The division also develops the Microsoft Outlook desktop information management program, which manages e-mail, calendars, contacts, tasks, and files on the PC. Outlook helps users communicate through e-mail and share information by means of public folders, forms, and Internet connectivity.

MICROSOFT PROJECT. Microsoft Project is a critical path project scheduling and resource allocation program. The product can perform as a budgeting, monitoring, and cost estimating tool for large business projects and as a critical path and schedule planning tool.

OTHER PRODUCTIVITY PRODUCTS. The Company also offers other productivity products, including Microsoft Works, Microsoft Publisher, and Microsoft FrontPage. Microsoft Works is an integrated software program that contains basic word processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Microsoft Publisher is an easy-to-use, entry-level desktop publishing program. Microsoft FrontPage is a Web site creation and management tool for Web sites on the Internet or intranets.

INTERACTIVE MEDIA

The Interactive Media Division develops and markets interactive entertainment and information products across a variety of media, including the Internet, The Microsoft Network, and CD-ROM.

LEARNING AND ENTERTAINMENT. Reference titles include Microsoft Encarta(R) and Microsoft Bookshelf. The Encarta multimedia encyclopedia database blends text in articles with a wealth of innovative, interactive information presented through animations, videos, maps, charts, sounds, and pictures. Bookshelf is a multimedia reference library that integrates seven well-respected and authoritative works, including a dictionary, world atlas, world almanac, thesaurus, concise encyclopedia, and two books of quotations.

Personal interest titles include Microsoft Cinemania(R), an interactive guide to the movies with entries for 19,000 films, Microsoft Dinosaurs, musical titles, and many others.

PC INPUT DEVICES

The Company's major input device is the Microsoft Mouse, a hand-held pointing device that facilitates use of a PC. It can be used with MS-DOS and Windows operating systems and works with most applications products from Microsoft and other companies. Microsoft also offers a mouse designed for the home and a mouse for young children. The Company also markets the Microsoft Natural(R) Keyboard, an ergonomically designed keyboard. Additionally, Microsoft sells joysticks and gamepads for use with PC games.

MICROSOFT PRESS

Microsoft Press publishes books about software products from Microsoft and other software developers and about current developments in the industry. Books published by Microsoft Press typically are written and copyrighted by independent authors who submit their manuscripts to the Company for publication and who receive royalties based on revenue generated by the book.

Microsoft Press contracts with an independent commercial printer for the manufacturing of its books. Publisher's Resources, Inc. acts as the Company's main fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press(R) books. Books are marketed by independent sales representatives and by Microsoft
<PAGE>

Press sales personnel. Internationally, Microsoft Press has numerous international agreements with publishers for the worldwide distribution of its books. Microsoft Press has granted a publisher in England the right to distribute English language versions of its books in all countries except the United States, Canada, Central and South America, and certain Asian countries. In most cases, Microsoft Press provides each publisher with a book's manuscript, and the publisher arranges for its translation and the printing, marketing, and distribution of the translated version.

PRODUCT DEVELOPMENT

The PC software industry is characterized by extremely rapid technological change, which requires constant attention to software technology trends and shifting consumer demand, and rapid product innovation. The pace of change has recently become even greater due to the surge of interest in the Internet, other forms of online services, PC server-based networking, and new programming languages, such as Java.

Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third-party development and localization of certain products. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved development methodologies for creating and enhancing its products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, or computers. Product documentation is generally created internally.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to new user needs or advances in PCs, servers, peripherals, and the Internet, without compromising product quality. The Company strives to become informed at the earliest possible time about changing usage patterns and hardware advances that may affect software design.

During fiscal years 1995, 1996, and 1997, the Company spent $860 million, $1.43 billion, and $1.93 billion, respectively, on product research and development activities. Those amounts represented 14.5%, 16.5%, and 16.9%, respectively, of revenue in each of those years excluding funding of joint venture activity. The Company is committed to continue high expenditures for research and product development.

LOCALIZATION

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In order to best serve the needs of users in foreign countries, Microsoft "localizes" many of its products to reflect local languages and conventions. In French versions, for example, all user messages and documentation are in French and all monetary references are in French francs. Various Microsoft products have been localized into more than 30 languages.

MANUFACTURING

- --

Microsoft contracts most of its manufacturing activity to third parties. Outside manufacturers produce various retail software packaged products, documentation, and hardware such as mouse pointing devices, keyboards, and joysticks. There are other custom manufacturers in the event that outsourced manufacturing becomes unavailable from current sources.

In recent years the Company's sales mix has shifted to OEM and corporate and organizational licenses from packaged products. Online distribution of software may increase in the future. During July 1996, Microsoft sold its domestic manufacturing and distribution operation.

The Company's remaining manufacturing facilities are located in Puerto Rico and Ireland. The Irish manufacturing facility replicates disks, assembles other purchased parts, and packages final product. The Puerto Rico facility manufactures CD-ROMs, assembles other purchased parts, and packages final product. Quality control tests are performed on purchased parts, finished disks and CD-ROMs, and other products. The chief materials and components used in Microsoft products include disks or CD-ROMs, books, and multicolor printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.
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MARKETING AND DISTRIBUTION

- --

Microsoft aligns its sales and marketing staff with several customer types, including OEMs, end-users, organizations, enterprises, applications developers, and Internet content providers (ICPs) and infrastructure owners. The Company's sales and marketing group seeks to build long-term relationships with customers of Microsoft products. In addition to the OEM channel, Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International).

The OEM customer unit includes the sales force which works with original equipment manufacturers that preinstall Microsoft software on their PCs.

The end-user customer unit has responsibility for activities that target end-users that make individual buying decisions for the PCs they use at work or home. Most sales and marketing activities aimed at end-user customers are performed by this unit, including developing and administering reseller relationships; reseller sales terms and conditions; channel marketing and promotions; end-user marketing programs; support policies; and seminars, events, partners such as distributors, aggregators, value-added resellers, and Solution Providers to provide complete business solutions to this customer segment. The unit's sales and marketing activities include providing technical training to Solution Providers (described below) and channel resellers; developing support policies; and supporting and providing seminars, events, and sales training for channel partners.

The enterprise customer unit has responsibility for sales and marketing activities that target large organizations. The unit works directly with these organizations, and through large account resellers, to create and support enterprisewide, mission critical solutions for business computing needs.

The applications developer customer unit targets corporate developers and independent software vendors (ISVs) who build business applications with a development platform based on Microsoft Windows and BackOffice architecture. The unit's sales and marketing activities include providing industry specific technical training, seminars, and events for ISVs.

The Internet customer unit is responsible for introducing the Company's products and technologies to the public infrastructure owners and ICPs. Infrastructure owners include network operators (telephone companies, cable companies, Internet service providers, etc.) who build, own, and operate the public networks and ICPs who provide content for the Web.

FINISHED GOODS CHANNELS
- ---

DISTRIBUTORS AND RESELLERS. The Company markets its products in the finished goods channels primarily through independent non-exclusive distributors and resellers. Distributors include CHS Electronics, Computer 2000, Ingram Micro, Softbank, Tech Data, and Merisel. Resellers include Software Spectrum and Stream International. Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

LARGE ACCOUNTS. The Microsoft Select program offers flexible software acquisition, licensing, and maintenance options specially customized to meet the needs of large multinational organizations. Targeted audiences include technology specialists and influential end-users in large enterprises. Marketing efforts and fulfillment are generally coordinated with the Microsoft network of large account resellers.

SOLUTION PROVIDERS. Microsoft's Solution Providers program is a comprehensive support relationship with independent organizations that provide network and system integration, custom development, training, and technical support for business computing solutions. The program supports value-added resellers (VARs), system integrators, consultants, custom application developers, solution developers, Internet service and hosting organizations, independent content providers, and sitebuilders (companies that build Web sites for other companies), as well as technical support and training organizations. Under this business partnership strategy, the Company provides sales and product information, development services, early access to Microsoft products, and customer support tools including priority telephone support, education, and business development support. To ensure high-quality technical services for the Company's products, Microsoft Solution Providers are required to have Microsoft-certified professionals on staff.
<PAGE>

of Microsoft products. Support personnel are located in various sites in the U.S. and around the world. Certain support is also supplied by qualified third-party support organizations. The Company hires individuals with product expertise and provides them with productivity tools, continuous product education and training, and consistent processes to deliver quality support for

Microsoft products. Coverage options range from standard no-charge toll telephone support to fee-based offerings providing unlimited 800 number telephone and electronic technical support for all Microsoft products 24 hours per day, 7 days per week.

Users have access to troubleshooting "wizards" and Microsoft's KnowledgeBase, a library of thousands of technical articles that is updated regularly with useful information regarding Microsoft products. Microsoft provides access to KnowledgeBase via MSN, America Online, CompuServe, Prodigy, and the Internet. Additionally, several support offerings include Microsoft TechNet and Microsoft Developer Network information subscription services.

As a supplement or alternative to direct support, the Company enhances the third-party support channel by providing Microsoft Solution Providers with education, training, tools, and support. Microsoft Solution Providers include Authorized Training Centers, which offer advanced product education and certification on Microsoft
<PAGE>

products; and Authorized Support Centers, which provide a wide spectrum of multinational support, multivendor support, and integration services.

COMPETITION
- ---

The PC software business is intensely competitive and subject to extremely rapid technological change. Microsoft faces formidable competition in all areas of its business activity, including competition from many companies much larger than Microsoft. The rapid pace of technological change constantly creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. The Company also faces constant competition from software pirates who unlawfully copy and distribute Microsoft's copyrighted software products.

OPERATING SYSTEMS. Microsoft's operating system products face substantial competition from a wide variety of companies. Major competitors such as IBM, Apple Computer, Digital Equipment Corporation, Hewlett-Packard, Sun Microsystems, and others are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on computers of their own manufacture. Many of these operating system software products are also licensed to third-party OEMs for preinstallation on their machines. Microsoft's operating system products compete with UNIX-based operating systems from a wide range of companies including IBM, AT&T, Hewlett-Packard, Sun, The Santa Cruz Operation, and others. Variants of UNIX run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems. As PC technology increasingly moves toward connectivity and communications, Microsoft's operating system products will face increased competition from network server operating systems such as Novell's NetWare, Banyan's Vines, the many variants of UNIX, IBM's OS/2, "middleware" products such as IBM's Lotus Notes, and intranet servers from Netscape, IBM, Sun, and others.

BUSINESS SYSTEMS. The Company is a fairly recent entrant into the business of providing enterprisewide computing solutions. Several competitors enjoy a larger share of sales and larger installed bases. Many companies offer operating system software for mainframes and midrange computers, including IBM, Digital Equipment, Hewlett-Packard, and Sun. Since legacy business systems are typically support-intensive, these competitors also offer substantive support services. Software developers that provide competing server applications for PC-based distributed client/server environments include Oracle, IBM, Computer Associates, Sybase, and Informix. There are also several software vendors who offer connectivity servers. As mentioned above, there are numerous companies and organizations that offer Internet and intranet server software which compete against the Company's business systems. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with the Company's workgroup and mail products.

DESKTOP APPLICATIONS. The Company's competitors include many software application vendors, such as IBM (Lotus), Oracle, Apple (Claris), Corel, and local application developers in Europe and the Far East. IBM and Corel have large installed bases with their spreadsheet and word processor products, respectively, and both have aggressive pricing strategies. Also, IBM and Apple preinstall certain of their software products on various models of their PCs, competing directly with Microsoft desktop application software.

DEVELOPER TOOLS. The Company's developer products compete against offerings from Borland, Macromedia, Oracle, Sun, Sybase, Symantec, and other companies.

NEWS SERVICES. The Company's MSNBC joint ventures face formidable competition from other 24-hour cable and Internet news organizations such as CNN and Fox News Network. MSNBC also competes with traditional news media such as newspapers and broadcast TV and Internet news services.

CONSUMER PLATFORMS. A wide variety of companies develop operating systems for information appliances, including Apple, Motorola, 3Com, Psion Software, and others. The Company's nascent WebTV offerings and other multimedia consumer products face competitors such as Sun, Oracle, NetChannel, and others. An enormous range of companies, including media conglomerates, telephone companies, cable companies, retailers, hardware manufacturers, and software developers, are competing to make interactive services widely available to the home.

INTERNET PLATFORMS AND SERVICES. The advent of the Internet as a computing, communication, and collaboration platform as well as a low cost and efficient distribution vehicle increases competition and creates uncertainty as to future technology directions. The Company faces intense competition in the development and marketing of Internet (and intranet) software from a wide variety of companies and organizations including IBM, Netscape, Novell, Oracle, Sun, and many others. In addition, the very low barriers to entry on the Internet have allowed numerous Web-based service companies to build significant businesses in areas such as electronic mail, electronic commerce,
<PAGE>

Web search engines, and information of numerous types. Competitors include Netscape, Lycos, Yahoo, Excite, Infoseek, CitySearch, and many others.

ONLINE SERVICES. Microsoft's online services network, MSN, faces formidable competition from America Online and other online networks, such as CompuServe (the sale of which to America Online is pending), Prodigy, and impending entrants. Additionally, MSN faces competition from online services that are offered to users directly via the World Wide Web.

INTERACTIVE MEDIA. The Company's Interactive Media division faces many smaller but focused and branded competitors, particularly in the areas of entertainment and education. Consolidation in this area of software development has made certain competitors even stronger. Competitors include Intuit, Broderbund, Electronic Arts, The Learning Company (including Softkey, MECC, and Compton's), Voyager, CUC International (including Sierra On Line, Knowledge Adventures, and Davidson Associates), and Dorling Kindersley. Still other competitors own branded content, such as Disney and Lucas Arts.

Additionally, PC-based games are increasingly competing head-to-head against games created for proprietary systems such as Nintendo, Sony PlayStation, and Sega. Input devices face substantial competition from computer manufacturers, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices.

A number of Microsoft's most significant competitors, including IBM, Sun, Oracle, and Netscape, have jointly embarked upon various technology development and marketing initiatives that are intended to increase customer demand for products from these companies. These initiatives relate in part to efforts to move software from individual PCs to centrally-managed servers. While the likely technological and business success of such "thin client" strategies is currently unknown, widespread adoption of such computing systems would present significant challenges to the Company's historical business model.

The Company's competitive position may be adversely affected by one or more of these factors in the future, particularly in view of the fast pace of technological change in the software industry.

EMPLOYEES

As of June 30, 1997, the Company employed 22,232 people on a full-time basis, 15,835 in the U.S. and 6,397 internationally. Of the total, 8,059 were in product research and development, 11,074 in sales, marketing, and support, 1,115 in manufacturing and distribution, and 1,984 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees are subject to collective bargaining agreements. The Company believes relations with its employees are excellent.

Item 2. Properties

The Company's corporate offices consist of approximately 3.6 million square feet of office building space located in King County, Washington. There are two sites that total approximately 300 acres of land. The Company is constructing three office buildings comprising approximately 565,000 square feet of space. Occupancy on this site will be phased starting in the winter of 1997 and completed by spring of 1998. Additionally, construction is continuing on another set of office buildings with approximately 423,000 square feet of space. This site will be occupied in the winter of 1999. The Company owns all of its corporate campus.

The Company leases a 45,000 square foot disk duplication facility in Humacao, Puerto Rico. The Puerto Rico facility, which began operation in April 1990, is leased under a 10-year lease, with an option to renew for an additional 10 years. The Company's European manufacturing operation consists of a 161,000 square foot facility situated on 12 acres in Dublin, Ireland. The Ireland site also includes office buildings with 157,000 square feet for international localization. The Ireland facilities are fully owned by the Company. In Les Ulis, France, the Company owns a 199,000 square foot office building on four acres of land.

The Company is constructing an office building complex with 225,000 square feet on 33 acres of land near Redding, England. This is a phased construction project, occupancy is expected to begin in the fall of 1997 and be completed in winter of 1997.

In addition, the Company leases office space in numerous locations in the United States and many other countries.

Item 3. Legal Proceedings

The information set forth in Notes to Financial Statements-Commitments and Contingencies on page 40 of the 1997 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

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

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 1997.

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PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

The information set forth on page 42 of the 1997 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.1.

Item 6. Selected Financial Data

The information set forth on page 1 of the 1997 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.2.

Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition

The information set forth on pages 26-31 of the 1997 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

Item 8. Financial Statements and Supplementary Data

The following financial statements for the Company and independent auditors' report set forth on pages 24-25, 32-41, 43 and 44 of the 1997 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

- Income Statements for the three years ended June 30, 1997
- Cash Flows Statements for the three years ended June 30, 1997
- Balance Sheets as of June 30, 1996 and 1997
- Stockholders' Equity Statements for the three years ended June 30, 1997
- Notes to Financial Statements
- Independent Auditors' Report

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None.
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PART III

Item 10. Directors and Executive Officers of the Registrant

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" on pages 1 and 2 of the Company's Proxy Statement dated September 26, 1997, for the Annual Meeting of Shareholders to be held November 14, 1997 (the "Proxy Statement"). Such information is incorporated herein by reference.

The executive officers of Microsoft as of September 12, 1997 were as follows:
<TABLE>
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Name	Age	Position with the Company
<S>	<C>	<C>
William H. Gates	41	Chairman of the Board; Chief Executive Officer
Steven A. Ballmer	41	Executive Vice President, Sales and Support
Robert J. Herbold	55	Executive Vice President; Chief Operating Officer
Frank M. (Pete) Higgins	39	Group Vice President, Interactive Media
Paul A. Maritz	42	Group Vice President, Platforms and Applications
Nathan P. Myhrvold	38	Group Vice President, Chief Technology Officier
Jeffrey S. Raikes	39	Group Vice President, Sales and Marketing
James E. Allchin	45	Senior Vice President, Personal and Business Systems Division
Joachim Kempin	55	Senior Vice President, OEM Sales
Michel Lacombe	46	Senior Vice President, Microsoft; President, Microsoft Europe
Craig J. Mundie	48	Senior Vice President, Consumer Platforms Division
William H. Neukom	55	Senior Vice President, Law and Corporate Affairs; Secretary
Brad A. Silverberg	43	Senior Vice President, Applications and Internet Client
Gregory B. Maffei	37	Vice President, Finance; Chief Financial Officer

</TABLE>

Mr. Gates co-founded Microsoft in 1975 and has been its Chairman of the Board and Chief Executive Officer since the original partnership was incorporated in 1981.

Mr. Ballmer was named Executive Vice President, Sales and Support in February 1992. He had been Senior Vice President, Systems Software since 1989. From 1984 until 1989, Mr. Ballmer served as Vice President, Systems Software. He joined Microsoft in 1980.

Mr. Herbold joined Microsoft as Executive Vice President and Chief Operating Officer in November 1994. Mr. Herbold had been with The Procter & Gamble Company since 1968, with experience in information services, advertising and market research. Most recently, he was P&G's Senior Vice President, Information Services and Advertising.

Mr. Higgins was named Group Vice President, Interactive Media Group in October 1996. He was named Group Vice President, Applications and Content in May 1995 and Senior Vice President, Desktop Applications Division in March 1993. He had been Vice President, Desktop Applications Division since 1992. Mr. Higgins joined Microsoft in 1983.

Mr. Maritz was named Group Vice President, Platforms and Applications in October 1996 and had been Group Vice President, Platforms since May 1995. He had been Senior Vice President, Product and Technology Strategy in November 1994 and had been Senior Vice President, Systems Division since February 1992. He had been Vice President, Advanced Operating Systems since 1989. Mr. Maritz joined Microsoft in 1986.

Mr. Myhrvold was named Group Vice President and Chief Technology Officer in October 1996. He was named Group Vice President, Applications and Content in May 1995 and had been Senior Vice President, Advanced Technology since July 1993. He had been Vice President, Advanced Technology and Business Development since 1989. Mr. Myhrvold joined Microsoft in 1986.
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Mr. Raikes was named Group Vice President, Sales and Marketing in July 1996. He was named Senior Vice President, Microsoft North America in January 1992 and had been Vice President, Office Systems since 1990. Mr. Raikes joined Microsoft in 1981.

Mr. Allchin was named Senior Vice President, Personal and Business Systems Group in February 1996. He was named Senior Vice President, Business Systems Division in November 1994 and had been Vice President, Business Systems Division, since July 1991. Mr. Allchin joined Microsoft in 1991.

Mr. Kempin was named Senior Vice President, OEM Sales in August 1993. He had been Vice President, OEM Sales since 1987. Mr. Kempin joined Microsoft in 1983.

Mr. Lacombe was named President, Microsoft Europe in July 1997 and Senior Vice President, Microsoft in December 1996. He had been Vice President, Europe since September 1995 and Vice President, End User Customer Unit, Europe since April 1994. Mr. Lacombe had been Regional Director of Southern Europe from May 1991. Mr. Lacombe joined Microsoft in 1983.

Mr. Mundie was named Senior Vice President, Consumer Platforms in February 1996. He was named Senior Vice President, Consumer Systems Division in May 1995 and had been Vice President, Advanced Consumer Technology since July 1993. He joined Microsoft as General Manager, Advanced Consumer Technology Group in December 1992.

Mr. Neukom was named Senior Vice President, Law and Corporate Affairs in February 1994. He joined Microsoft in 1985 as Vice President, Law and Corporate Affairs.

Mr. Silverberg was named Senior Vice President, Applications and Internet Client Group in December 1996. He had been Senior Vice President, Internet Platform and Tools Division since February 1996. He was named Senior Vice President, Personal Systems Division in November 1994 after joining Microsoft in August 1990 as Vice President, Personal Operating Systems Division.

Mr. Maffei was named Vice President, Finance and Chief Financial Officer in July 1997. He was named Vice President, Corporate Development in July 1996 and Treasurer in April 1994. He joined Microsoft in April 1993 as Director, Business Development & Investments. Previously, Mr. Maffei was Executive Vice President and Chief Financial Officer of Pay 'N Pac Stores, Inc. from 1991 to 1992.

Item 11. Executive Compensation

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" on pages 4 through 7 and "Information Regarding the Board and its Committees" on page 2 is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information set forth under the caption "Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management" on page 3 of the Proxy Statement is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information set forth in Notes to Financial Statements--Acquisitions on page 40 of the 1997 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.
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PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) Financial Statements and Schedules

The financial statements as set forth under Item 8 of this report on Form 10-K are incorporated herein by reference.

Financial statement schedules have been omitted since they are either not required, not applicable, or the information is otherwise included.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the last quarter of fiscal 1997.

(c) Exhibit Listing

<TABLE>
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Exhibit Number	Description
<C>	<S>
3.1	Restated Articles of Incorporation (1)
3.2	Bylaws (1)
10.1	Microsoft Corporation 1991 Stock Option Plan
10.2	Microsoft Corporation 1981 Stock Option Plan (2)
10.3	Microsoft Corporation Stock Option Plan for Non-Employee Directors (1)
10.4	Microsoft Corporation Stock Option Plan for Consultants and Advisors (1)
10.5	Microsoft Corporation 1997 Employee Stock Purchase Plan
10.6	Microsoft Corporation Savings Plus Plan (1)
10.7	Trust Agreement dated June 1, 1993 between Microsoft Corporation and First Interstate Bank of Washington (3)
10.8	Form of Indemnification Agreement (3)
11.	Computation of Earnings Per Share
13.1	Quarterly and Market Information Incorporated by Reference to Page 42 of 1997 Annual Report to Shareholders ("1997 Annual Report")
13.2	Selected Financial Data Incorporated by Reference to Page 1 of 1997 Annual Report
13.3	Management's Discussion and Analysis of Results of Operations and Financial Condition Incorporated by Reference to Pages 26-31 of 1997 Annual Report
13.4	Financial Statements Incorporated by Reference to Pages 24-25, 32-41, 43, and 44 of 1997 Annual Report
21.	Subsidiaries of Registrant (4)
23.	Independent Auditors' Consent
27.	Financial Data Schedule

</TABLE>

---

(1) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1994.
(2) Incorporated by reference to Registration Statement 33-37623 on Form S-8.
(3) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.

(4) Incorporated by reference to Exhibit 13.4 filed herein.
<PAGE>

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Redmond, State of Washington, on September 26, 1997.

MICROSOFT CORPORATION

By /s/ Gregory B. Maffei

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on September 26, 1997.

<TABLE>
<CAPTION>

Signature	Title
<S>	<C>
/s/ William H. Gates William H. Gates	Chairman of the Board of Directors and Chief Executive Officer
/s/ Paul G. Allen Paul G. Allen	Director
Jill E. Barad	Director
/s/ Richard A. Hackborn Richard A. Hackborn	Director
/s/ David F. Marquardt David F. Marquardt	Director
/s/ Robert D. O'Brien Robert D. O'Brien	Director
/s/ Wm. G. Reed, Jr.	

Wm. G. Reed, Jr.	Director
/s/ Jon A. Shirley	
Jon A. Shirley	Director
/s/ Gregory B. Maffei	
Gregory B. Maffei	Vice President, Finance; Chief Financial Officer (Principal Financial and Accounting Officer)

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EXHIBIT INDEX

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Exhibit 10.1.

Microsoft Corporation 1991 Stock Option Plan, As Amended

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MICROSOFT CORPORATION

1991 STOCK OPTION PLAN, AS AMENDED

1. Purpose of the Plan. The purposes of this Stock Option Plan are to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to such individuals, and to promote the success of the Company's business by aligning employee financial interests with long-term shareholder value.

Options granted hereunder may be either Incentive Stock Options or Nonqualified Stock Options, at the discretion of the Board and as reflected in the terms of the written option agreement.

2. Definitions. As used herein, the following definitions shall apply:

(a) "Board" shall mean the Committee, if such Committee has been appointed, or the Board of Directors of the Company, if such Committee has not been appointed.

(b) "Code" shall mean the Internal Revenue Code of 1986, as amended.

(c) "Committee" shall mean the Committee appointed by the Board of

Directors in accordance with paragraph (a) of Section 4 of the Plan, if one is appointed; provided, however, if the Board of Directors appoints more than one Committee pursuant to Section 4, then "Committee" shall refer to the appropriate Committee, as indicated by the context of the reference.

(d) "Common Shares" shall mean the common shares of Microsoft Corporation.

(e) "Company" shall mean Microsoft Corporation, a Washington corporation and any successor thereto.

(f) "Continuous Status as an Employee" shall mean the absence of any interruption or termination of service as an Employee. Continuous Status as an Employee shall not be considered interrupted in the case of sick leave, maternity leave, infant care leave, medical emergency leave, military leave, or any other leave of absence authorized in writing by a Vice President of the Company prior to its commencement.

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(g) "Employee" shall mean any person, including officers, employed by the Company or any Parent or Subsidiary of the Company.

(h) "Incentive Stock Option" shall mean any Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code.

(i) "Maximum Annual Employee Grant" shall have the meaning set forth in Section 5(e).

(j) "Non-Employee Director" shall have the same meaning as defined or interpreted for purposes of Rule 16b-3 (including amendments and successor provisions) as promulgated by the Securities and Exchange Commission pursuant to its authority under the Exchange Act ("Rule 16b-3").

(k) "Nonqualified Stock Option" shall mean an Option not intended to qualify as an Incentive Stock Option.

(l) "Option" shall mean a stock option granted pursuant to the Plan.

(m) "Optioned Shares" shall mean the Common Shares subject to an Option.

(n) "Optionee" shall mean an Employee who receives an Option.

(o) "Outside Director" shall have the same meaning as defined or interpreted for purposes of Section 162(m) of the Code.

(p) "Parent" shall mean a "parent corporation," whether now or hereafter existing, as defined in Section 424(e) of the Code.

(q) "Plan" shall mean this 1991 Stock Option Plan, including any amendments thereto.

(r) "Share" shall mean one Common Share, as adjusted in accordance with Section 11 of the Plan.

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(s) "Subsidiary" shall mean (i) in the case of an Incentive Stock Option a "subsidiary corporation," whether now or hereafter existing, as defined in Section 424(f) of the Code, and (ii) in the case of a Nonqualified Stock Option, in addition to a subsidiary corporation as defined in (i), a limited liability company, partnership or other entity in which the Company controls 50 percent or more of the voting power or equity interests.

3. Shares Subject to the Plan. Subject to the provisions of Section 11 of the Plan, the maximum aggregate number of shares which may be optioned and sold under the Plan is 520,000,000 Common Shares. The Shares may be authorized, but unissued, or reacquired Common Shares.

If an Option should expire or become unexercisable for any reason without having been exercised in full, the unpurchased Shares which were subject thereto shall, unless the Plan shall have been terminated, become available for future grant under the Plan.

4. Administration of the Plan.

(a) Procedure. The Plan shall be administered by the Board of Directors of the Company.

(1) The Board of Directors may appoint one or more Committees each consisting of not less than two members of the Board of Directors to administer the Plan on behalf of the Board of Directors, subject to such terms and conditions as the Board of Directors may prescribe. Once appointed, such Committees shall continue to serve until otherwise directed by the Board of Directors.

(2) Any grants of Options to officers who are subject to Section 16 of the Securities Exchange Act of 1934 (the "Exchange Act") shall be made by (i) a Committee of two or more directors, each of whom is a Non-Employee Director and an Outside Director or (ii) as otherwise permitted by both Rule 16b-3, Section 162(m) of the Code and other applicable regulations.

(3) Subject to the foregoing subparagraphs (1) and (2), from time to time the Board of Directors may increase the size of the Committee(s) and appoint additional members thereof, remove members (with or without cause) and appoint new members in substitution therefor, or fill vacancies however caused.

(b) Powers of the Board. Subject to the provisions of the Plan, the Board shall have the authority, in its discretion: (i) to grant Incentive Stock Options or Nonqualified Stock Options; (ii) to determine, in accordance with Section 8(b) of the Plan, the fair market value of the Shares; (iii) to determine, in accordance with Section 8(a) of the Plan, the exercise price per

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share of Options to be granted; (iv) to determine the Employees to whom, and the time or times at which, Options shall be granted and the number of Shares to be represented by each Option; (v) to interpret the Plan; (vi) to prescribe, amend, and rescind rules and regulations relating to the Plan; (vii) to determine the terms and provisions of each Option granted (which need not be identical) and, with the consent of the holder thereof, modify or amend each Option; (viii) to reduce the exercise price per share of outstanding and unexercised Options; (ix) to accelerate or defer (with the consent of the Optionee) the exercise date of any Option; (x) to authorize any person to execute on behalf of the Company any instrument required to effectuate the grant of an Option previously granted by the Board; and (xi) to make all other determinations deemed necessary or advisable for the administration of the Plan.

(c) Effect of Board's Decision. All decisions, determinations, and interpretations of the Board shall be final and binding on all Optionees and any other holders of any Options granted under the Plan.

5. Eligibility.

(a) Options may be granted only to Employees. For avoidance of doubt, directors are not eligible to participate in the Plan unless they are full-time Employees.

(b) Each Option shall be designated in the written option agreement as either an Incentive Stock Option or a Nonqualified Stock Option. However, notwithstanding such designations, to the extent that the aggregate fair market value of the Shares with respect to which Options designated as Incentive Stock Options are exercisable for the first time by any Optionee during any calendar year (under all plans of the Company) exceeds $100,000, such Options shall be treated as Nonqualified Stock Options.

(c) For purposes of Section 5(b), Options shall be taken into account in the order in which they were granted, and the fair market value of the Shares shall be determined as of the time the Option with respect to such Shares is granted.

(d) Nothing in the Plan or any Option granted hereunder shall confer upon any Optionee any right with respect to continuation of employment with the Company, nor shall it interfere in any way with the Optionee's right or the Company's right to terminate the employment relationship at any time, with or without cause.

(e) The maximum number of Shares with respect to which an Option or Options may be granted to any Employee in any one taxable year of the Company shall not exceed 2,000,000 shares (the "Maximum Annual Employee Grant").
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6. Term of Plan. The Plan shall become effective upon its adoption by the Board. It shall continue in effect until August 16, 2001, unless sooner terminated under Section 14 of the Plan.

7. Term of Option. The term of each Option shall be no more than ten (10) years from the date of grant. However, in the case of an Incentive Stock Option granted to an Optionee who, at the time the Option is granted, owns Shares representing more than ten percent (10%) of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the term of the Option shall be no more than five (5) years from the date of grant.

8. Exercise Price and Consideration.

(a) The per Share exercise price under each Option shall be such price as is determined by the Board, subject to the following:

(1) In the case of an Incentive Stock Option

(i) granted to an Employee who, at the time of the grant of such Incentive Stock Option, owns shares representing more than ten percent (10%) of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the per Share exercise price shall be no less than 110% of the fair market value per Share on the date of grant.

(ii) granted to any other Employee, the per Share exercise price shall be no less than 100% of the fair market value per Share on the date of grant.

(2) In the case of a Nonqualified Stock Option the per Share exercise price may be less than, equal to, or greater than the fair market value per Share on the date of grant.

(b) The fair market value per Share shall be the closing price per share of the Common Share on the Nasdaq Stock Market ("Nasdaq") on the date of grant. If the Shares cease to be listed on Nasdaq, the Board shall designate an alternative method of determining the fair market value of the Shares.

(c) The consideration to be paid for the Shares to be issued upon exercise of an Option, including the method of payment, shall be determined by the Board at the time of grant and may consist of cash and/or check. Payment may also be made by delivering a properly executed exercise notice together with irrevocable instructions to a broker to promptly deliver to the Company the amount of sale proceeds necessary to pay the exercise price. If the Optionee is
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an officer of the Company within the meaning of Section 16 of the Exchange Act, he may in addition be allowed to pay all or part of the purchase price with Shares. Shares used by officers to pay the exercise price shall be valued at their fair market value on the exercise date.

(d) Prior to issuance of the Shares upon exercise of an Option, the Optionee shall pay any federal, state, and local withholding obligations of the Company, if applicable. If an Optionee is an officer of the Company within the meaning of Section 16 of the Exchange Act, he may elect to pay such withholding tax obligations by having the Company withhold Shares having a value equal to the amount required to be withheld. The value of the Shares to be withheld shall equal the fair market value of the Shares on the day the Option is exercised. The right of an officer to dispose of Shares to the Company in satisfaction of withholding tax obligations shall be deemed to be approved as part of the initial grant of an option, unless thereafter rescinded, and shall otherwise be made in compliance with Rule 16b-3 and other applicable regulations.

9. Exercise of Option.

(a) Procedure for Exercise; Rights as a Shareholder. Any Option granted hereunder shall be exercisable at such times and under such conditions as determined by the Board at the time of grant, and as shall be permissible under the terms of the Plan.

An Option may not be exercised for a fraction of a Share.

An Option shall be deemed to be exercised when written notice of such exercise has been given to the Company in accordance with the terms of the Option by the person entitled to exercise the Option and full payment for the Shares with respect to which the Option is exercised has been received by the Company. Full payment may, as authorized by the Board, consist of any consideration and method of payment allowable under Section 8(c) of the Plan. Until the issuance (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company) of the share certificate evidencing such Shares, no right to vote or receive dividends or any other rights as a shareholder shall exist with respect to the Optioned Stock, notwithstanding the exercise of the Option. The Company shall issue (or cause to be issued) such share certificate promptly upon exercise of the Option. In the event that the exercise of an Option is treated in part as the exercise of an Incentive Stock Option and in part as the exercise of a Nonqualified Stock Option pursuant to Section 5(b), the Company shall issue a share certificate evidencing the Shares treated as acquired upon the exercise of an Incentive Stock Option and a separate share certificate evidencing the Shares treated as acquired upon the exercise of a Nonqualified Stock Option, and shall identify each such certificate accordingly in its share transfer records. No adjustment will be made for a dividend or other right for which the record date is prior to the date the share certificate is issued, except as provided in Section 11 of the Plan.
<PAGE>

Exercise of an Option in any manner shall result in a decrease in the number of Shares which thereafter may be available, both for purposes of the Plan and for sale under the Option, by the number of Shares as to which the Option is exercised.

(b) Termination of Status as Employee. In the event of termination of an Optionee's Continuous Status as an Employee, such Optionee may exercise stock options to the extent exercisable on the date of termination. Such exercise must occur within three (3) months (or such shorter time as may be specified in the grant), after the date of such termination (but in no event later than the date of expiration of the term of such Option as set forth in the Option Agreement). To the extent that the Optionee was not entitled to exercise the Option at the date of such termination, or does not exercise such Option within the time specified herein, the Option shall terminate.

(c) Disability of Optionee. Notwithstanding the provisions of Section 9(b) above, in the event of termination of an Optionee's Continuous Status as an Employee as a result of total and permanent disability (i.e., the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of twelve (12) months), the Optionee may exercise the Option, but only to the extent of the right to exercise that would have accrued had the Optionee remained in Continuous Status as an Employee for a period of twelve (12) months after the date on which the Employee ceased working as a result of the total and permanent disability. Such exercise must occur within eighteen (18) months (or such shorter time as is specified in the grant) from the date on which the Employee ceased working as a result of the total and permanent disability (but in no event later than the date of expiration of the term of such Option as set forth in the Option Agreement). To the extent that the Optionee was not entitled to exercise such Option within the time specified herein, the Option shall terminate.

(d) Death of Optionee. Notwithstanding the provisions of Section 9(b) above, in the event of the death of an Optionee:

(i) who is at the time of death an Employee of the Company, the Option may be exercised, at any time within six (6) months following the date of death (but in no event later than the date of expiration of the term of such Option as set forth in the Option Agreement), by the Optionee's estate or by a person who acquired the right to exercise the Option by bequest or inheritance, but only to the extent of the right to exercise that would have accrued had the Optionee continued living and remained in Continuous Status as an Employee twelve (12) months after the date of death; or

(ii) whose Option has not yet expired but whose Continuous Status as an Employee terminated prior to the date of death, the Option may be exercised, at any time within six (6) months following the date of death (but in no event later than the date of expiration of the term of such Option as set forth in the Option Agreement), by the Optionee's estate or by a
<PAGE>

person who acquired the right to exercise the Option by bequest or inheritance, but only to the extent of the right to exercise that had accrued at the date of termination.

(e) Notwithstanding subsections (b), (c), and (d) above, the Board shall have the authority to extend the expiration date of any outstanding option in circumstances in which it deems such action to be appropriate (provided that no such extension shall extend the term of an option beyond the date on which the option would have expired if no termination of the Employee's Continuous Status as an Employee had occurred).

10. Non-Transferability of Options. The Option may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution and may be exercised, during the lifetime of the Optionee, only by the Optionee; provided that the Board may permit further transferability, on a general or specific basis, and may impose conditions and limitations on any permitted transferability.

11. Adjustments Upon Changes in Capitalization or Merger. Subject to any required action by the shareholders of the Company, the number of Shares covered by each outstanding Option, the Maximum Annual Employee Grant and the number of Shares which have been authorized for issuance under the Plan but as to which no Options have yet been granted or which have been returned to the Plan upon cancellation or expiration of an Option, as well as the price per Share covered by each such outstanding Option, shall be proportionately adjusted for any increase or decrease in the number of issued Shares resulting from a stock split, reverse stock split, stock dividend, combination, or reclassification of the Shares, or any other increase or decrease in the number of issued Shares effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been "effected without receipt of consideration." Such adjustment shall be made by the Board, whose determination in that respect shall be final, binding, and conclusive. Except as expressly provided herein, no issuance by the Company of shares of any class, or securities convertible into shares of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of Shares subject to an Option.

In the event of the proposed dissolution or liquidation of the Company, the Option will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Board. The Board may, in the

exercise of its sole discretion in such instances, declare that any Option shall terminate as of a date fixed by the Board and give each Optionee the right to exercise an Option as to all or any part of the Optioned Shares, including Shares as to which the Option would not otherwise be exercisable. In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, each Option shall be assumed or an equivalent option shall be substituted by such successor corporation or a parent or subsidiary of such successor corporation, unless such successor corporation does not agree to assume the Option or to substitute an equivalent option, in which case the Board shall, in lieu of such assumption or substitution, provide for the Optionee to have the right to exercise the Option as to all of the Optioned Shares, including Shares as to which the Option would not otherwise be exercisable. If the Board makes an Option
<PAGE>

fully exercisable in lieu of assumption or substitution in the event of a merger or sale of assets, the Board shall notify the Optionee that the Option shall be fully exercisable for a period of fifteen (15) days from the date of such notice, and the Option will terminate upon the expiration of such period.

12. Time of Granting Options. The date of grant of an Option shall, for all purposes, be the date on which the Company completes the corporate action relating to the grant of an option and all conditions to the grant have been satisfied, provided that conditions to the exercise of an option shall not defer the date of grant. Notice of a grant shall be given to each Employee to whom an Option is so granted within a reasonable time after the determination has been made.

13. Substitutions and Assumptions. The Board shall have the right to substitute or assume Options in connection with mergers, reorganizations, separations, or other transactions to which Section 424(a) of the Code applies, provided such substitutions and assumptions are permitted by Section 424 of the Code and the regulations promulgated thereunder. The number of Shares reserved pursuant to Section 3 may be increased by the corresponding number of Options assumed and, in the case of a substitution, by the net increase in the number of Shares subject to Options before and after the substitution.

14. Amendment and Termination of the Plan.

(a) Amendment and Termination. The Board may amend or terminate the Plan from time to time in such respects as the Board may deem advisable (including, but not limited to amendments which the Board deems appropriate to enhance the Company's ability to claim deductions related to stock option exercises); provided that any increase in the number of Shares subject to the Plan, other than in connection with an adjustment under Section 11 of the Plan, shall require approval of or ratification by the shareholders of the Company.

(b) Employees in Foreign Countries. The Board shall have the authority to adopt such modifications, procedures, and subplans as may be necessary or desirable to comply with provisions of the laws of foreign countries in which the Company or its Subsidiaries may operate to assure the viability of the benefits from Options granted to Employees employed in such countries and to meet the objectives of the Plan.

(c) Effect of Amendment or Termination. Any such amendment or termination of the Plan shall not affect Options already granted and such Options shall remain in full force and effect as if this Plan had not been amended or terminated, unless mutually agreed otherwise between the Optionee and the Board, which agreement must be in writing and signed by the Optionee and the Company.

15. Conditions Upon Issuance of Shares. Shares shall not be issued pursuant to the exercise of an Option unless the exercise of such Option and the issuance and delivery of such
<PAGE>

Shares pursuant thereto shall comply with all relevant provisions of law, including, without limitation, the Securities Act of 1933, as amended, the Exchange Act, the rules and regulations promulgated thereunder, and the requirements of any stock exchange upon which the Shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

16. Reservation of Shares. The Company, during the term of this Plan, will at all times reserve and keep available such number of Shares as shall be sufficient to satisfy the requirements of the Plan.

17. Shareholder Approval. The Plan, as amended, is subject to approval by the shareholders of the Company at the Annual Meeting of Shareholders to be held on November 12, 1996. If the Plan, as herein amended, is not so approved by the shareholders, the Plan, as previously approved, shall continue in effect.

[The number of shares in Sections 3 and 5(e) have been increased to reflect the 2-for-1 stock splits in May 1994 and November 1996.]

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Exhibit 10.5.

Microsoft Corporation 1997 Employee Stock Purchase Plan

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MICROSOFT CORPORATION

1997 EMPLOYEE STOCK PURCHASE PLAN

Microsoft Corporation (the "Company") does hereby establish its 1997 Employee Stock Purchase Plan as follows:

1. Purpose of the Plan. The purpose of this Plan is to provide eligible employees who wish to become shareholders in the Company a convenient method of doing so. It is believed that employee participation in the ownership of the

business will be to the mutual benefit of both the employees and the Company.

2. Definitions.

2.1 "Base pay" means regular straight time earnings, plus review cycle bonuses and overtime payments, payments for incentive compensation, and other special payments except to the extent that any such item is specifically excluded by the Board of Directors of the Company (the "Board").

2.2 "Account" shall mean the funds accumulated with respect to an individual employee as a result of deductions from his paycheck for the purpose of purchasing stock under this Plan. The funds allocated to an employee's account shall remain the property of the respective employee at all times but may be commingled with the general funds of the Company.

3. Employees Eligible to Participate. Any employee of the Company or any of its subsidiaries who is in the employ of the Company or subsidiary on an offering commencement date is eligible to participate in that offering, except (a) employees whose customary employment is less than 20 hours per week, and (b) employees whose customary employment is for not more than five months in any calendar year.

4. Offerings. There will be twelve separate consecutive six-month offerings pursuant to the Plan. The first offering shall commence on January 1, 1997. Thereafter, offerings shall commence on each subsequent July 1 and January 1, and the final offering under this Plan shall commence on July 1, 2002 and terminate on December 31, 2002. In order to become eligible to purchase shares, an employee must sign an Enrollment Agreement, and any other necessary papers on or before the commencement date (January 1 or July 1) of the particular offering in which he wishes to participate. Participation in one offering under the Plan shall neither limit, nor require, participation in any other offering.

5. Price. The purchase price per share shall be the lesser of (1) 85% of the fair market value of the stock on the offering date; or (2) 85% of the fair market value of the stock on the last business day of the offering. Fair market value shall mean the closing bid price as reported on the National Association of Securities Dealers Automated Quotation System or, if the stock is traded on a stock exchange, the closing price for the stock on the principal such exchange.

6. Offering Date. The "offering date" as used in this Plan shall be the commencement date of the offering, if such date is a regular business day, or the first regular business day following such commencement date. A different date may be set by resolution of the Board.
<PAGE>

7. Number of Shares to be Offered. The maximum number of shares that will be offered under the Plan is 20,000,000 shares. The shares to be sold to participants under the Plan will be common stock of the Company. If the total number of shares for which options are to be granted on any date in accordance with Section 10 exceeds the number of shares then available under the Plan (after deduction of all shares for which options have been exercised or are then outstanding), the Company shall make a pro rata allocation of the shares remaining available in as nearly a uniform manner as shall be practicable and as it shall determine to be equitable. In such event, the payroll deductions to be made pursuant to the authorizations therefor shall be reduced accordingly and the Company shall give written notice of such reduction to each employee affected thereby.

8. Participation.

8.1 An eligible employee may become a participant by completing an Enrollment Agreement provided by the Company and filing it with Shareholder Services prior to the Commencement of the offering to which it relates.

8.2 Payroll deductions for a participant shall commence on the offering date, and shall end on the termination date of such offering unless earlier terminated by the employee as provided in Paragraph 14.

9. Payroll Deductions.

9.1 At the time a participant files his authorization for a payroll deduction, he shall elect to have deductions made from his pay on each payday during the time he is a participant in an offering at the rate of 2%, 4%, 6%, 8%, or 10% of his base pay.

9.2 All payroll deductions made for a participant shall be credited to his account under the Plan. A participant may not make any separate cash payment into such account nor may payment for shares be made other than by payroll deduction.

9.3 A participant may discontinue his participation in the Plan as provided in Section 14, but no other change can be made during an offering and, specifically, a participant may not alter the rate of his payroll deductions for that offering.

10. Granting of Option. On the offering date, this Plan shall be deemed to have granted to the participant an option for as many full shares as he will be able to purchase with the payroll deductions credited to his account during his participation in that offering. Notwithstanding the foregoing, no participant may purchase more than 2,000 shares of stock during any single offering.

11. Exercise of Option. Each employee who continues to be a participant in an offering on the last business day of that offering shall be deemed to have exercised his option on such date and shall be deemed to have purchased from the Company such number of full shares of common stock reserved for the purpose of the Plan as his accumulated payroll deductions on such date will pay for at the option price.
<PAGE>

12. Employee's Rights as a Shareholder. No participating employee shall have any right as a shareholder with respect to any shares until the shares have been purchased in accordance with Section 11 above and the stock has been issued by the Company.

13. Evidence of Stock Ownership.

13.1 Promptly following the end of each offering, the number of shares of common stock purchased by each participant shall be deposited into an account established in the participant's name at a stock brokerage or other financial services firm designated by the Company (the "ESPP Broker").

13.2 The participant may direct, by written notice to the Company at the time of his enrollment in the Plan, that his ESPP Broker account be established in the names of the participant and one other person designated by the participant, as joint tenants with right of survivorship, tenants in common, or community property, to the extent and in the manner permitted by applicable law.

13.3 A participant shall be free to undertake a disposition (as that term is defined in Section 424(c) of the Code) of the shares in his account at any time, whether by sale, exchange, gift, or other transfer of legal title, but in the absence of such a disposition of the shares, the shares must remain in the participant's account at the ESPP Broker until the holding period set forth in Section 423(a) of the Code has been satisfied. With respect to shares for which the Section 423(a) holding period has been satisfied, the participant may move those shares to another brokerage account of participant's choosing or request that a stock certificate be issued and delivered to him.

13.4 A participant who is not subject to payment of U.S. income taxes may move his shares to another brokerage account of his choosing or request that a stock certificate be issued and delivered to him at any time, without regard to the satisfaction of the Section 423(a) holding period.

14. Withdrawal.

14.1 An employee may withdraw from an offering, in whole but not in part, at any time prior to the last business day of such offering by delivering a Withdrawal Notice to the Company, in which event the Company will refund the entire balance of his deductions as soon as practicable thereafter.

14.2 To re-enter the Plan, an employee who has previously withdrawn must file a new Enrollment Agreement in accordance with Section 8.1. The employee's re-entry into the Plan will not become effective before the beginning of the next offering following his withdrawal, and if the withdrawing employee is an officer of the Company within the meaning of Section 16 of the Securities Exchange Act of 1934 he may not re-enter the Plan before the beginning of the second offering following his withdrawal.

15. Carryover of Account. At the termination of each offering the Company shall automatically re-enroll the employee in the next offering, and the balance in the employee's account shall be used for option exercises in the new offering, unless the employee has advised the Company otherwise. Upon termination of the Plan, the balance of each employee's account shall be refunded to him.

16. Interest. No interest will be paid or allowed on any money in the accounts of participating employees.

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17. Rights Not Transferable. No employee shall be permitted to sell, assign, transfer, pledge, or otherwise dispose of or encumber either the payroll deductions credited to his account or any rights with regard to the exercise of an option or to receive shares under the Plan other than by will or the laws of descent and distribution, and such right and interest shall not be liable for, or subject to, the debts, contracts, or liabilities of the employee. If any such action is taken by the employee, or any claim is asserted by any other party in respect of such right and interest whether by garnishment, levy, attachment or otherwise, such action or claim will be treated as an election to withdraw funds in accordance with Section 14.

18. Termination of Employment. Upon termination of employment for any

reason whatsoever, including but not limited to death or retirement, the balance in the account of a participating employee shall be paid to the employee or his estate.

19. Amendment or Discontinuance of the Plan. The Board shall have the right to amend, modify, or terminate the Plan at any time without notice, provided that no employee's existing rights under any offering already made under Section 4 hereof may be adversely affected thereby, and provided further that no such amendment of the Plan shall, except as provided in Section 20, increase above 20,000,000 shares the total number of shares to be offered unless shareholder approval is obtained therefor.

20. Changes in Capitalization. In the event of reorganization, recapitalization, stock split, stock dividend, combination of shares, merger, consolidation, offerings of rights, or any other change in the structure of the common shares of the Company, the Board may make such adjustment, if any, as it may deem appropriate in the number, kind, and the price of shares available for purchase under the Plan, and in the number of shares which an employee is entitled to purchase.

21. Share Ownership. Notwithstanding anything herein to the contrary, no employee shall be permitted to subscribe for any shares under the Plan if such employee, immediately after such subscription, owns shares (including all shares which may be purchased under outstanding subscriptions under the Plan) possessing 5% or more of the total combined voting power or value of all classes of shares of the Company or of its parent or subsidiary corporations. For the foregoing purposes the rules of Section 425(d) of the Internal Revenue Code of 1986 shall apply in determining share ownership. In addition, no employee shall be allowed to subscribe for any shares under the Plan which permits his rights to purchase shares under all "employee stock purchase plans" of the Company and its subsidiary corporations to accrue at a rate which exceeds $25,000 of the fair market value of such shares (determined at the time such right to subscribe is granted) for each calendar year in which such right to subscribe is outstanding at any time.

22. Administration. The Plan shall be administered by the Board. The Board may delegate any or all of its authority hereunder to such committee of the Board or officer of the Company as it may designate. The administrator shall be vested with full authority to make, administer, and interpret such rules and regulations as it deems necessary to administer the Plan, and any determination, decision, or action of the administrator in connection with the construction, interpretation, administration, or application of the Plan shall be final, conclusive, and binding upon all participants and any and all persons claiming under or through any participant.

23. Notices. All notices or other communications by a participant to the Company under or in connection with the Plan shall be deemed to have been duly given when received by Shareholder Services of the Company or when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.
<PAGE>

24. Termination of the Plan. This Plan shall terminate at the earliest of the following:

24.1 December 31, 2002;

24.2 The date of the filing of a Statement of Intent to Dissolve by the Company or the effective date of a merger or consolidation wherein the Company is not to be the surviving corporation, which merger or consolidation is not between or among corporations related to the Company. Prior to the occurrence of either of such events, on such date as the Company may determine, the Company may permit a participating employee to exercise the option to purchase shares for as many full shares as the balance of his account will allow at the price set forth in accordance with Section 5. If the employee elects to purchase shares, the remaining balance of his account will be refunded to him after such purchase.

24.3 The date the Board acts to terminate the Plan in accordance with Section 19 above.

24.3 The date when all shares reserved under the Plan have been purchased.

25. Limitations on Sale of Stock Purchased Under the Plan. The Plan is intended to provide common stock for investment and not for resale. The Company does not, however, intend to restrict or influence any employee in the conduct of his own affairs. An employee, therefore, may sell stock purchased under the Plan at any time he chooses, subject to compliance with any applicable Federal or state securities laws. THE EMPLOYEE ASSUMES THE RISK OF ANY MARKET FLUCTUATIONS IN THE PRICE OF THE STOCK.

26. Governmental Regulation. The Company's obligation to sell and deliver shares of the Company's common stock under this Plan is subject to the approval of any governmental authority required in connection with the authorization, issuance, or sale of such shares.

[The number of shares in Sections 7, 10, and 19 have been increased to reflect the 2-for-1 stock split in November 1996.]
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Exhibit 11.

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

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	Year Ended June 30		
	1995	1996	1997
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Weighted average common shares outstanding	1,176	1,194	1,204
Common equivalent shares from stock options	78	87	108
Average common and equivalent shares outstanding /(1)/	1,254	1,281	1,312

Net income	$1,453	$2,195	$3,454
Earnings per share /(1)/	$ 1.16	$ 1.71	$ 2.63

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/(1)/ Fully diluted earnings per share have not been presented because the effects are not material.

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Exhibit 13.1

Quarterly Information
(In millions, except per share data) (Unaudited)

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	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
<S>	<C>	<C>	<C>	<C>	<C>
1995					
Revenue	$1,247	$1,482	$ 1,587	$ 1,621	$5,937
Operating income	437	520	549	532	2,038
Net income	316	373	396	368	1,453
Earnings per share	0.25	0.30	0.32	0.29	1.16
Common stock price per share:					
High	29.63	32.56	37.06	46.19	46.19
Low	23.44	26.94	29.13	34.38	23.44
1996					
Revenue	$2,016	$2,195	$ 2,205	$ 2,255	$8,671
Operating income	708	786	774	810	3,078
Net income	499	575	562	559	2,195
Earnings per share	0.39	0.45	0.44	0.43	1.71
Common stock price per share:					
High	54.63	51.69	53.53	62.94	62.94
Low	42.50	40.19	39.94	49.81	39.94
1997					
Revenue	$2,295	$2,680	$ 3,208	$ 3,175	$11,358
Operating income	902	1,081	1,568	1,579	5,130
Net income	614	741	1,042	1,057	3,454
Earnings per share	0.47	0.57	0.79	0.80	2.63
Common stock price per share:					
High	69.31	86.13	103.50	134.94	134.94
Low	53.75	65.44	80.75	89.75	53.75

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Exhibit 13.2

Financial Highlights
(In millions, except earnings per share)

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Year Ended June 30	1993	1994	1995	1996	1997
<S>	<C>	<C>	<C>	<C>	<C>
Revenue	$3,753	$4,649	$5,937	$ 8,671	$11,358
Net income	953	1,146	1,453	2,195	3,454
Earnings per share /(1)/	0.79	0.94	1.16	1.71	2.63
Return on revenue	25.4%	24.7%	24.5%	25.3%	30.4%
Cash and short-term investments	$2,290	$3,614	$4,750	$ 6,940	$ 8,966
Total assets	3,805	5,363	7,210	10,093	14,387
Stockholders' equity	3,242	4,450	5,333	6,908	10,777

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/(1)/ Earnings per share have been restated to reflect a two-for-one stock split in December 1996
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Exhibit 13.3

Management's Discussion and Analysis

Results of Operations for 1995, 1996, and 1997

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including scalable operating systems for information appliances, personal computers (PCs), and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company has recently expanded its interactive content efforts, including entertainment and information software programs, MSN, The Microsoft Network online service, Internet-based services, and alliances with companies involved with other forms of digital interactivity. Microsoft also sells personal

Applications & Content Product Group revenue was $3.58 billion, $4.56 billion, and $5.39 billion in 1995, 1996, and 1997. Applications and Content revenue includes primarily licenses of desktop and consumer productivity applications,
<PAGE>

desktop applications, the continued shift in mix toward corporate licenses from packaged products, and the ratable revenue recognition model for Office 97.

Absolute increases in desktop applications revenue during the three-year period were led by Microsoft Office. The primary programs in Microsoft Office are Microsoft Word word processor, Microsoft Excel spreadsheet, and Microsoft PowerPoint presentation graphics program. Various versions of Office, which are available for the 32-bit version of Windows, the 16-bit version of Windows, and Macintosh operating systems, also include Microsoft Access database management program, Microsoft Outlook desktop information manager, or other programs. Revenue from stand-alone versions of Microsoft Excel, Microsoft Word, and Microsoft PowerPoint continued to decrease as the sales mix shifted to integrated product suites. Microsoft Project scheduling and project management program revenue increased during the three-year period.

Microsoft offers a broad range of interactive media products, which also showed moderate growth. Products include CD-ROM multimedia reference titles and programs for home and small office productivity, children's creativity, and entertainment. In addition to The Microsoft Network, recently introduced online Internet services include travel information and reservations, local event information, and new-car buying.

The Company also markets input devices. Mouse and gaming device sales increased while keyboard revenue was steady during the three-year period.

Sales channels. The Company distributes its products primarily through OEM licenses, corporate and organizational licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the United States and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate and organization licenses and packaged products in these channels are primarily to distributors and resellers.

OEM channel revenue was $1.65 billion in 1995, $2.50 billion in 1996, and $3.48 billion in 1997. The primary source of OEM revenue is the licensing of desktop operating systems, and OEM revenue is highly dependent on PC shipment volume.

Licensing programs continued to grow in popularity across all geographic areas during the three-year period. Packaged product volume increased in 1996 due to the release of retail upgrade versions of Windows 95. U.S. and Canadian channel revenue was $1.88 billion, $2.68 billion, and $3.41 billion in 1995, 1996, and 1997. Revenue in Europe was $1.49 billion, $2.02 billion, and $2.54 billion in 1995, 1996, and 1997. Growth rates have been lower in Europe than in other geographic areas due to general economic slowness, higher existing market shares, and a more dramatic shift to licensing programs. Other International channel revenue was $924 million in 1995, $1.47 billion in 1996, and $1.93 billion in 1997. Growth rates were higher in the Other International channel due to customers accepting newly localized products, particularly in Japan, and penetration in emerging markets.

The Company's operating results are affected by foreign exchange rates. Approximately 37%, 34%, and 32% of the Company's revenue was collected in foreign currencies during 1995, 1996, and 1997. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

Operating Expenses

Exhibit 13.4

Microsoft Corporation

Financial Statements

Income Statements for the three years ended June 30, 1997

Cash Flows Statements for the three years ended June 30, 1997

Balance Sheets as of June 30, 1996 and 1997

Stockholders' Equity Statements for the three years ended June 30, 1997

Notes to Financial Statements

Independent Auditors' Report
<PAGE>

Income Statements
(In millions, except earnings per share)

<TABLE>
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Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Revenue	$5,937	$8,671	$11,358
Operating expenses:			
Cost of revenue	877	1,188	1,085
Research and development	860	1,432	1,925
Sales and marketing	1,895	2,657	2,856
General and administrative	267	316	362
Total operating expenses	3,899	5,593	6,228
Operating income	2,038	3,078	5,130
Interest income	191	320	443
Other expenses	(62)	(19)	(259)
Income before income taxes	2,167	3,379	5,314
Provision for income taxes	714	1,184	1,860
Net income	1,453	2,195	3,454
Preferred stock dividends	--	--	15
Net income available for common shareholders	$1,453	$2,195	$ 3,439
Earnings per share(1)	$ 1.16	$ 1.71	$ 2.63
Weighted average shares outstanding(1)	1,254	1,281	1,312

</TABLE>

See accompanying notes.

(1) Share and per share amounts have been restated to reflect a two-for-one stock split in December 1996.
<PAGE>

Cash Flows Statements
(In millions)

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Cash flows from operations			
Net income	$ 1,453	$ 2,195	$ 3,454
Depreciation and amortization	269	480	557
Unearned revenue	69	983	1,601
Recognition of unearned revenue from prior periods	(54)	(477)	(743)
Other current liabilities	404	584	321
Accounts receivable	(91)	(71)	(336)
Other current assets	(60)	25	(165)
Net cash from operations	1,990	3,719	4,689
Cash flows used for financing			
Common stock issued	332	504	744
Common stock repurchased	(698)	(1,385)	(3,101)
Put warrant proceeds	49	124	95
Preferred stock issued	--	--	980
Preferred stock dividends	--	--	(15)
Stock option income tax benefits	179	352	796
Net cash used for financing	(138)	(405)	(501)
Cash flows used for investments			
Additions to property, plant, and equipment	(495)	(494)	(499)
Equity investments and other	(230)	(625)	(1,669)
Short-term investments	(651)	(1,551)	(921)
Net cash used for investments	(1,376)	(2,670)	(3,089)
Net change in cash and equivalents	476	644	1,099
Effect of exchange rates on cash and equivalents	9	(5)	6
Cash and equivalents, beginning of year	1,477	1,962	2,601
Cash and equivalents, end of year	1,962	2,601	3,706
Short-term investments	2,788	4,339	5,260
Cash and short-term investments	$ 4,750	$ 6,940	$ 8,966

</TABLE>

See accompanying notes.
<PAGE>

Balance Sheets
(In millions)

<TABLE>
<CAPTION>

June 30	1996	1997
<S>	<C>	<C>
Assets		
Current assets:		
Cash and short-term investments	$ 6,940	$ 8,966
Accounts receivable	639	980
Other	260	427
Total current assets	7,839	10,373
Property, plant, and equipment	1,326	1,465
Equity investments	675	2,346
Other assets	253	203
Total assets	$10,093	$14,387
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 808	$ 721
Accrued compensation	202	336
Income taxes payable	484	466

Unearned revenue	560	1,418
Other	371	669
Total current liabilities	2,425	3,610
Minority interest	125	--
Put warrants	635	--
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock--shares authorized 0 and 100; shares issued and outstanding 0 and 13	--	980
Common stock and paid-in capital--shares authorized 4,000; shares issued and outstanding 1,194 and 1,204	2,924	4,509
Retained earnings	3,984	5,288
Total stockholders' equity	6,908	10,777
Total liabilities and stockholders' equity	$10,093	$14,387

</TABLE>

See accompanying notes.
<PAGE>

Stockholders' Equity Statements
(In millions)

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Convertible preferred stock			
Convertible preferred stock issued	--	--	$ 980
Balance, end of year	--	--	980
Common stock and paid-in capital			
Balance, beginning of year	$1,500	$ 2,005	2,924
Common stock issued	332	504	744
Common stock repurchased	(30)	(41)	(91)
Proceeds from sale of put warrants	49	124	95
Reclassification of put warrant obligation	(25)	(20)	45
Stock option income tax benefits	179	352	792
Balance, end of year	2,005	2,924	4,509
Retained earnings			
Balance, beginning of year	2,950	3,328	3,984
Net income	1,453	2,195	3,454
Preferred stock dividends	--	--	(15)
Common stock repurchased	(668)	(1,344)	(3,010)
Reclassification of put warrant obligation	(380)	(210)	590
Net unrealized investment gains and other	(27)	15	285
Balance, end of year	3,328	3,984	5,288
Total stockholders' equity	$5,333	$ 6,908	$10,777

</TABLE>

See accompanying notes.
<PAGE>

Notes to Financial Statements
(In millions, except per share amounts)

Significant Accounting Policies

Accounting principles. The financial statements are prepared on a basis consistent with U.S. generally accepted accounting principles and International

Accounting Standards formulated by the International Accounting Standards Committee (IASC).

Principles of consolidation. The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated. Investments in 50% owned joint ventures are accounted for using the equity method; the Company's share of joint ventures' activities is reflected in other expenses.

Estimates and assumptions. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates.

Foreign currencies. Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenue, costs, and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

Revenue recognition. Revenue is recognized when earned. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from corporate and organization license programs is recorded when the user installs the product. Revenue from packaged product sales to distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. Revenue attributable to significant support (technical support and unspecified enhancements such as service packs and Internet browser updates) is based on the price charged or derived value of the undelivered elements and is recognized ratably on a straight-line basis over the product's life cycle. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for returns and bad debts.

Research and development. Research and development costs are expensed as incurred. The current U.S. accounting rule, Statement of Financial Accounting Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.

Telephone support. Telephone support costs are included in sales and marketing.

Income taxes. Income tax expense includes U.S. and international income taxes, plus an accrual for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

Earnings per share. Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options using the "treasury stock" method and preferred shares using the "if-converted" method. Beginning in the second quarter of 1998, Microsoft will be required to report earnings per outstanding common share in addition to diluted earnings per share. Earnings per common share computed under the new pronouncement would have been $1.25, $1.85, and $2.87 while reported diluted earnings per share were $1.16, $1.71, and $2.63 in 1995, 1996, and 1997.

Stock split. In December 1996, outstanding shares of common stock were split two-for-one. All share and per share amounts have been restated.

Financial instruments. The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and five years from the purchase date. All cash and short-term investments are classified as available for sale and are recorded at market. Cost approximates market for all classifications of cash and short-term investments; realized and unrealized gains and losses were not material.

Publicly tradeable equity securities are recorded at market; unrealized gains and losses are reflected in stockholders' equity.

Property, plant, and equipment. Property, plant, and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 30 years.
<PAGE>

Reclassifications. Certain reclassifications have been made for consistent presentation.

Unearned Revenue

In fiscal 1996, Microsoft committed to integrating its Internet technologies, such as the Company's Internet browser, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other support commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating systems revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was $425 million and $860 million at June 30, 1996 and 1997.

Since Office 97 is also tightly integrated with the rapidly evolving Internet, and subsequent delivery of new Internet technologies, enhancements, and other support is likely to be more than minimal, a ratable revenue recognition policy became effective for Office 97 licenses beginning in 1997. Approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled $300 million at June 30, 1997.

Unearned revenue also includes maintenance and other subscription contracts, including custom corporate license agreements.

Financial Risks

The Company's investment portfolio is diversified and consists primarily of short-term investment grade securities. At June 30, 1996 and 1997, approximately 38% and 31% of accounts receivable represented amounts due from 10 channel purchasers. One customer accounted for approximately 12%, 13%, and 12% of revenue while another customer accounted for approximately 12%, 8%, and 5% of revenue in 1995, 1996, and 1997.

Finished goods sales to international customers in Europe, Japan, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. European manufacturing costs and international selling, distribution, and support costs are generally disbursed in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Therefore, foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses. As a result, Microsoft's hedging activities for balance sheet exposures have been minimal.

At June 30, 1997, the Company had contracts to deliver $500 million in a foreign currency, expiring July 1998, which hedge foreign exchange rate risk related to a foreign currency denominated investment.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a percentage of planned international revenue with purchased options. The notional amount of the options outstanding at June 30, 1997 was $2.1 billion. At June 30, 1997, the fair value and premiums paid for the options were not material.

Cash and Short-Term Investments

<TABLE>
<CAPTION>

June 30	1996	1997
<S>	<C>	<C>
Cash and equivalents:		
Cash	$ 64	$ 246
Commercial paper	1,664	1,660
Money market preferreds	105	946
Certificates of deposit	768	854
Cash and equivalents	2,601	3,706
Short-term investments:		
Municipal securities	1,357	571
Corporate notes and bonds	1,125	1,907
U.S. Treasury securities	1,591	1,513
Certificates of deposit	266	1,269
Short-term investments	4,339	5,260
Cash and short-term investments	$6,940	$8,966

</TABLE>
<PAGE>

Property, Plant, and Equipment

<TABLE>
<CAPTION>

June 30	1996	1997
<S>	<C>	<C>
Land	$ 183	$ 183
Buildings	787	1,027
Computer equipment	885	1,064
Other	491	503
Property, plant, and equipment--at cost	2,346	2,777
Accumulated depreciation	(1,020)	(1,312)
Property, plant, and equipment--net	$ 1,326	$ 1,465

</TABLE>

During 1996 and 1997, depreciation expense, of which the majority related to computer equipment, was $363 million and $353 million; disposals were immaterial.

Income Taxes

The provision for income taxes consisted of:

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Current taxes:			
U.S. and state	$ 518	$1,139	$1,710
International	151	285	412
Current taxes	669	1,424	2,122
Deferred taxes	45	(240)	(262)
Provision for income taxes	$ 714	$1,184	$1,860

</TABLE>

U.S. and international components of income before income taxes were:

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
U.S.	$1,549	$2,356	$3,775
International	618	1,023	1,539
Income before income taxes	$2,167	$3,379	$5,314

</TABLE>

Income taxes payable were:

<TABLE>
<CAPTION>

June 30	1996	1997
<S>	<C>	<C>
Deferred income tax assets:		
Revenue items	$ 193	$ 474
Expense items	322	505
Deferred income tax assets	515	979
Deferred income tax liabilities:		
International earnings	(261)	(465)
Other	(6)	(4)
Deferred income tax liabilities	(267)	(469)
Current income tax liabilities	(732)	(976)
Income taxes payable	$(484)	$(466)

</TABLE>

Income taxes have been settled with the Internal Revenue Service for all years

through 1989. The IRS has assessed taxes for 1990 and 1991 that the Company is contesting in Tax Court. The IRS is examining the Company's U.S. income tax returns for 1992 through 1994. Management believes any related adjustments that might be required will not be material to the financial statements. Income taxes paid were $430 million, $758 million, and $1.1 billion in 1995, 1996, and 1997.
<PAGE>

Convertible Preferred Stock

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

Common Stock

Shares of common stock outstanding were as follows:

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Balance, beginning of year	1,162	1,176	1,194
Issued	38	44	47
Repurchased	(24)	(26)	(37)
Balance, end of year	1,176	1,194	1,204

</TABLE>

The Company repurchases its common stock in the open market to provide shares for issuing to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 1998.

Put Warrants

To enhance its stock repurchase program, the Company sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 1996 and 1997, 13.0 million and 3.0 million warrants were outstanding. Outstanding put warrants at June 30, 1997 expire in September 1997 and have strike prices of $105 per share. At June 30, 1996, the outstanding put warrants were settleable in cash at Microsoft's option thus resulting in a reclassification of the maximum potential repurchase obligation of $635 million from stockholders' equity to put warrants. The outstanding put warrants at June 30, 1997 permitted a net-share settlement at the Company's option and did not result in a put warrant liability on the balance sheet.

Employee Stock and Savings Plans

Employee stock purchase plan. The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1995, 1996, and 1997, employees purchased 2.1

million, 1.8 million, and 1.4 million shares at average prices of $23.38, $37.72, and $59.64 per share. At June 30, 1997, 19.4 million shares were reserved for future issuance.

Savings plan. The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may defer up to 15% of pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were $12 million, $15 million, and $28 million in 1995, 1996, and 1997.

Stock option plans. The Company has stock option plans for directors, officers, and all employees, which provide for nonqualified and incentive stock options. The option exercise price is the fair market value at the date of grant. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after 10 years. At June 30, 1997, options for 113 million shares were vested and 290 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

<TABLE>
<CAPTION>

		Price per Share	
	Shares	Range	Weighted Average
<S>	<C>	<C>	<C>
Balance, June 30, 1994	228	$ 0.16 - $ 25.07	$11.65
Granted	44	23.88 - 41.57	25.25
Exercised	(35)	0.16 - 23.88	7.91
Canceled	(9)	2.56 - 37.50	17.70
Balance, June 30, 1995	228	0.77 - 41.57	14.56
Granted	57	40.10 - 58.94	44.99
Exercised	(40)	0.77 - 45.25	10.75
Canceled	(7)	2.59 - 55.44	27.85
Balance, June 30, 1996	238	1.10 - 58.94	22.07
Granted	55	55.31 - 119.19	58.29
Exercised	(45)	1.10 - 58.94	13.27
Canceled	(9)	17.00 - 97.13	38.83
Balance, June 30, 1997	239	2.24 - 119.19	31.43

</TABLE>
<PAGE>

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1997 were as follows:

<TABLE>
<CAPTION>

		Outstanding options		Exercisable options	
Range of exercise prices	Shares	Remaining life (years)	Weighted average price	Shares	Weighted average price

<S>	<C>	<C>	<C>	<C>	<C>
$2.24-$17.00	65	3.5	$ 9.64	64	$ 9.63
17.01-24.00	65	5.4	20.81	39	20.10
24.01-55.00	56	5.8	43.13	10	41.02
55.01-119.19	53	6.6	58.47	--	--

</TABLE>

The Company follows APB Opinion 25, Accounting for Stock Issued to Employees, to account for stock option and employee stock purchase plans. No compensation cost is recognized because the option exercise price is equal to the market price of the underlying stock on the date of grant. Had compensation cost for these plans been determined based on the Black-Scholes value at the grant dates for awards as prescribed by SFAS Statement 123, Accounting for Stock-Based Compensation, pro forma net income and earnings per share would have been:

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Pro forma net income	$1,243	$1,902	$3,053
Pro forma earnings per share	$ 0.99	$ 1.48	$ 2.32

</TABLE>

The pro forma disclosures above include the amortization of the fair value of all options vested during 1995, 1996, and 1997. If only options granted during 1996 and 1997 were valued, as prescribed by SFAS 123, pro forma net income would have been $2,073 million and $3,179 million, and earnings per share would have been $1.62 and $2.42 for 1996 and 1997.

The weighted average Black-Scholes value of options granted under the stock option plans during 1995, 1996, and 1997 was $10.46, $17.72, and $23.43. Value was estimated using an expected life of five years, no dividends, volatility of .30, and risk-free interest rates of 7.0%, 6.0%, and 6.5% in 1995, 1996, and 1997.

MSN, The Microsoft Network

During October 1996, Microsoft and a subsidiary of Tele-Communications, Inc. (TCI) terminated a partnership under which TCI owned a 20% minority interest in The Microsoft Network, LLC, owner of the business assets of MSN, an online service. Due to the evolving nature of the online industry and the move by MSN to a Web-based offering, the original direction of the partnership changed and both Microsoft and TCI agreed to terminate this partnership focused exclusively on MSN. In return for approximately $125 million of TCI securities, Microsoft became the sole owner of MSN and the minority interest on the accompanying balance sheet was eliminated. There was no other material financial impact of the dissolution.

Acquisition

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. A director of the
<PAGE>

Company owned 10% of WebTV. Microsoft paid $425 million in stock and cash for WebTV. The Company expects to record an in-process R&D write-off of

$300 million in the first quarter of 1998.

Commitments and Contingencies

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $86 million, $92 million, and $92 million in 1995, 1996, and 1997. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1998, $67; 1999, $54; 2000, $43; 2001, $30; 2002, $12; and thereafter, $16.

In connection with the Company's communications infrastructure and the operation of MSN, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 1998, $133; 1999, $119; 2000, $92; and 2001, $20. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed $300 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

In an ongoing investigation, the Antitrust Division of the U.S. Department of Justice requested information from Microsoft concerning various issues. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business. Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

Geographic Information

<TABLE>
<CAPTION>

Year Ended June 30	1995	1996	1997
<S>	<C>	<C>	<C>
Revenue			
U.S. operations	$ 4,495	$ 6,739	$ 8,877
European operations	1,607	2,215	2,770
Other international operations	821	1,267	1,757
Eliminations	(986)	(1,550)	(2,046)
Total revenue	$ 5,937	$ 8,671	$11,358
Operating income			
U.S. operations	$ 1,414	$ 2,137	$ 3,733
European operations	444	649	1,013
Other international operations	163	297	469
Eliminations	17	(5)	(85)
Total operating income	$ 2,038	$ 3,078	$ 5,130
Identifiable assets			
U.S. operations	$ 5,862	$ 8,193	$11,630
European operations	1,806	2,280	3,395
Other international operations	689	1,042	705
Eliminations	(1,147)	(1,422)	(1,343)
Total identifiable assets	$ 7,210	$10,093	$14,387

</TABLE>

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the United States, licensing to OEMs, and exports of finished goods directly to international customers, primarily in Asia, South America, and Canada. Exports and international OEM transactions are primarily in U.S. dollars and totaled $1.3 billion, $2.1 billion, and $2.5 billion in 1995, 1996, and 1997.

"Other international operations" primarily include subsidiaries in Japan, Canada, Australia, and Brazil. International revenue, which includes European operations, other international operations, exports, and OEM distribution, was 55%, 56%, and 56% of total revenue in 1995, 1996, and 1997. Most international identifiable assets are U.S. dollar denominated investment securities.
<PAGE>

Subsidiaries

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399
Microsoft FSC Corp. (U.S. VIRGIN ISLANDS)
Microsoft Investments, Inc. (NEVADA)
Microsoft Licensing, Inc. (NEVADA)
Microsoft Manufacturing B.V. (THE NETHERLANDS)
Microsoft Puerto Rico, Inc. (Manufacturing) (DELAWARE)
Microsoft Research Limited (United Kingdom)
The Microsoft Network L.L.C. (DELAWARE)
GraceMac Corporation (NEVADA)
Vermeer Technologies, Inc. (DELAWARE)
Microsoft de Argentina S.A.
Microsoft Pty. Limited (AUSTRALIA)
Microsoft Gesellschaft m.b.H. (AUSTRIA)
Microsoft N.V. (BELGIUM)
Microsoft Informatica Limitada (BRAZIL)
Microsoft Canada Co.
SOFTIMAGE, Inc. (CANADA)
Microsoft Chile S.A.
Microsoft Colombia Inc. (DELAWARE)
Microsoft de Centroamerica S.A. (COSTA RICA)
Microsoft Hrvatska d.o.o. (CROATIA)
Microsoft s.r.o. (CZECH REPUBLIC)
Microsoft Danmark ApS (DENMARK)
Microsoft Del Ecuador S.A.
Microsoft Corporation (Representative Office) (EGYPT)
Microsoft Oy (FINLAND)
Microsoft France S.A.R.L.
Microsoft G.m.b.H. (GERMANY)
SOFTIMAGE G.m.b.H. (GERMANY)
Microsoft Hellas S.A. (GREECE)
Microsoft de Guatemala, S.A.
Microsoft Hong Kong Limited
Microsoft Hungary Kft.
Microsoft Corporation (India) Private Limited
PT. Microsoft Indonesia
Microsoft Israel Ltd.
Microsoft S.p.A. (ITALY)
Microsoft Cote d'Ivoire (IVORY COAST)
Microsoft Company, Limited (JAPAN)
East Africa Software Limited (KENYA)
Microsoft CH (KOREA)
Microsoft (Malaysia) Sdn. Bhd.
Microsoft Mexico, S.A. de C.V.

Microsoft Maroc S.A.R.L. (MOROCCO)
<PAGE>

Microsoft B.V. (THE NETHERLANDS)
Microsoft International B.V. (THE NETHERLANDS)
Microsoft New Zealand Limited
Microsoft Norge AS (NORWAY)
Microsoft de Panama, S.A.
Microsoft (China) Company Limited (THE PEOPLE'S REPUBLIC OF CHINA)
Microsoft Peru, S.A.
Microsoft Philippines, Inc.
Microsoft sp. z.o.o. (POLAND)
MSFT-Software Para Microcomputadores, LDA (PORTUGAL)
Microsoft Caribbean, Inc. (PUERTO RICO) (DELAWARE)
Microsoft Romania SRL
Microsoft ZAO (RUSSIA)
Microsoft Singapore Pte Ltd
Microsoft Slovakia s.r.o.
Microsoft d.o.o., Ljubljana (SLOVENIA)
Microsoft (S.A.) (Proprietary) Limited (SOUTH AFRICA)
Microsoft Iberica S.R.L. (SPAIN)
Microsoft Aktiebolag (SWEDEN)
Microsoft AG (SWITZERLAND)
Microsoft Taiwan Corporation
Microsoft (Thailand) Limited
Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (TURKEY)
Microsoft Corporation (UNITED ARAB EMIRATES)
Microsoft Limited (UNITED KINGDOM)
SOFTIMAGE U.K. Limited
Microsoft Uruguay S.A.
Corporation MS 90 de Venezuela S.A.
The Resident Representative Office of MICROSOFT Corporation in Hanoi (VIETNAM)
DreamWorks Interactive L.L.C. (WASHINGTON, 50% owned)
MSBET L.L.C. (DELAWARE, 50% owned)
MSFDC, L.L.C. (DELAWARE, 50% owned)
MSNBC Cable, L.L.C. (DELAWARE, 50% owned)
MSNBC Interactive News, L.L.C. (DELAWARE, 50% owned)
<PAGE>

Independent Auditors' Report

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1996 and 1997, and the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1996 and 1997, and the results of their operations and their cash flows for each of the three years ended June 30, 1997 in conformity with accounting principles generally accepted in the United States and International Accounting Standards.

/s/ DELOITTE & TOUCHE LLP

Deloitte & Touche LLP

Seattle, Washington
July 17, 1997 (August 1, 1997 as to Acquisition Note)
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Exhibit 23.

Independent Auditors' Consent

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981 Stock Option Plan), 33-44302 and 33-51583 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors), 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors), 333-16665 (Microsoft Corporation 1997 Employee Stock Purchase Plan) and 333-06298 of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, 33-63471, 33-64870, 333-857, 333-1177, 333-2759, 333-5961, 333-8081, 333-12441, 333-17143, 333-18055, 333-18195, 333-23621, and 333-31803 of Microsoft Corporation on Forms S-3 and 333-26411 of Microsoft Corporation on Form S-4 of our report dated July 17, 1997 (August 1, 1997 as to Acquisition Note) appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 1997.

/s/ DELOITTE & TOUCHE LLP

Deloitte & Touche LLP

Seattle, Washington
September 26, 1997
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STATE OF INCORPORATION: DE
FISCAL YEAR END: 0630

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BUSINESS ADDRESS:
STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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ITEM 1. BUSINESS

GENERAL

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and development tools. Microsoft also markets personal computer books and input devices and is engaged in the research and development of online and advanced technology software products. Microsoft(R) products are available for most PCs, including Intel-type microprocessor-based computers and Apple computers.

Microsoft's business strategy emphasizes the development of a broad line of microcomputer software products for business and personal use, marketed through multiple channels of distribution. The Company is divided into four main groups: the Platforms Product Group; the Applications and Content Product Group; the Sales and Support Group; and the Operations Group.

The Platforms Product Group is comprised of four divisions, each responsible for a particular area of platforms software development and marketing. The Personal Systems Division designs and develops operating systems and technologies (such as multimedia, user interface, and online browsers) for general and home PC users. The Business Systems Division is responsible for computing solutions for corporate and enterprise use, including client-server operating systems, networking products, and server and workgroup applications. The Developer Division creates database products, as well as programming language products and software development tools. The Consumer Systems Division is developing software products and technologies for use on the emerging public networks, including future interactive television networks, and for creating advanced multimedia applications, such as 3D titles.

The Applications and Content Product Group has two divisions that create and market productivity programs for PCs and multimedia content titles. The group also includes online systems and research. The Desktop Applications Division creates productivity applications. The Consumer Division develops products designed for the home, school, and small business market, including multimedia consumer products and PC input devices. The MSN Division is responsible for an online and Internet service. Microsoft Research is a research lab dedicated to creating new technology in support of the Company's vision for the evolution of personal computing.

The Sales and Support Group is responsible for building long-term business relationships with customers. This group is organized to serve three customer types: OEMs (original equipment manufacturers), end users, and organizations. The Sales and Support Group manages the channels that serve those customers. These include the OEM channel and the following geographic channels: U.S. and Canada, Europe, and Other International. The group also provides support for the Company's products through Product Support Services, Consulting Services, and Solutions Providers.

The Operations Group is responsible for managing business operations and overall business planning. This includes the process of manufacturing and delivering finished goods, licenses, subscriptions, and fulfillment orders; the programs. The Company also has Windows NT and Macintosh versions of Microsoft Word.

Microsoft Excel: The Company's spreadsheet program is Microsoft Excel, which is available for Windows 95, Windows 3.x, Windows NT, and Macintosh operating systems. It is an integrated spreadsheet with pivot table, database, and business graphics capabilities. Microsoft Excel allows full linking and embedding of objects that permits users to view and edit graphics or charts from other Windows-based programs from the worksheet in which the object is stored. Microsoft Excel graphics capabilities can be linked to its spreadsheets to allow simultaneous changes to charts as changes are made to the spreadsheets.

Microsoft PowerPoint: Microsoft PowerPoint is a presentation graphics program for producing slides, overheads, transparencies, and prints. The Company markets versions of PowerPoint for Windows 95, Windows 3.x, and the Macintosh.

Microsoft Project: Microsoft Project is a critical path project scheduling and resource allocation program that runs on Windows 95, Windows 3.x, and Macintosh operating systems. The product can perform as a budgeting, monitoring, and cost estimating tool for large business projects and as a critical path and schedule planning tool.

ONLINE SERVICES

The MSN Division manages MSN, The Microsoft Network, a new, interactive online service. MSN provides easy and inexpensive access for users to a wide range of graphically-rich online content, a compelling business model and platform for independent content providers (ICPs), and rich and powerful development tools.

The Microsoft Network: Client-access software for MSN is included as a feature of Windows 95, which was released commercially on August 24, 1995. The online service provides access to the Internet, electronic mail, bulletin boards, and myriad additional services offered by Microsoft and by independent content providers. The Microsoft Internet Explorer, an Internet browser, takes advantage of various technical advances in Windows 95 and includes real-time audio capabilities. Content and service providers aligned with MSN

have flexibility in creating products and pricing their services, such as subscriptions, online transactions, and ticket events. Services may be supported by advertising and commerce.

MSN is owned by The Microsoft Network, LLC (formerly the Microsoft Online Services Partnership). Microsoft owns 80% of the entity and a wholly owned subsidiary of Tele-Communications, Inc. (TCI) owns the remaining 20%.

CONSUMER PRODUCTS

The Microsoft Consumer Division develops and markets useful, enjoyable, and fundamental software and services for small businesses, schools, and homes. The division is developing and managing a synergistic product line focusing on the following categories of consumer usage: Information, Productivity, Kids, Personal Finance, Entertainment, and PC Input Devices. Many of the titles are available on CD-ROM.

Information: Reference titles include Microsoft Encarta(TM) and Microsoft Bookshelf(R), which are both available for Windows 3.x and Macintosh operating systems. The Encarta multimedia encyclopedia database blends text in articles with a wealth of innovative, interactive information presented through animations, videos, maps, charts, sounds, and pictures. Bookshelf is a multimedia reference library that integrates seven well-respected and authoritative works on one compact disc, including a dictionary, world atlas, world almanac, thesaurus, concise encyclopedia, and two books of quotations.

Personal interest titles include Microsoft Cinemania(TM), an interactive guide to the movies with entries for 19,000 films, Microsoft Dinosaurs, and many musical titles.

Geography and travel products include Automap Road Atlas, a comprehensive route-planning program with detailed maps and road information for routes in North America.

Productivity: The Company's leading consumer productivity products are Microsoft Works and Microsoft Publisher. The Company markets versions of Microsoft Works that run on Windows 95, Windows 3.x, MS-DOS, and Macintosh operating systems. Microsoft Works is an integrated software program that contains basic word processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Microsoft Publisher is an easy-to-use, entry-level desktop publishing tool for Windows 95 and Windows 3.x operating systems. Publisher features an interactive tool that automates the design process of 12 custom publications, including newsletters, calendars, greeting cards, and invitations.

Kids: Titles for children include Microsoft Creative Writer and Microsoft Fine Artist. Creative Writer is a full-featured creative writing and publishing program; Fine Artist is a comprehensive art program. Both products take advantage of the computer's ability to integrate text, high-quality graphics, sound, and animation to produce an enriching creative experience for children. The Company also has a series of products based on the popular children's books and television series, The Magic School Bus.

Personal Finance: Microsoft Money is a financial organization product that allows users to computerize their household finances. Microsoft Money is available for systems running Windows 95 and became available August 24, 1995. It is visually appealing, easy to use, and focuses on the financial tasks that people do most often. Microsoft Money provides enhanced online home-banking services with 17 different banks in the U.S. Users who are customers of participating banks will be able to pay bills online, access up-to-date statements and balances, transfer funds, and send email messages and inquiries to their banks.

Entertainment: The Company also has a line of entertainment products. Microsoft Flight Simulator, which was developed by Bruce Artwick Organization Ltd., is a popular airplane-flying game available for MS-DOS and Macintosh operating systems. Microsoft Golf, licensed from Access Software, Inc., is a realistic simulation of the sport of golf for Windows 95 and Windows 3.x operating systems.

PC Input Devices: The Company's major input device is the Microsoft Mouse, a hand-held pointing device that facilitates use of a PC. It can be used with MS-DOS, Windows 95, and Windows 3.x operating systems and works with many applications products from Microsoft and other companies. The Microsoft BallPoint(R) Mouse is designed especially for use with laptop and notebook computers. The BallPoint Mouse is shipped with a universal clamp that fits on the keyboards of most laptop computers and a positioner that allows

the user to adjust the angle of the mouse to the keyboard. The Company also designed and markets the Microsoft Natural Keyboard(TM), an ergonomically-designed keyboard.

MICROSOFT PRESS

Microsoft Press publishes books about software products from Microsoft and other software developers and about current developments in the industry. Books published by Microsoft Press typically are written and copyrighted by independent authors who submit their manuscripts to the Company for publication and who receive royalties based on net revenues generated by the book.

Microsoft Press contracts with an independent commercial printer for the manufacturing of its books. Publisher's Resources, Inc. acts as the Company's main fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press books. Books are marketed by independent sales representatives and by Microsoft Press sales personnel. Internationally, Microsoft Press has numerous international agreements with publishers for the worldwide distribution of its books. Microsoft Press has granted a publisher in England the right to distribute English language versions of its books in all countries except the United States, Canada, Central and South America, and certain Asian countries. In most cases, Microsoft Press provides each publisher with a book's manuscript, and the publisher arranges for its translation and the printing, marketing, and distribution of the translated version.

PRODUCT DEVELOPMENT

The PC software industry is characterized by extremely rapid technological change, which requires a continuous and high level of expenditures for enhancing existing products and developing new products. The Company is committed to continued high expenditures for research and product development.

Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third party development for certain products. Product documentation is also created internally. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved a development methodology for creating and enhancing its products. These tools and methodology are also designed to simplify a product's portability among different operating systems or computers.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to new user needs or advances in hardware design, without compromising product quality. The Company strives to become as informed as possible at the earliest possible time about changing usage patterns and hardware advances that may affect software design.

During fiscal years 1993, 1994, and 1995, the Company spent $470 million, $610 million, and $860 million, respectively, on product research and development activities. Those amounts represented 12.5%, 13.1%, and 14.5%, respectively, of net revenues in each of those years.

LOCALIZATION

In order to best serve the needs of users in foreign countries, Microsoft "localizes" many of its products to reflect local languages and conventions. In France, for example, all user messages and documentation are in French and all monetary references are in French francs, and in the United Kingdom, monetary references are in British pounds and user messages and documentation reflect certain British conventions. Various Microsoft products have been localized into more than 30 languages.

MANUFACTURING

The Company has manufacturing facilities located in the United States, Puerto Rico, and Ireland. The Company's manufacturing operations involve disk replication, assembly of purchased parts, and final packaging. Quality control tests are performed on purchased parts, finished disks, and other products. The

chief materials and components used in Microsoft products include disks or CD-ROMs, books, and multicolor printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.

The Company contracts a substantial portion of its manufacturing activity to third parties. Outside manufacturers produce various software products, documentation, and hardware such as mouse pointing devices and keyboards. There are other custom manufacturers in the event that outsourced manufacturing becomes unavailable from current sources.

MARKETING AND DISTRIBUTION

Microsoft aligns its sales and marketing people with three customer types: end users, organizations, and OEMs. The Company's sales and marketing staff seeks to build long-term relationships with these customers of Microsoft products. Microsoft has four major channels of distribution which deliver product to end users: finished goods in the U.S. and Canada, Europe, and Other International; and OEM.

The end user customer unit has responsibility for activities that target end users who make individual buying decisions for the PCs they use at work or home. All sales and marketing activities aimed at end user customers are performed by this unit, including developing and administering distributor and reseller relationships; reseller sales terms and conditions; channel marketing and promotions; end user marketing programs; support policies; and seminars, events, and sales training for resellers. The key products licensed and sold are the Company's personal operating systems and consumer and desktop applications.

The organization customer unit has responsibility for activities that target groups of users in organizations of all sizes. The unit works with Solutions Providers, the Microsoft Consulting Services division, and directly with organizations to create enterprise-wide solutions to business computing problems. The unit's sales and marketing activities include providing technical training of Solutions Providers and channel resellers; developing support policies; and supporting and providing seminars, events, and sales training for resellers and Solutions Providers. Key products are the Company's business systems, developer software, and software sold via volume licensing programs. In the U.S., the organization customer unit is further segregated into an enterprise customer unit, which services only large organization customers, and a more specialized unit which services small and medium customers.

The OEM customer unit includes the sales force which works with original equipment manufacturers that include Microsoft software on their PCs.

FINISHED GOODS CHANNELS

Distributors and Resellers: The Company markets its products in the finished goods channels primarily through independent non-exclusive distributors and resellers. Distributors include Computer 2000, Ingram Micro, and Merisel. Resellers include Egghead Software, Softbank, Software Spectrum, and Stream International (formerly Corporate Software). Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

Large Accounts: The Company has a program designed to make it easier for large organizations to acquire and maintain Microsoft products. The program, Microsoft Select, offers flexible software acquisition, licensing, and maintenance options specially designed to meet the needs of large multinational organizations. Targeted audiences include technology specialists and influential end users in large enterprises. Marketing efforts and fulfillment are generally coordinated with the Microsoft network of large account resellers.

Solutions Providers: Microsoft's Solutions Providers program is a comprehensive support relationship with independent organizations that provide network and system integration, custom development, training, and technical support for business computing solutions. The program supports value-added resellers (VARs), system integrators, consultants, and developers, as well as technical support and training organizations. Under this business partnership strategy, the Company provides sales and product information, development services, early access to Microsoft products, and customer support tools including priority telephone support, education,

and business development support. To ensure high-quality technical services for the Company's products, Microsoft Solutions Providers are required to have Microsoft-certified professionals on staff.

Consulting Services: The Company's Consulting Services Division assists customers in using the Company's computer operating systems, applications, and communications products. The group works with Solutions Providers and helps create enterprise-wide computing solutions for large corporate accounts.

Direct Marketing: Microsoft promotes some of its products through direct marketing techniques directed toward existing and potential users of the Company's products. Promotional materials are typically delivered through the mail, utilizing lists of targeted individuals. Fulfillment of product to the end user is accomplished by either direct shipment or through resellers.

International Sales Sites: The Company has established marketing, support, and/or distribution subsidiaries in Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Colombia, Costa Rica, the Czech Republic, Denmark, Ecuador, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Ireland, Israel, Italy, Japan, Malaysia, Mexico, Morocco, the Netherlands, New Zealand, Norway, the People's Republic of China, Peru, the Philippines, Poland, Portugal, Puerto Rico, Russia, Singapore, Slovakia, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Arab Emirates, the United Kingdom, and Venezuela.

The Company's international operations, both OEM and finished goods, are subject to certain risks common to foreign operations in general, such as governmental regulations, import restrictions, and foreign exchange rate fluctuations. Microsoft hedges a portion of its foreign exchange risk.

OEM CHANNEL

The Company's operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of Microsoft's products with their computers. The Company also markets certain language and applications programs to OEMs under similar arrangements. In addition, the Company markets the Microsoft Mouse, BallPoint Mouse, and Natural Keyboard to OEMs for distribution to buyers of their computers. In almost all cases, the products are distributed under Microsoft trademarks. The Company has OEM agreements covering one or more of its products with virtually all of the major microcomputer OEMs, including AST Research, Acer, Digital Equipment Corporation, Dell, Compaq, Gateway 2000, Hewlett-Packard, IBM, NEC, Olivetti, Packard Bell, and Toshiba.

ADVERTISING

The Company works closely with large advertising and direct marketing firms. Advertising, direct marketing, worldwide packaging, and marketing materials are targeted to various end-user segments. The Company utilizes broad consumer media (television, radio, and business publications) and trade publications. Microsoft has programs under which qualifying resellers and OEMs are reimbursed for certain advertising expenditures. Microsoft also invests heavily in direct marketing and customer satisfaction areas. In 1996, the Company plans to spend more than $150 million on a broad campaign emphasizing the Microsoft brand identity.

CUSTOMERS

As described above, Microsoft has three customer types: end users, organizations, and OEMs. Most end users of Microsoft products are individuals in businesses, government agencies, educational institutions, and at home. These end users obtain Microsoft products primarily through distributors, resellers, and OEMs, which include certain Microsoft products with their hardware. Notes to Financial Statements describe customers that represent more than 10% of the Company's revenues. The Company's practice is to ship its products promptly upon receipt of purchase orders from its customers and, consequently, backlog is not significant.

PRODUCT SUPPORT SERVICES

The Company's Product Support Services group, with locations in the U.S. and in various Microsoft subsidiaries, provides product support coverage options to meet the needs of users of Microsoft products. The Company hires individuals with proven product expertise and provides them with productivity tools, continuous product education and training, and consistent processes to deliver quality support for Microsoft products. Certain telephone support is also supplied by qualified third-party support organizations. Coverage options range from standard no-charge toll telephone support to fee-based offerings providing unlimited 800 number telephone and electronic technical support across all Microsoft products 24 hours per day, 7 days per week.

Users have access to Microsoft KnowledgeBase, a library of thousands of technical articles that is updated regularly with useful information regarding Microsoft products. Microsoft provides access to KnowledgeBase via MSN, America Online, CompuServe(R), GEnie(TM), Prodigy, and the Internet. Additionally, the Company offers two information subscription services: Microsoft TechNet and Microsoft Developer Network.

As a supplement or alternative to direct support, the Company enhances the third party support channel by providing Microsoft Solutions Providers with education, training, tools, and support. Microsoft Solutions Providers include Authorized Training Centers, which offer advanced product education and certification on Microsoft products; and Authorized Support Centers, which provide a wide spectrum of multinational support, multivendor support, and integration services.

COMPETITION

The microcomputer software business is intensely competitive and subject to extremely rapid technological change. Microsoft faces formidable competition in all areas of its business activity, including competition from many companies whose revenues and resources are much larger than Microsoft's.

Operating systems. Microsoft's operating systems products face substantial competition from a number of sources. Major competitors such as IBM, Apple Computer, Digital Equipment Corporation, and others, which are vertically integrated in both software development and hardware manufacture, have developed operating systems that they preinstall on computers of their own manufacture. Many of these operating system software products are also licensed to third party OEMs for preinstallation on their machines. Microsoft's operating systems products compete with UNIX-based operating systems from a wide range of companies including IBM, AT&T, Hewlett Packard, Sun Microsystems, Novell, The Santa Cruz Operation, and others. Variants of UNIX run on a wide variety of computer platforms and are gaining increasing acceptance as desktop operating systems. As microcomputer technology increasingly moves toward connectivity and communications, Microsoft's operating systems products will face increased competition from network server operating systems, such as Novell NetWare, and "middleware" products such as Lotus Notes from IBM. Microsoft's operating systems products also face constant competition from software pirates who unlawfully copy and distribute Microsoft's copyrighted software products.

(now owned by IBM) has a large installed base of Lotus Notes and cc:Mail, which compete with the Company's workgroup products.

Desktop applications. The Company's competitors include many software application vendors, such as Lotus, Oracle, Claris, and Novell. Some of the competitors in this arena do not offer products in every major desktop application category (e.g., spreadsheet, word processors, databases, etc.) and as a result may be able to more effectively focus their efforts on enhancing particular product offerings.

Online services. An enormous range of companies, including media conglomerates, telephone companies, cable companies, retailers, hardware manufacturers, and software developers, are competing to make online services widely available to computer users. Microsoft's new online services network, MSN, faces

formidable competition from both established online networks, such as CompuServe (owned by H&R Block), Prodigy (owned by IBM and Sears), America Online, and others, and impending entrants, such as a number of new online networks that will be offered by AT&T. MSN and other online networks also face competition from online services that are offered to users directly via the Internet, including, in particular, the World Wide Web portion of the Internet. Additionally, Netscape, Adobe, Sun Microsystems, and many other companies offer software for Internet servers and for user navigation of the Internet.

Developer. The Company's developer products compete against offerings from Sybase, Borland, and many other companies.

Consumer. Microsoft's Consumer division faces many smaller but focused competitors, particularly in the areas of entertainment and education. Examples include Intuit, Broderbund, Electronic Arts, Softkey, The Learning Company, Davidson Associates, Voyager, Comptons, Edmark, Sierra On-Line, and Dorling Kindersley. Still other competitors own branded content, such as Walt Disney and Lucas Arts. Additionally, as platforms become more powerful, PC-based games will compete head-to-head with games created for proprietary systems such as Nintendo and Sega. The Consumer Division's input devices face substantial competition from computer manufactures, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices.

The Company believes that the principal competitive factors in marketing PC software are the product's reputation, features and functions, ease of use, reliability, price relative to performance, timeliness of delivery, and availability and quality of support services. There is no assurance that the Company's competitive position will not be adversely affected by one or more of these factors in the future, particularly in view of the fast pace of technological change in the software industry.

EMPLOYEES

As of June 30, 1995, the Company employed 17,801 people, 12,193 domestically and 5,608 internationally. Of the total, 5,397 were in product research and development, 9,166 in sales, marketing, and support, 1,639 in manufacturing and distribution, and 1,599 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees are subject to

Joachim Kempin	--	Senior Vice President, Consumer Systems Division
Craig J. Mundie	46	
William H. Neukom	53	Senior Vice President, Law and Corporate Affairs; Secretary

Jeffrey S. Raikes	37	Senior Vice President, North America
Brad A. Silverberg	41	Senior Vice President, Personal Systems Division
Patricia Q. Stonesifer	39	Senior Vice President, Consumer Division
Bernard P. Vergnes	50	Senior Vice President, Microsoft; President, Microsoft Europe
Michael W. Brown	49	Vice President, Finance; Chief Financial Officer

</TABLE>

Mr. Gates co-founded Microsoft in 1975 and has been its Chief Executive Officer and Chairman of the Board since the original partnership was incorporated in 1981.

Mr. Ballmer was named Executive Vice President, Worldwide Sales and Support in February 1992. He had been Senior Vice President, Systems Software since 1989. From 1984 until 1989, Mr. Ballmer served as Vice President, Systems Software. He joined Microsoft in 1980.

Mr. Herbold joined Microsoft as Executive Vice President and Chief Operating Officer in November 1994. Herbold had been with The Procter & Gamble Company since 1968, with experience in information services, advertising and market research. Most recently, he was P&G's Senior Vice President, Information Services and Advertising.

Mr. Higgins was named Group Vice President, Applications and Content Group in May 1995. He was named Senior Vice President, Desktop Applications Division in March 1993. He had been Vice President, Desktop Applications Division since 1992 and previously, Vice President, Analysis Business Unit since 1991. Mr. Higgins joined Microsoft in 1983.

Mr. Maritz was named Group Vice President, Platforms Group in May 1995. He was named Senior Vice President, Product and Technology Strategy in November 1994 and had been Senior Vice President, Systems

Division since February 1992. He had been Vice President, Advanced Operating Systems since 1989. Mr. Maritz joined Microsoft in 1986.

Mr. Myhrvold was named Group Vice President, Applications and Content Group in May 1995. He was named Senior Vice President, Advanced Technology in July 1993. He had been Vice President, Advanced Technology and Business Development since 1989. Mr. Myhrvold joined Microsoft in 1986.

Mr. Allchin was named Senior Vice President, Business Systems Division in November 1994. He had been Vice President, Business Systems Division, since July 1991. Prior to joining Microsoft in 1991, Mr. Allchin spent seven years at Banyan Systems, Inc., where he held numerous positions, most recently Senior Vice President and Chief Technology Officer.

Mr. Heinen joined Microsoft as Senior Vice President, Developer Division in January 1993. He had been Senior Vice President and General Manager of the Macintosh Software Division at Apple Computer, Inc. from 1990 to 1993. Prior to 1990, Heinen was a corporate consulting engineer for software at Digital Equipment Corporation.

Mr. Kempin was named Senior Vice President, Worldwide OEM Sales in August 1993. He had been Vice President, OEM Sales since 1987. Mr. Kempin had served as General Manager of Microsoft's German subsidiary since its inception in 1983.

Mr. Mundie was named Senior Vice President, Consumer Systems Division in May 1995. He had been Vice President, Advanced Consumer Technology since July 1993. He joined Microsoft as General Manager, Advanced Consumer Technology Group in December 1992. Previously, Mr. Mundie had been CEO of Alliant Computer Systems Corporation, which declared bankruptcy on May 25, 1992 and was liquidated.

Mr. Neukom was named Senior Vice President, Law and Corporate Affairs in February 1994. He joined Microsoft in 1985 as Vice President. Mr. Neukom formerly was a member of the Seattle law firm of Shidler McBroom Gates & Lucas (now Preston Gates & Ellis), Microsoft's primary outside law firm.

Mr. Raikes was named Senior Vice President, Microsoft North America in January 1992. He had been Vice President, Office Systems since 1990. Mr. Raikes came to Microsoft in 1981.

Mr. Silverberg was named Senior Vice President, Personal Systems Division in November 1994. He joined Microsoft in August 1990 as Vice President, Personal Operating Systems Division. From 1987 until joining Microsoft, Mr. Silverberg served as Vice President, Engineering for Borland International, Inc.

Ms. Stonesifer was named Senior Vice President, Consumer Division in November 1994, after having been Vice President, Consumer Division since June 1993. She had been Vice President, Support since 1992 and General Manager of Product Support Services since 1991. Previously, she was General Manager of Microsoft Canada and before that, General Manager for Microsoft Press. Prior to joining Microsoft in 1988, Ms. Stonesifer was with Que Corporation, a publisher of books for computer users.

Mr. Vergnes is a Senior Vice President of Microsoft and was named President, Microsoft Europe in April 1992. He had been Vice President, Europe since 1989. Mr. Vergnes served as General Manager of Microsoft's French subsidiary since its inception in 1983.

Mr. Brown was named Chief Financial Officer in August 1994 and Vice President, Finance in April 1993. He had been Treasurer since February 1990, after joining Microsoft in January 1990. Previously, Mr. Brown was a partner in the accounting firm Deloitte & Touche, Microsoft's independent auditors.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On September 8, 1995, there were 35,643 holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

QUARTERLY FINANCIAL AND STOCK PRICE INFORMATION
(IN MILLIONS, EXCEPT PER SHARE DATA)

<TABLE>
<CAPTION>

	QUARTER ENDED				
	SEPTEMBER 30	DECEMBER 31	MARCH 31	JUNE 30	YEAR
<S>	<C>	<C>	<C>	<C>	<C>
1993					
Net revenues	$ 818	$ 938	$ 958	$1,039	$3,753
Operating income	289	326	338	373	1,326
Net income	209	236	243	265	953
Earnings per share	0.35	0.39	0.40	0.43	1.57
Common stock price per share:					
High	41	47 1/2	47 1/8	49	49
Low	32 3/4	37 7/8	38 3/8	39 7/8	32 3/4
1994					
Net revenues	$ 983	$1,129	$ 1,244	$1,293	$4,649
Operating income	343	415	480	488	1,726
Net income	239	289	256	362	1,146
Earnings per share	0.39	0.48	0.42	0.59	1.88
Common stock price per share:					
High	44 1/4	43 1/4	44 5/8	54 5/8	54 5/8
Low	35 1/8	38	39	41	35 1/8

1995					
Net revenues......................	$ 1,247	$1,482	$ 1,587	$1,621	$5,937
Operating income..................	437	520	549	532	2,038
Net income........................	316	373	396	368	1,453
Earnings per share................	0.51	0.60	0.63	0.58	2.32
Common stock price per share:					
High..............................	59 1/4	65 1/8	74 1/8	92 3/8	92 3/8
Low...............................	46 7/8	53 7/8	58 1/4	68 3/4	46 7/8

</TABLE>

ITEM 6. SELECTED FINANCIAL DATA

FINANCIAL HIGHLIGHTS
(IN MILLIONS, EXCEPT EARNINGS PER SHARE)

<TABLE>
<CAPTION>

	YEAR ENDED JUNE 30				
	1991	1992	1993	1994	1995
<S>	<C>	<C>	<C>	<C>	<C>
Net revenues................................	$1,843	$2,759	$3,753	$4,649	$5,937
Net income..................................	463	708	953	1,146	1,453
Earnings per share..........................	0.82	1.20	1.57	1.88	2.32
Return on net revenues......................	25.1%	25.7%	25.4%	24.7%	24.5%
Cash and short-term investments.............	$ 686	$1,345	$2,290	$3,614	$4,750
Total assets................................	1,644	2,640	3,805	5,363	7,210
Stockholders' equity........................	1,351	2,193	3,242	4,450	5,333

</TABLE>

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS FOR 1993, 1994, AND 1995

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating system platforms for personal computers (PCs), workstations, and servers; business and consumer applications for productivity, reference, education, and entertainment; and development tools. Microsoft also sells personal computer books and input devices, and is engaged in the research and development of online and advanced technology software products.

NET REVENUES

Microsoft's net revenues grew 24% in the fiscal year ended June 30, 1994 and 28% in fiscal year 1995. Software license volume (as opposed to price) increases have been the principal factor in Microsoft revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, e.g., Microsoft Office, are less than the sum of the prices for the individual programs included in these products when such programs are licensed separately.

Product groups. Microsoft has a platforms product group and an applications and content product group.

Platforms product group revenues were $1.52 billion, $1.83 billion, and $2.36 billion in 1993, 1994, and 1995.

Principal personal systems products have been the MS-DOS and Microsoft Windows operating systems. MS-DOS is preinstalled on PCs by most OEMs, and strong increase in 1993 when the MS-DOS 6 Upgrade was released. There were no major upgrades of MS-DOS in 1994 or 1995. The Microsoft Windows operating system was an increasingly strong contributor to revenues as the number of new PCs preinstalled with Windows increased rapidly during the three-year period. Windows units licensed to new users were 15 million, 30 million, and 40 million in 1993, 1994, and 1995.

Business systems products offer an enterprise-wide distributed client/server environment based on the Microsoft Windows NT operating system and the server applications in the Microsoft BackOffice family of products. Revenues from these products increased strongly in 1994 and 1995.

Revenues from developer products increased steadily in all three years, as more independent software vendors, corporate developers, and solutions developers licensed tools to develop software for Windows and Windows NT.

Applications and content product group revenues were $2.24 billion, $2.82 billion, and $3.58 billion in 1993, 1994, and 1995.

Increases in desktop applications revenues were led by strong sales of Microsoft Office. The Microsoft Office Standard product includes the Microsoft Excel spreadsheet, the Microsoft Word word processor, the Microsoft PowerPoint presentation graphics program, and a Microsoft Mail client-access license, while the Microsoft Office Professional version also includes the Microsoft Access database management system. Sales of stand-alone versions of Microsoft Excel and Microsoft Word decreased in 1994 and 1995 as the sales mix continued to shift to integrated product suites.

Microsoft Home, a broad range of consumer products, also showed continued growth. The Microsoft Home brand includes CD-ROM multimedia reference titles and software products for home and small office productivity, children's creativity, and entertainment. Microsoft also markets the Microsoft Mouse and Microsoft Natural Keyboard. Mouse sales were flat during the three-year period, while the initial introduction of the keyboard increased revenues in 1995.

Sales channels. Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM channel revenues were $731 million in 1993, $1.18 billion in 1994, and $1.65 billion in 1995. The primary source of OEM revenues is the licensing of operating systems, particularly MS-DOS and Microsoft Windows. As such, OEM channel revenues are highly dependent on PC shipment volume.

U.S. and Canada channel revenues were $1.37 billion, $1.58 billion, and $1.88 billion in 1993, 1994, and 1995.

Revenues in Europe were $1.26 billion, $1.36 billion, and $1.49 billion in 1993, 1994, and 1995. Growth rates have been lower in Europe than in other geographic areas due to general economic slowness, higher existing market shares, and a more dramatic shift to corporate licensing programs.

Other International channel revenues were $392 million in 1993, $532 million in 1994, and $924 million in 1995. Growth rates continue to be strong due to customer acceptance of newly localized products, particularly in Japan, and early entrance into emerging markets.

Microsoft's operating results are affected by foreign exchange rates.

1994, primarily due to the patent litigation charge and increased research and development expenses, offset by the lower relative level of sales and marketing expenses.

FINANCIAL CONDITION

Microsoft's cash and short-term investments totaled $4.75 billion at June 30, 1995. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are investment grade and liquid. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. Microsoft's portfolio is invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs. Microsoft has no material long-term debt. Microsoft has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management.

Stockholders' equity at June 30, 1995 exceeded $5.3 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, investments will continue in research and development in existing and advanced areas of technology. Microsoft's cash will also be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including facilities and computer systems for research and development, sales and marketing, product support, and administrative staff. For example, on June 30, 1995, commitments related to the construction of new buildings approximated $150 million.

The exercise of stock options by employees provides additional cash. These proceeds have been used in Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This program will continue in 1996.

During 1995, to enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to Microsoft on certain dates at specified prices.

Also during 1995, a subsidiary of Tele-Communications, Inc. (TCI) purchased a 20% minority interest in the newly formed Microsoft Online Services Partnership. TCI contributed $125 million of TCI common stock, and Microsoft contributed the business assets of its online service, The Microsoft Network, which was in development.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements in 1996. Microsoft's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuit of Microsoft's long-term strategies.

Microsoft shareholders have also authorized the issuance of up to 100 million shares of preferred stock, which may be used for any proper corporate purpose.

Microsoft has not paid cash dividends on its common stock.

OUTLOOK AND UNCERTAINTIES

Microsoft does not provide forecasts of potential future financial performance. While management of Microsoft is optimistic about Microsoft's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

Rapid technological change. The personal computer software industry is characterized by rapid technological change and uncertainty as to the impact of emerging areas such as the Internet and online services, the information highway, networked collaboration products, and electronic commerce.

Long-term investment cycle. Developing and localizing software is expensive and the investment in product development often involves a long payback cycle. Microsoft's plans for 1996 include significant investments in software research and development and related product opportunities from which significant revenues are not anticipated for a number of years. Management expects total spending for research and development in 1996 to increase over spending in 1995.

Customer acceptance. While Microsoft performs extensive usability and beta testing of new products, user acceptance and corporate penetration rates ultimately dictate the success of development and marketing efforts of products such as Windows 95, Microsoft Office for Windows 95, or the Microsoft BackOffice family of products.

Product ship schedules. Delays in the release of new products can cause operational inefficiencies that impact manufacturing and distribution logistics, independent software vendor (ISV) and OEM relationships, and telephone support staffing.

Prices. Future prices Microsoft is able to obtain for its products may decrease from historical levels depending on competitive market or cost factors. Prices of software in Europe are generally higher than in the U.S. to cover localization costs and higher costs of distribution. Such price uplifts could erode in the future.

Integrated suites. The price of integrated suites such as Microsoft Office, is less than the sum of the prices for the individual programs included in this product when such programs are licensed separately. Revenues from Microsoft Office may continue to increase as a percentage of total revenues.

Saturation. Product upgrades, enabling users to upgrade from earlier versions of Microsoft's products or from competitors' products, have lower prices and margins than new products. As the desktop applications market becomes saturated, the sales mix shifts from standard products to upgrade products. This trend is expected to continue.

Channel mix. Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenues was achieved through the OEM channel during 1994 and 1995.

Corporate licenses. Average revenue per unit from corporate license programs is lower than average revenue per unit from retail versions shipped through the finished goods channels. Unit sales under corporate licensing programs may continue to increase.

Cost of revenues. Although cost of revenues as a percentage of net revenues decreased in 1994 and 1995, it varies with channel mix and product mix within channels. Changes in channel and product mix, including the potential retail upgrade cycle of Windows 95, may increase cost of revenues as a percentage of net revenues in 1996.

Sales and marketing and support investments. Microsoft's plans for 1996 include continued investments in its sales and marketing and support groups. Microsoft brand advertising is also expected to increase.

Foreign exchange. A large percentage of Microsoft's sales and costs of manufacturing and marketing are transacted in local currencies. As a result, Microsoft's international results of operations are subject to foreign exchange rate fluctuations.

Intellectual property rights. Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenues to Microsoft. While this adversely affects U.S. revenues, revenue loss is even more significant outside of the U.S., particularly in certain countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. There can be no assurance that continued efforts will affect revenues positively.

Future growth rates. If a substantial number of users upgrade to Windows 95, revenue growth rates in the initial shipping quarters of 1996 could be at relatively high levels. Revenue growth rates in the comparable quarters of 1997 may not approach such levels. As discussed above, operating expenses are expected to increase in 1996. Because of the fixed nature of a significant portion of such expenses, coupled with the possibility of slower revenue growth, operating margins in 1997 may decrease from those in 1996.

Litigation. Litigation regarding intellectual property rights, patents, and copyrights is increasing in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO FINANCIAL STATEMENTS

<TABLE>

</TABLE>

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

None.

INCOME STATEMENTS
(IN MILLIONS, EXCEPT EARNINGS PER SHARE)

<TABLE>
<CAPTION>

	YEAR ENDED JUNE 30		
	1993	1994	1995
<S>	<C>	<C>	<C>
Net revenues	$3,753	$4,649	$5,937
Operating expenses:			
Cost of revenues	633	763	877
Research and development	470	610	860
Sales and marketing	1,205	1,384	1,895

General and administrative	119	166	267
Total operating expenses	2,427	2,923	3,899
Operating income	1,326	1,726	2,038
Interest income -- net	82	102	191
Noncontinuing items	--	(90)	(46)
Other expenses	(7)	(16)	(16)
Income before income taxes	1,401	1,722	2,167
Provision for income taxes	448	576	714
Net income	$ 953	$1,146	$1,453
Earnings per share	$ 1.57	$ 1.88	$ 2.32
Weighted average shares outstanding	606	610	627

</TABLE>

See accompanying notes.

CASH FLOWS STATEMENTS
(IN MILLIONS)

<TABLE>
<CAPTION>

	YEAR ENDED JUNE 30		
	1993	1994	1995
<S>	<C>	<C>	<C>
CASH FLOWS FROM OPERATIONS			
Net income	$ 953	$ 1,146	$ 1,453
Depreciation and amortization	151	237	269
Current liabilities	177	360	419
Accounts receivable	(121)	(146)	(91)
Inventories	(51)	23	15
Other current assets	(35)	(27)	(75)
Net cash from operations	1,074	1,593	1,990
CASH FLOWS FROM FINANCING			
Common stock issued	229	280	332
Common stock repurchased	(250)	(348)	(649)
Stock option income tax benefits	207	151	179
Net cash from financing	186	83	(138)
CASH FLOWS USED FOR INVESTMENTS			
Additions to property, plant, and equipment	(236)	(278)	(495)
Other assets	(17)	(64)	(230)
Short-term investments	(723)	(860)	(651)
Net cash used for investments	(976)	(1,202)	(1,376)
Net change in cash and equivalents	284	474	476
Effect of exchange rates on cash	(62)	(10)	9
Cash and equivalents, beginning of year	791	1,013	1,477
Cash and equivalents, end of year	1,013	1,477	1,962
Short-term investments	1,277	2,137	2,788

Cash and short-term investments	$2,290	$ 3,614	$ 4,750

</TABLE>

See accompanying notes.

BALANCE SHEETS
(IN MILLIONS)

<TABLE>
<CAPTION>

<S>	JUNE 30 1994 <C>	JUNE 30 1995 <C>
ASSETS		
Current assets:		
Cash and short-term investments	$3,614	$4,750
Accounts receivable -- net of allowances of $92 and $139	475	581
Inventories	102	88
Other	121	201
Total current assets	4,312	5,620
Property, plant, and equipment -- net	930	1,192
Other assets	121	398
Total assets	$5,363	$7,210
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 324	$ 563
Accrued compensation	96	130
Income taxes payable	305	410
Other	188	244
Total current liabilities	913	1,347
Minority interest	--	125
Put warrants	--	405
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 2,000; issued and outstanding 581 and 588	1,500	2,005
Retained earnings	2,950	3,328
Total stockholders' equity	4,450	5,333
Total liabilities and stockholders' equity	$5,363	$7,210

</TABLE>

See accompanying notes.

STOCKHOLDERS' EQUITY STATEMENTS
(IN MILLIONS)

<TABLE>

<CAPTION>

<S>	1993 <C>	1994 <C>	1995 <C>
	YEAR ENDED JUNE 30		
COMMON STOCK AND PAID-IN CAPITAL			
Balance, beginning of year	$ 657	$1,086	$1,500
Common stock issued	229	280	332
Common stock repurchased	(7)	(17)	(30)
Proceeds from sale of put warrants	--	--	49
Reclassification of put warrant obligation	--	--	(25)
Stock option income tax benefits	207	151	179
Balance, end of year	1,086	1,500	2,005
RETAINED EARNINGS			
Balance, beginning of year	1,536	2,156	2,950
Common stock repurchased	(243)	(331)	(668)
Reclassification of put warrant obligation	--	--	(380)
Net income	953	1,146	1,453
Translation adjustment	(90)	(21)	(27)
Balance, end of year	2,156	2,950	3,328
Total stockholders' equity	$3,242	$4,450	$5,333

</TABLE>

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS
(IN MILLIONS)

SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation. The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated.

Foreign currencies. Assets and liabilities recorded in foreign currencies on the books of foreign subsidiaries are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenues, costs, and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

Revenue recognition. Revenue from sales to distributors and resellers is recognized when related products are shipped. Revenue from corporate license programs generally is recognized when the product is installed by the user. Finished goods revenue attributable to significant support (telephone support and specified and unspecified enhancements) is recognized when such obligations are fulfilled. Costs related to insignificant obligations, which includes telephone support for certain products, are accrued.

Revenue from products licensed to original equipment manufacturers is recognized when the licensed products are shipped by the OEM.

Revenue from software maintenance, service, and support contracts is recognized ratably over the contract period.

Provisions are recorded for returns and bad debts.

Research and development. Research and development costs are expensed as incurred. The current accounting rule, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.

Telephone support. Telephone support costs are included in sales and marketing.

Income taxes. Income tax expense includes U.S. and international income taxes, plus an accrual for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

Earnings per share. Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, computed using the treasury stock method.

Financial instruments. The Company considers all liquid investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and three years from the purchase date. All cash and short-term investments are classified as available for sale. Cost approximates market value for all classifications of cash and short-term investments; realized and unrealized gains and losses are not material.

Statement of Financial Accounting Standard Accounting for Certain Investments in Debt and Equity Securities was adopted in 1995 and did not have a material impact on the financial statements.

Inventories. Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property, plant, and equipment. Property, plant, and equipment is stated at cost and depreciated using the straight-line method. Estimated lives are as follows: buildings, 30 years; leasehold improvements, the lease term; computer equipment and other, principally three years.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)
(IN MILLIONS)

Diversification of risk. The Company's investment portfolio is diversified and consists of short-term investment grade securities. At June 30, 1994 and 1995, approximately 40% of accounts receivable represented amounts due from ten channel purchasers. Two of these each accounted for approximately 10%, 13%, and 12% of revenues in 1993, 1994, and 1995.

Finished goods sales to international customers in Europe, Japan, Australia, and Canada are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. European manufacturing costs and international selling, distribution, and support costs are generally disbursed in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments upon receipt. Therefore, foreign exchange rate fluctuations generally do not create a risk of material transaction gains or losses. As a result, Microsoft's hedging activities for transaction exposures have been minimal. No material hedge contracts were outstanding at June 30, 1995.

Translated results of operations of the Company's foreign subsidiaries are affected by foreign exchange rates. During 1995 and for 1996, the Company hedged a percentage of planned translated international finished goods revenues by purchasing options on the applicable currencies. Premiums paid for the options, which were not material, are being amortized over the lives of the options. Any gains will be recognized when and if realized.

Reclassifications. Certain reclassifications have been made for consistent presentation.

CASH AND SHORT-TERM INVESTMENTS

<TABLE>
<CAPTION>

<S>	JUNE 30 1994 <C>	JUNE 30 1995 <C>
Cash and equivalents:		
Cash	$ 263	$ 135
Commercial paper	619	1,035
Money market preferreds	180	255
Certificates of deposit	218	492
Bank loan participations	197	45
Cash and equivalents	1,477	1,962
Short-term investments:		
Municipal securities	1,245	1,291
Corporate notes and bonds	423	866
U.S. Treasury securities	417	444
Commercial paper	52	187
Short-term investments	2,137	2,788
Cash and short-term investments	$3,614	$4,750

</TABLE>

PROPERTY, PLANT, AND EQUIPMENT

<TABLE>
<CAPTION>

<S>	JUNE 30 1994 <C>	JUNE 30 1995 <C>
Land	$ 162	$ 206
Buildings	440	607
Computer equipment	532	707
Other	311	387
Property, plant, and equipment -- at cost	1,445	1,907
Accumulated depreciation	(515)	(715)
Property, plant, and equipment -- net	$ 930	$1,192

</TABLE>

NOTES TO FINANCIAL STATEMENTS (CONTINUED)
(IN MILLIONS)

INCOME TAXES

The provision for income taxes was composed of:

<TABLE>
<CAPTION>

<S>	1993 <C>	1994 <C>	1995 <C>
Current taxes:			
U.S. and state	$352	$470	$518
International	123	94	151
Current taxes	475	564	669
Deferred taxes	(27)	12	45
Provision for income taxes	$448	$576	$714

</TABLE>

Differences between the U.S. statutory and effective tax rates were:

<TABLE>
<CAPTION>

<S>	1993 <C>	1994 <C>	1995 <C>
U.S. statutory rate	34.0%	35.0%	35.0%
Tax exempt income	(0.6)	(0.9)	(1.1)
Foreign sales corporation	(1.0)	(1.0)	(0.7)
Tax credits	(0.9)	(2.1)	(1.6)
State taxes and other -- net	0.5	2.5	1.4
Effective tax rate	32.0%	33.5%	33.0%

</TABLE>

Deferred income tax balances were:

<TABLE>
<CAPTION>

	JUNE 30	
<S>	1994 <C>	1995 <C>
Deferred income tax assets:		
Revenue items	$ 61	$ 68
Expense items	143	221
Deferred income tax assets	204	289
Deferred income tax liabilities:		
International earnings	(147)	(276)
Other	(4)	(5)
Deferred income tax liabilities	(151)	(281)
Net deferred income tax asset	$ 53	$ 8

</TABLE>

U.S. and international components of income before income taxes were:

<TABLE>
<CAPTION>

	1993	1994	1995

U.S.	$ 960	$1,281	$1,549
International	441	441	618
Income before income taxes	$1,401	$1,722	$2,167

The Internal Revenue Service is examining the Company's U.S. income tax returns for 1990 and 1991. The Company believes any adjustments from the examination will not be material to the financial statements. Income taxes paid were $187 million, $247 million, and $430 million in 1993, 1994, and 1995.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)
(IN MILLIONS)

COMMON STOCK

Shares of common stock outstanding were as follows:

	1993	1994	1995
Balance, beginning of year	544	565	581
Issued	27	25	19
Repurchased	(6)	(9)	(12)
Balance, end of year	565	581	588

The Company repurchases its common stock in the open market to provide shares for issuance to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 1996.

PUT WARRANTS

In connection with the Company's stock repurchase program, put warrants were sold to independent third parties during 1995. The put warrants entitle the holders to sell shares of Microsoft common stock to the Company at specified prices. On June 30, 1995, 8.0 million warrants were outstanding with a strike price of $69.75 per share. The warrants expire at various dates between February 1996 and November 1996, are exercisable only at maturity, and are settleable in cash at Microsoft's option. The maximum potential repurchase obligation of $405 million has been reclassified from stockholders' equity to put warrants as of June 30, 1995. There was no impact on earnings per share in 1995.

EMPLOYEE STOCK AND SAVINGS PLANS

Employee stock purchase plan. The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1993, 1994, and 1995, employees purchased 1.0 million, 1.1 million, and 1.0 million shares at average prices of $33.29, $34.16, and $46.76 per share. At June 30, 1995, 2.1 million shares were reserved for future issuance.

Savings plan. The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Under the plan, participating U.S. employees may defer up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar contributed by a participant, with a maximum contribution of 3% of a participant's earnings. The Company's matching contributions to the savings plan were $7 million, $9 million, and $12 million in 1993, 1994, and 1995.

Stock option plans. The Company has stock option plans for directors, officers, and all employees, which provide for nonqualified and incentive stock options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. Options granted prior to 1995 generally vest over four and one-half years and expire ten years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after ten years. At June 30, 1995, options for 58.5 million shares were vested and 92.8 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

<TABLE>
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		PRICE PER SHARE	
	NUMBER	RANGE	WEIGHTED AVERAGE
<S>	<C>	<C>	<C>
Balance, June 30, 1992	120.3	$ 0.31-39.79	$12.44
Granted	24.4	30.88-44.25	34.30
Exercised	(26.2)	0.31-36.92	7.95
Canceled	(4.4)	4.97-44.13	14.23
Balance, June 30, 1993	114.1	0.31-44.25	18.06
Granted	26.2	35.50-50.13	37.47
Exercised	(20.9)	1.51-44.25	11.42
Canceled	(5.5)	5.01-44.13	28.67
Balance, June 30, 1994	113.9	0.31-50.13	23.29
Granted	21.7	47.75-83.13	50.50
Exercised	(17.6)	0.31-47.75	15.81
Canceled	(4.2)	5.11-75.00	35.40
Balance, June 30, 1995	113.8	1.54-83.13	29.12

</TABLE>

LEASES

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $54 million, $68 million, and $86 million in 1993, 1994, and 1995. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1996, $78; 1997, $65; 1998, $56; 1999, $44; 2000, $28; and thereafter, $13.

THE MICROSOFT NETWORK

During 1995, a wholly owned subsidiary of Tele-Communications, Inc. (TCI) purchased a 20% minority interest in the newly formed Microsoft Online Services

(IN MILLIONS)

Partnership. TCI contributed $125 million of TCI common stock and Microsoft contributed the business assets of its online service, The Microsoft Network, which was in development. Microsoft owns 80% of the entity, whose operations have not been material to the financial results of Microsoft. The entity was subsequently reorganized into The Microsoft Network, LLC.

NONCONTINUING ITEMS

In the fourth quarter of 1995, the Company paid a $46 million breakup fee to Intuit Inc. in connection with the termination of a planned merger.

In the third quarter of 1994, the Company recorded a $120 million charge to reflect the estimated impact of a jury verdict in the Stac Electronics patent litigation and related expenses. In June 1994, the Company reached an agreement with Stac to settle the litigation and adjusted its estimate accordingly, resulting in a credit of $30 million in the fourth quarter and a net pretax charge of $90 million for 1994.

CONTINGENCIES

On July 15, 1994, Microsoft and the U.S. Department of Justice (DOJ) entered into a consent decree resolving the DOJ's non-public investigation of Microsoft. In the consent decree, which involves no admission of wrongdoing on Microsoft's part, Microsoft agreed to make certain changes in its OEM licensing practices. Microsoft also agreed to employ a uniform duration in its nondisclosure agreement for precommercial versions

of certain operating system products, and clarified the rights and responsibilities of those signing such nondisclosure agreements. The consent decree was approved by the U.S. District Court for the District of Columbia on August 21, 1995.

The Antitrust Division of the DOJ has stated that it is conducting an investigation concerning Microsoft's inclusion of client-access software for The Microsoft Network in Windows 95. Although there is no assurance that this matter will be resolved favorably and that Microsoft's future financial statements will not be adversely affected, Microsoft currently believes that resolution of this matter will not have a material adverse effect on its financial condition or results of operations.

INFORMATION BY GEOGRAPHIC AREA

<TABLE>
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	1993	1994	1995
<S>	<C>	<C>	<C>
Net revenues	$2,655	$3,472	$4,495
U.S. operations	1,289	1,401	1,575
European operations	395	375	558
Other international operations	(586)	(599)	(691)
Eliminations	------	------	------
Total net revenues	$3,753	$4,649	$5,937
	======	======	======
Operating income	$ 961	$1,394	$1,709
U.S. operations	360	346	412
European operations	18	31	91
Other international operations	(13)	(45)	(174)
Eliminations			

Total operating income	$1,326	$1,726	$2,038
Identifiable assets			
U.S. operations	$2,944	$4,397	$5,862
European operations	1,133	1,366	1,806
Other international operations	310	423	689
Eliminations	(582)	(823)	(1,147)
Total identifiable assets	$3,805	$5,363	$7,210

</TABLE>

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the U.S., licensing to OEMs, and exports of finished goods directly to international customers, primarily in Canada, South America, and Asia. Exports and international OEM transactions are primarily in U.S. dollars and totaled $426 million, $787 million, and $1,263 million in 1993, 1994, and 1995. "Other international operations" primarily include subsidiaries in Australia, Japan, Korea, and Taiwan. International revenues, which include European operations, other international operations, exports, and OEM distribution, were 55.3%, 54.0%, and 55.3% of total revenues in 1993, 1994, and 1995.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1994 and 1995, the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1995. Our audits also included the financial statement schedule listed in the Index at Item 8. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1994 and 1995, and the results of their operations and their cash flows for each of the three years ended June 30, 1995 in conformity with generally accepted accounting principles. Also, in our opinion the financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
July 17, 1995
(August 21, 1995 as to
Contingencies Note)

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" on pages 1 and 2 of the Company's Proxy Statement dated September 25, 1995, for the Annual Meeting of Shareholders to be held October 27, 1995 (the "Proxy Statement"). Such information is incorporated herein by reference. Information with respect to Executive Officers may be found on pages 11 and 12 hereof, under the caption "Executive Officers of the Registrant."

ITEM 11. EXECUTIVE COMPENSATION

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" on pages 4 through 8 and "Information Regarding the Board and its Committees" on page 2 is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information set forth under the caption "Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management" on page 3 of the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information set forth under the caption "Certain Transactions" on page 8 of the Proxy Statement is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Financial Statements and Schedules

The financial statements of Microsoft as set forth under Item 8 are filed as part of this report.

Supplemental Schedule II -- Valuation and Qualifying Accounts is filed on page 32 of this report.

Financial statement schedules other than those listed above have been omitted since they are either not required, not applicable, or the information is otherwise included.

The independent auditors' report with respect to the above-listed financial statements and schedule appears on page 29 of this report.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the last quarter of fiscal 1995.

(c) Exhibit Listing

<TABLE>
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EXHIBIT NUMBER	DESCRIPTION

<S>	<C>
3.1	Restated Articles of Incorporation(1)
3.2	Bylaws(1)
10.1	Microsoft Corporation 1991 Stock Option Plan(1)
10.2	Microsoft Corporation 1981 Stock Option Plan(2)
10.3	Microsoft Corporation Stock Option Plan for Non-Employee Directors(1)
10.4	Microsoft Corporation Stock Option Plan for Consultants and Advisor(1)
10.5	Microsoft Corporation 1991 Employee Stock Purchase Plan
10.6	Microsoft Corporation Savings Plus Plan(1)
10.7	Trust Agreement dated June 1, 1993 between Microsoft Corporation and First Interstate Bank of Washington(3)
10.8	Form of Indemnification Agreement(3)
11.	Computation of Earnings Per Share
21.	Subsidiaries
23.	Independent Auditors' Consent
27.	Financial Data Schedule
99.1	Financial Statements for the Microsoft Corporation 1991 Employee Stock Purchase Plan for the Three Years Ended June 30, 1995
99.2	Financial Statements for the Microsoft Corporation Savings Plus Plan for the Two Years Ended December 31, 1994 and the Nine Months Ended December 31, 1992

</TABLE>

- ---------------

(1) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1994.

(2) Incorporated by reference to Registration Statement 33-37623 on Form S-8.

(3) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.

<PAGE> 34

SCHEDULE II -- VALUATION AND QUALIFYING ACCOUNTS

ALLOWANCE FOR DOUBTFUL ACCOUNTS
(IN MILLIONS)

<TABLE>
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	YEAR ENDED JUNE 30		
	1993	1994	1995
<S>	<C>	<C>	<C>
Balance, beginning of year	$ 57	$ 76	$ 92
Additions charged to expense	47	27	51
Deductions	(28)	(11)	(4)
Balance, end of year	$ 76	$ 92	$139

</TABLE>

<PAGE> 35

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Redmond, State of Washington, on September 13, 1995.

MICROSOFT CORPORATION

By /s/ MICHAEL W. BROWN

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on September 13, 1995.

<TABLE>
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SIGNATURE	TITLE
<S>	<C>
/s/ WILLIAM H. GATES William H. Gates	Chairman of the Board of Directors and Chief Executive Officer
/s/ PAUL G. ALLEN Paul G. Allen	Director
/s/ RICHARD A. HACKBORN Richard A. Hackborn	Director
/s/ DAVID F. MARQUARDT David F. Marquardt	Director
/s/ ROBERT D. O'BRIEN Robert D. O'Brien	Director
Wm. G. Reed, Jr.	Director
/s/ JON A. SHIRLEY Jon A. Shirley	Director
/s/ MICHAEL W. BROWN Michael W. Brown	Vice President, Finance; Chief Financial Officer (Principal Financial and Accounting Officer)

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EXHIBIT 10.5

MICROSOFT CORPORATION

1991 EMPLOYEE STOCK PURCHASE PLAN

As approved by the Board of Directors
on August 11, 1990 and the
Shareholders on October 26, 1990,
and amended by the Board of Directors
on April 23, 1994 and May 13, 1995

<PAGE> 2

MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN

Microsoft Corporation (the "Company") does hereby establish its 1991 Employee Stock Purchase Plan as follows:

1. Purpose of the Plan. The purpose of this Plan is to provide eligible employees who wish to become shareholders in the Company a convenient method of doing so. It is believed that employee participation in the ownership of the business will be to the mutual benefit of both the employees and the Company. It is the intention of the Company to have the Plan qualify as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code of 1986. The provisions of the Plan shall, accordingly, be construed so as to extend and limit participation in a manner consistent with the requirements of that Section of the Code.

2. Definitions.

2.1 "Base pay" means regular straight time earnings, plus review cycle bonuses and overtime payments, payments for incentive compensation, and other special payments except to the extent that any such item is specifically excluded by the Board of Directors of the Company (the "Board").

2.2 "Account" shall mean the funds accumulated with respect to an individual employee as a result of deductions from his paycheck for the purpose of purchasing stock under this Plan. The funds allocated to an employee's account shall remain the property of the respective employee at all times but may be commingled with the general funds of the Company.

3. Employees Eligible to Participate. Any regular employee of the Company or any of its subsidiaries who is in the employ of the Company on one or more offering dates is eligible to participate in the Plan, except (a) employees whose customary employment is less than 20 hours per week, and (b) employees whose customary employment is for not more than five months in any calendar year.

4. Offerings. There will be twelve separate consecutive six-month offerings pursuant to the Plan. The first offering shall commence on January 1, 1991. Thereafter, offerings shall commence on each subsequent July 1 and January 1, and the final offering under this Plan shall commence on July 1, 1996 and terminate on December 31, 1996. In order to become eligible to purchase shares, an employee must sign an Enrollment Agreement, and any other necessary papers on or before the commencement date (January 1 or July 1) of the particular offering in which he wishes to participate. Participation in one offering under the Plan shall neither limit, nor require, participation in

any other offering.

5. Price. The purchase price per share shall be the lesser of (1) 85% of the fair market value of the stock on the offering date; or (2) 85% of the fair market value of the stock on the last business day of the offering. Fair market value shall mean the closing bid price as reported on the National Association of Securities Dealers Automated Quotation System or, if the stock is traded on a stock exchange, the closing price for the stock on the principal such exchange.

6. Offering Date. The "offering date" as used in this Plan shall be the commencement date of the offering, if such date is a regular business day, or the first regular business day following such commencement date. A different date may be set by resolution of the Board.

7. Number of Shares to be Offered. The maximum number of shares that will be offered under the Plan is 6,750,000. The shares to be sold to participants under the Plan will be common stock of the Company. If the total number of shares for which options are to be granted on any date in accordance with Section 10 exceeds the number of shares then available under the Plan (after deduction

of all shares for which options have been exercised or are then outstanding), the Company shall make a pro rata allocation of the shares remaining available in as nearly a uniform manner as shall be practicable and as it shall determine to be equitable. In such event, the payroll deductions to be made pursuant to the authorizations therefor shall be reduced accordingly and the Company shall give written notice of such reduction to each employee affected thereby.

8. Participation.

8.1 An eligible employee may become a participant by completing an Enrollment Agreement provided by the Company and filing it with Shareholder Services prior to the Commencement of the offering to which it relates.

8.2 Payroll deductions for a participant shall commence on the offering date, and shall end on the termination date of such offering unless earlier terminated by the employee as provided in Paragraph 14.

9. Payroll Deductions.

9.1 At the time a participant files his authorization for a payroll deduction, he shall elect to have deductions made from his pay on each payday during the time he is a participant in an offering at the rate of 2%, 4%, 6%, 8%, or 10% of his base pay.

9.2 All payroll deductions made for a participant shall be credited to his account under the Plan. A participant may not make any separate cash payment into such account nor may payment for shares be made other than by payroll deduction.

9.3 A participant may discontinue his participation in the Plan as provided in Section 14, but no other change can be made during an offering and, specifically, a participant may not alter the rate of his payroll deductions for that offering.

10. Granting of Option. On the offering date, this Plan shall be deemed to have granted to the participant an option for as many full shares as he will be able to purchase with the payroll deductions credited to his account

during his participation in that offering. Notwithstanding the foregoing, no participant may purchase more than 2,250 shares of stock during any single offering.

11. Exercise of Option. Each employee who continues to be a participant in an offering on the last business day of that offering shall be deemed to have exercised his option on such date and shall be deemed to have purchased from the Company such number of full shares of common stock reserved for the purpose of the Plan as his accumulated payroll deductions on such date will pay for at the option price.

12. Employee's Rights as a Shareholder. No participating employee shall have any right as a shareholder with respect to any shares until the shares have been purchased in accordance with Section 11 above and the stock has been issued by the Company.

13. Evidence of Stock Ownership.

13.1 Promptly following the end of each offering, the number of shares of common stock purchased by each participant shall be deposited into an account established in the participant's name at a stock brokerage or other financial services firm designated by the Company (the "ESPP Broker").

13.2 The participant may direct, by written notice to the Company at the time of his enrollment in the Plan, that his ESPP Broker account be established in the names of the participant and one other person designated by the participant, as joint tenants with right of survivorship, tenants in common, or community property, to the extent and in the manner permitted by applicable law.

13.3 A participant shall be free to undertake a disposition (as that term is defined in Section 424(c) of the Code) of the shares in his account at any time, whether by sale, exchange, gift, or other transfer of legal title, but in the absence of such a disposition of the shares, the shares must remain in the participant's account at the ESPP Broker until the holding period set forth in Section 423(a) of the Code has been satisfied. With respect to shares for which the Section 423(a) holding period has been satisfied, the participant may move those shares to another brokerage account of participant's choosing or request that a stock certificate be issued and delivered to him.

13.4 A participant who is not subject to payment of U.S. income taxes may move his shares to another brokerage account of his choosing or request that a stock certificate be issued and delivered to him at any time, without regard to the satisfaction of the Section 423(a) holding period.

14. Withdrawal.

14.1 An employee may withdraw from an offering, in whole but not in part, at any time prior to the last business day of such offering by delivering a Withdrawal Notice to the Company, in which event the Company will refund the entire balance of his deductions as soon as practicable thereafter.

14.2 To re-enter the Plan, an employee who has previously withdrawn must file a new Enrollment Agreement in accordance with Section 8.1. The employee's re-entry into the Plan will not become effective before the beginning of the next offering following his withdrawal, and if the withdrawing employee is an officer of the Company within the meaning of Section 16 of the Securities Exchange Act of 1934 he may not re-enter the Plan before the beginning of the second offering following his withdrawal.

15. Carryover of Account. At the termination of each offering the Company shall automatically re-enroll the employee in the next offering, and the balance in the employee's account shall be used for option exercises in the new offering, unless the employee has advised the Company otherwise. Upon termination of the Plan, the balance of each employee's account shall be refunded to him.

16. Interest. No interest will be paid or allowed on any money in the accounts of participating employees.

17. Rights Not Transferable. No employee shall be permitted to sell, assign, transfer, pledge, or otherwise dispose of or encumber either the payroll deductions credited to his account or any rights with regard to the exercise of an option or to receive shares under the Plan other than by will or the laws of descent and distribution, and such right and interest shall not be liable for, or subject to, the debts, contracts, or liabilities of the employee. If any such action is taken by the employee, or any claim is asserted by any other party in respect of such right and interest whether by garnishment, levy, attachment or otherwise, such action or claim will be treated as an election to withdraw funds in accordance with Section 14.

18. Termination of Employment. Upon termination of employment for any reason whatsoever, including but not limited to death or retirement, the balance in the account of a participating employee shall be paid to the employee or his estate.

19. Amendment or Discontinuance of the Plan. The Board shall have the right to amend, modify, or terminate the Plan at any time without notice, provided that no employee's existing rights under any offering already made under Section 4 hereof may be adversely affected thereby, and provided further that no such amendment of the Plan shall, except as provided in Section 20, increase above 6,750,000 the total number of shares to be offered unless shareholder approval is obtained therefor.

20. Changes in Capitalization. In the event of reorganization, recapitalization, stock split, stock dividend, combination of shares, merger, consolidation, offerings of rights, or any other change in the structure of the common shares of the Company, the Board may make such adjustment, if any, as it may deem appropriate in the number, kind, and the price of shares available for purchase under the Plan, and in the number of shares which an employee is entitled to purchase.

21. Share Ownership. Notwithstanding anything herein to the contrary, no employee shall be permitted to subscribe for any shares under the Plan if such employee, immediately after such subscription, owns shares (including all shares which may be purchased under outstanding subscriptions under the Plan) possessing 5% or more of the total combined voting power or value of all classes of shares of the Company or of its parent or subsidiary corporations. For the foregoing purposes the rules of Section 425(d) of the Internal Revenue Code of 1986 shall apply in determining share ownership. In addition, no employee shall be allowed to subscribe for any shares under the Plan which permits his rights to purchase shares under all "employee stock purchase plans" of the Company and its subsidiary corporations to accrue at a rate which exceeds $25,000 of the fair market value of such shares (determined at the time such right to subscribe is granted) for each calendar year in which such right to subscribe is outstanding at any time.

22. Administration. The Plan shall be administered by the Board. The Board shall be vested with full authority to make, administer, and interpret such rules and regulations as it deems necessary to administer the Plan, and any determination, decision, or action of the Board in connection with the construction, interpretation, administration, or application of the Plan shall be final, conclusive, and binding upon all participants and any and all persons claiming under or through any participant.

The Board may delegate any or all of its authority hereunder to such committee as it may designate.

23. Notices. All notices or other communications by a participant to the Company under or in connection with the Plan shall be deemed to have been duly given when received by Shareholder Services of the Company or when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.

24. Termination of the Plan. This Plan shall terminate at the earliest of the following:

24.1 December 31, 1996;

24.2 The date of the filing of a Statement of Intent to Dissolve by the Company or the effective date of a merger or consolidation wherein the Company is not to be the surviving corporation, which merger or consolidation is not between or among corporations related to the Company. Prior to the occurrence of either of such events, on such date as the Company may determine, the Company may permit a participating employee to exercise the option to purchase shares for as many full shares as the balance of his account will allow at the price set forth in accordance with Section 5. If the employee elects to purchase shares, the remaining balance of his account will be refunded to him after such purchase.

24.3 The date the Board acts to terminate the Plan in accordance with Section 19 above.

24.3 The date when all shares reserved under the Plan have been purchased.

25. Limitations on Sale of Stock Purchased Under the Plan. The Plan is intended to provide common stock for investment and not for resale. The Company does not, however, intend to restrict or influence any employee in the conduct of his own affairs. An employee, therefore, may sell stock purchased under the Plan at any time he chooses, subject to compliance with any applicable Federal or state securities laws. THE EMPLOYEE ASSUMES THE RISK OF ANY MARKET FLUCTUATIONS IN THE PRICE OF THE STOCK.

26. Governmental Regulation. The Company's obligation to sell and deliver shares of the Company's common stock under this Plan is subject to the approval of any governmental authority required in connection with the authorization, issuance, or sale of such shares.

[The number of shares set forth in Sections 7, 10, and 19 have been changed to reflect the effect of three-for-two stock splits in 1991 and 1992, and a two-for-one stock split in 1994.]

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EXHIBIT 11.

COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share)

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	Year Ended June 30		
	1993	1994	1995
<S>	<C>	<C>	<C>
Weighted average common shares outstanding	556	571	582
Common equivalent shares from stock options	50	39	45
Average common and equivalent shares outstanding (1)	606	610	627
Net income	$ 953	$1,146	$1,453
Earnings per share (1)	$1.57	$ 1.88	$ 2.32

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(1) Fully diluted earnings per share have not been presented because the effects are not material.

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EXHIBIT 21.

SUBSIDIARIES

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Antura S.A.R.L.	Microsoft Informatica Limitada (Brazil)
ASCII Network Technology, Inc. (Japan JV)	Microsoft Institute PTY Limited
CorporacionMicrosoft Del Ecuador S.A.	Microsoft International BV (The Netherlands)
Corporation MS 90 de Venezuela SA	Microsoft Israel Ltd.
Dram Realty, Inc.	Microsoft Kft (Hungary)
Dreamworks Interactive L.L.C. (U.S. JV)	Microsoft Limited (U.K.)
Forethought Inc.	Microsoft (Thailand) Limited
Fox Software GmbH (Germany)	Microsoft (S.A.) (Proprietary) Limited (South Africa)
Fox Software, Inc.	Microsoft Manufacturing B.V. (Ireland manufacturing)
Fox Software (U.K.) Limited	Microsoft Maroc S.A.R.L. (Morocco)
Fox Software S.A.R.L. (France)	Microsoft Mexico, S.A. de C.V.
GraceMac Corporation	Microsoft New Zealand Limited
HomePlate, Inc.	Microsoft Norge AS (Norway)

ImageWare Research and Development, Inc. (Canada)
Microsoft A.O. (Russia)
Microsoft AG (Switzerland)
Microsoft Aktiebolag (Sweden)
Microsoft B.V. (The Netherlands)
Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (Turkey)
Microsoft Canada Inc.
Microsoft Caribbean, Inc. (Puerto Rico)
Microsoft CH (Korea)
Microsoft Chile S.A.
Microsoft Colombia Inc.
Microsoft Company, Limited (Japan)
Microsoft Coris, S.P.A. (Italy JV)
Microsoft Corporation-Beijing Representative Office (The Peoples Republic of China)
Microsoft Corporation (Dubai Branch)
Microsoft Corporation Limitada (Colombia)
Microsoft Corporation (India) Private Limited
Microsoft d.o.o., Ljubljana (Slovenia)
Microsoft Danmark ApS (Denmark)
Microsoft de Argentina S.A.
Microsoft De Centroamerica S.A. (Costa Rica)
Microsoft Distribution Limited (Ireland)
Microsoft Europe S.A.R.L. (European Headquaters)
Microsoft France S.A.R.L.
Microsoft FSC Corp.
Microsoft Gesellschaft m.b.H. (Austria)
Microsoft G.m.b.H. (Germany)
Microsoft Hellas S.A. (Greece)
Microsoft Hong Kong Limited
Microsoft Iberica S.R.L. (Spain)
Microsoft N.V. (Belgium)
Microsoft Oy (Finland)
Microsoft Perc, S.A.
Microsoft Phillipines, Inc.
Microsoft Properties France S.A.R.L.
Microsoft Properties UK Limited

Microsoft Pty Limited (Australia)
Microsoft Puerto Rico, Inc. (Manufacturing)
Microsoft Rendermorphics Limited (U.K.)
Microsoft (Malaysia) Sdn. Bhd.
Microsoft Singapore Pte Ltd
Microsoft Slovakia s.r.o.
MSFT-Software Para Microcomputadores, LDA (Portugal)
Microsoft S.p.A. (Italy)

Microsoft sp. z.o.o. (Poland)
Microsoft s.r.o. (Czech Republic)
Microsoft Taiwan Corporation
Microsoft Venezuela, S.A.
Microsoft Workgroup Canada, Inc.
MSHC Inc. (Holding Company)
NRI India, Inc.
On Australia Pty. Limited (Australia JV)
SoftCapital, Inc.
SOFTIMAGE France S.A.R.L.
SOFTIMAGE, Inc. (Canada)
SOFTIMAGE, Italy S.R.L.
SOFTIMAGE U.K. Limited
Technology Resources Management Corporation
The Monotype Corporation

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EXHIBIT 23.

INDEPENDENT AUDITORS' CONSENT

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981 Stock Option Plan), 33-44302 and 33-51583 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors) and 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors) of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, and 33-64870 of Microsoft Corporation on Forms S-3 of our report dated July 17, 1995 (August 21, 1995 as to Contingencies Note) appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 1995.

/S/ DELOITTE & TOUCHE LLP

Seattle, Washington
September 25, 1995

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EXHIBIT 99.1

MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN
FINANCIAL STATEMENTS FOR THE
THREE YEARS ENDED JUNE 30, 1995,
1994, AND 1993, AND
INDEPENDENT AUDITORS' REPORT

<PAGE> 2

INDEPENDENT AUDITORS' REPORT

Plan Administrator
Microsoft Corporation
1991 Employee Stock Purchase Plan
Redmond, Washington

We have audited the accompanying statements of assets available for benefits of the Microsoft Corporation 1991 Employee Stock Purchase Plan (the Plan) as of June 30, 1995 and 1994, and the related statements of changes in assets available for benefits for the years ended June 30, 1995, 1994, and 1993. These financial statements are the responsibility of the Plan Administrator. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the assets available for benefits of the Plan as of June 30, 1995 and 1994, and the changes in assets available for benefits for the years ended June 30, 1995, 1994, and 1993, in conformity with generally accepted accounting principles.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
August 11, 1995

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MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN

STATEMENTS OF ASSETS AVAILABLE FOR BENEFITS
JUNE 30, 1995 AND 1994

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ASSETS:		
Cash	$295,579	$492,243
ASSETS AVAILABLE FOR BENEFITS	$295,579	$492,243

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See note to financial statements.

MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN

STATEMENTS OF CHANGES IN ASSETS AVAILABLE FOR BENEFITS
YEARS ENDED JUNE 30, 1995, 1994, AND 1993

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ASSETS AVAILABLE FOR BENEFITS, beginning of period	$ 492,243	$ 961,962	$ 366,638
ADDITIONS: Employee contributions	48,835,432	48,614,990	34,114,121
DEDUCTIONS: Cost of shares purchased	49,032,095	39,084,709	33,518,797
CHANGES IN ASSETS AVAILABLE FOR BENEFITS	(196,664)	(469,719)	595,324
ASSETS AVAILABLE FOR BENEFITS, end of period	$ 295,579	$ 492,243	$ 961,962

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See note to financial statements.

MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN

NOTE TO FINANCIAL STATEMENTS
YEARS ENDED JUNE 30, 1995, 1994, AND 1993

NOTE 1: THE PLAN

The following description of the Microsoft Corporation 1991 Employee Stock

Purchase Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

GENERAL: The Plan Administrator believes the Plan meets the qualification standards of Section 423 of the Internal Revenue Code of 1986. The Plan is not subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

The Plan covers substantially all employees of Microsoft Corporation (the Company) whose customary employment is greater than 20 hours per week, and more than five months in any calendar year.

CONTRIBUTIONS: Participants may make contributions to the Plan through payroll deductions (not exceeding 10% of their compensation) for the purpose of purchasing the Company's common stock. The Plan commenced on January 1, 1991, and participants are given the opportunity to purchase shares on each June 30 and December 31 until such time as the Plan is terminated (see Termination of the Plan). The maximum number of shares that will be offered under the Plan is 6,750,000.

OPTIONS GRANTED AND WITHDRAWALS: Participants are granted the option to purchase shares of Microsoft Corporation common stock from the Company at 85% of the lesser of the fair market value on the first or last day of each six-month period ending June 30 or December 31. If the participant does not exercise the option, the Company refunds the participant for amounts withheld. The Plan purchased 1,049,695, 1,147,508, and 1,006,988, shares during the years ended June 30, 1995, 1994, and 1993, respectively. A total of 4,686,060 shares have been purchased under the Plan since inception with 2,063,940 shares reserved for future issue.

ASSETS AVAILABLE FOR BENEFITS: Assets available for benefits represent cash in participant accounts that was less than the amount necessary to purchase a full share and cash contributed to the Plan greater than the cost of the maximum number of shares allowed to be purchased in a six-month period (see Limitations). Participants may carry over such amounts to the next period.

LIMITATIONS: No employee shall be permitted to subscribe for any shares under the Plan if such employee owns shares representing 5% or more of the total combined voting power or value of all classes of shares of the Company. Additionally, no participant may purchase more than 2,250 shares of stock during a six-month period, or purchase shares through the Plan with an aggregate fair market value in excess of $25,000 in any one calendar year.

TERMINATION OF THE PLAN: The Plan shall terminate at the earliest of the following:

- December 31, 1996

- The date of the filing of a statement of intent to dissolve by the Company or the effective date of a merger or consolidation (except with a related company) where the Company is not to be the surviving corporation
- The date the Board acts to terminate the Plan
- The date when all shares reserved under the Plan have been purchased

In the event of a dissolution, merger, or acquisition, the Company may permit a participating employee to exercise options to the extent that employee payroll deductions have accumulated. In the event of termination, Plan assets will be distributed to the participants.

PLAN ADMINISTRATION: All expenses for administration of the Plan are paid by the Company, and are not reflected in the accompanying statements.

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EXHIBIT 99.2

MICROSOFT CORPORATION
SAVINGS PLUS PLAN

FINANCIAL STATEMENTS FOR THE
TWO YEARS ENDED DECEMBER 31, 1994, AND
NINE MONTHS ENDED DECEMBER 31, 1992, AND
INDEPENDENT AUDITORS' REPORT

<PAGE> 2

INDEPENDENT AUDITORS' REPORT

Plan Administrator
Microsoft Corporation Savings Plus Plan
Redmond, Washington

We have audited the accompanying statements of assets available for benefits of the Microsoft Corporation Savings Plus Plan (the Plan) as of December 31, 1994 and 1993, and the related statements of changes in assets available for benefits for the two years ended December 31, 1994, and the nine months ended December 31, 1992. These financial statements are the responsibility of the Plan administrator. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the assets available for benefits of the Plan as of December 31, 1994 and 1993, and the related statements of changes in assets available for benefits for the two years ended December 31, 1994, and the nine months ended December 31, 1992, in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of assets held for investment as of December 31, 1994, and reportable transactions for the year then ended are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
July 10, 1995

<PAGE> 3

MICROSOFT CORPORATION SAVINGS PLUS PLAN

STATEMENTS OF ASSETS AVAILABLE FOR BENEFITS
DECEMBER 31, 1994 AND 1993

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<S>	1994 <C>	1993 <C>
ASSETS:		
Investments held by trustee at fair value:		
Microsoft Corporation Stock Fund	$ 96,047,305	$ 57,717,671
Fidelity Magellan Fund	30,791,846	19,930,432
Fidelity U.S. Equity Index Fund	23,368,129	20,685,406
Fidelity Retirement Money Market Fund	19,881,402	16,776,143
Fidelity Growth Company Fund	17,814,128	11,638,038
Fidelity Intermediate Bond Fund	15,775,411	14,653,568
Fidelity Overseas Fund	11,290,171	5,292,574
Participant loans receivable	1,867,625	1,122,588
ASSETS AVAILABLE FOR BENEFITS	$216,836,017	$147,816,420

</TABLE>

See notes to financial statements.

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MICROSOFT CORPORATION SAVINGS PLUS PLAN

STATEMENTS OF CHANGES IN ASSETS

AVAILABLE FOR BENEFITS
TWO YEARS ENDED DECEMBER 31, 1994, AND
NINE MONTHS ENDED DECEMBER 31, 1992

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<S>	1994 <C>	1993 <C>	1992 <C>
ADDITIONS:			
Investment income:			
Interest and dividends	$ 4,440,600	$ 4,978,058	$2,530,108
Net appreciation in fair value of investments	25,559,250	328,116	4,705,139
Total net investment income	29,999,850	5,306,174	7,235,247
Contributions:			
Employer	10,616,736	8,539,976	5,003,882
Employee	35,374,522	26,901,086	16,310,632
Total contributions	45,991,258	35,441,062	21,314,514
Total additions	75,991,108	40,747,236	28,549,761
DEDUCTIONS:			
Benefits paid to participants	6,971,511	2,734,102	1,320,423
CHANGES IN ASSETS AVAILABLE FOR BENEFITS	69,019,597	38,013,134	27,229,338
ASSETS AVAILABLE FOR BENEFITS:			
Beginning of year	147,816,420	109,803,286	82,573,948
End of year	$216,836,017	$147,816,420	$109,803,286

</TABLE>

See notes to financial statements.

MICROSOFT CORPORATION SAVINGS PLUS PLAN

NOTES TO FINANCIAL STATEMENTS
TWO YEARS ENDED DECEMBER 31, 1994, AND
NINE MONTHS ENDED DECEMBER 31, 1992

NOTE 1: DESCRIPTION OF THE PLAN AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PLAN DESCRIPTION: The Microsoft Corporation Savings Plus Plan (the Plan) is a defined contribution plan. All employees of Microsoft Corporation (the Company) who have reached 18 years of age may enroll during the month following completion of six months of service or during any subsequent quarterly enrollment period. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The Plan is administered by the Vice President of Human Resources and Administration of Microsoft Corporation.

CONTRIBUTIONS: Participants may contribute from 1% to 15% of their compensation, tax deferred, through payroll deductions up to a maximum of $9,240 under current law. The amount of a participant's tax-deferred contributions may be subject to limitations. Participant contributions may be suspended at any time. Contributions may be reinstated on the first day of the quarter that is at least six months after contributions were suspended.

The Company makes a matching contribution equal to 50% of a participant's contributions up to 6% of the participant's individual compensation. Company contributions are funded on a semimonthly basis.

VESTING: Employee contributions are fully vested immediately. Employer contributions vest fully upon completion of two years of service by a participant, or when a participant reaches age 65, dies, or becomes disabled.

DISTRIBUTIONS: Participants may make a withdrawal from the vested portion of their account if the Plan administrator determines a withdrawal is necessary to avoid a financial hardship or if the participant is at least 59-1/2 years of age.

FORFEITURES: Any nonvested interest of a terminated employee shall not be forfeited to the Plan until a one-year period of severance service has passed. At this time, the forfeited amount is distributed to the Plan. If a terminated employee is reemployed before five consecutive one-year periods of severance have passed, the forfeited amount will be reallocated to the individual's account.

ADMINISTRATIVE EXPENSES: Expenses for administration of the Plan are paid by the Company.

PLAN AMENDMENT AND TERMINATION: The Company has the right to modify, amend, suspend or terminate the Plan at any time and for any reason. If the Plan is terminated, account balances will be fully vested and will be distributed in the form and manner determined by the Plan administrator.

VALUATION OF INVESTMENTS AND PARTICIPANT LOANS: Investments are recorded at fair value. Security transactions are accounted for as of the trade date. Fair market value is based on quoted prices. Loans to participants are recorded at contract value, which approximates fair value. Dividend income is recorded on the ex-dividend date and interest income is recorded as earned.

NOTE 2: INVESTMENTS

Fidelity Investments (Fidelity) is trustee of the Plan. All Plan investments are held by Fidelity. Investment funds available to participants are summarized as follows:

MICROSOFT CORPORATION STOCK FUND: The Microsoft Corporation Stock Fund consists entirely of the Company's common stock.

FIDELITY U.S. EQUITY INDEX FUND: The Fidelity U.S. Equity Index Fund consists mainly of common stocks of the companies that make up Standard & Poor's 500 Index. The fund seeks investment results that correspond to the total return performance of United States publicly traded common stocks.

FIDELITY RETIREMENT MONEY MARKET FUND: The Fidelity Retirement Money Market Fund strives to maintain a stable $1 share price while its yield will fluctuate with changes in market conditions. The fund seeks as high a level of current income as is consistent with the preservation of capital and liquidity.

FIDELITY INTERMEDIATE BOND FUND: The Fidelity Intermediate Bond Fund consists of investment-grade fixed income obligations. The fund seeks a high level of current income.

FIDELITY MAGELLAN FUND: The Fidelity Magellan Fund consists of common stocks, and securities convertible to common stock, issued by companies operating in the United States or abroad. The fund seeks long-term capital appreciation.

FIDELITY GROWTH COMPANY FUND: The Fidelity Growth Company Fund consists mainly of investments in companies with above average growth characteristics as demonstrated in earnings or gross sales. The fund seeks long-term capital appreciation.

FIDELITY OVERSEAS FUND: The Fidelity Overseas Fund consists of investments in securities of issuers whose principal activities are outside the United States. The fund seeks long-term capital appreciation.

The following details activity for each of the participant-directed investment accounts at fair value.

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<S>	Microsoft Corporation Stock Fund <C>	Fidelity Magellan Fund <C>	Fidelity U.S. Equity Index Fund <C>	Fidelity Retirement Money Market Fund <C>
Balance, December 31, 1993	$57,717,671	$19,930,432	$20,685,406	$16,776,143
Net investment income (loss)	30,227,408	(534,447)	235,253	753,604
Employer contributions	2,965,531	2,303,844	1,207,840	1,055,766
Employee contributions	9,650,674	7,649,724	3,981,633	3,294,995
Benefits paid to participants	(2,610,753)	(712,176)	(940,002)	(1,177,295)
Transfers	(1,903,226)	2,154,469	(1,802,001)	(821,811)
Balance, December31,1994	$96,047,305	$30,791,846	$23,368,129	$19,881,402

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<S>	Fidelity Growth Company Fund <C>	Fidelity Intermediate Fund <C>	Fidelity Overseas Fund <C>	Participant Loan Fund <C>	Total assets available for benefits <C>
Balance, December 31, 1993	$11,638,038	$14,653,568	$5,292,574	$1,122,588	$147,816,420
Net investment income (loss)	(300,914)	(286,380)	(94,674)		29,999,850
Employer contributions	1,304,567	964,777	814,411		10,616,736
Employee contributions	4,729,657	3,052,750	3,015,089		35,374,522
Benefits paid to participants	(606,881)	(646,537)	(277,867)		(6,971,511)
Transfers	1,049,661	(1,962,767)	2,540,638	745,037	
Balance, December 31, 1994	$17,814,128	$15,775,411	$11,290,171	$1,867,625	$216,836,017

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NOTE 3: PARTICIPANT LOANS

Effective January 1, 1993, Plan participants are permitted to borrow up to 50% of the total vested account balance. Participants are limited to one residential loan and one nonresidential loan outstanding. The interest rate for residential loans is based on the yield for the Federal Home Loan Mortgage Corporation 30-year mortgage commitment for a standard conventional fixed rate mortgage, plus 1%. The interest rate for nonresidential loans will be the prime rate on corporate loans plus 1%. The range of interest rates was 7% - 9.5% for nonresidential loans and 8.78% - 10.26% for residential loans for the year ended December 31, 1994. Loan repayment is made through after-tax semimonthly payroll deductions over a period of up to 15 years for residential loans and five years for nonresidential loans. If a participant's employment terminates for any reason and the loan balance is not paid in full by the participant in the month of termination, the loan balance will be cancelled and become taxable income to the participant.

NOTE 4: TAX STATUS

The Internal Revenue Service has determined and informed the Plan by a letter dated June 18, 1990, that the Plan is tax-exempt under the appropriate sections of the Internal Revenue Code (the Code). The Plan has been amended subsequent to the date of the determination letter. The Plan administrator, however, believes that the Plan is in compliance with the applicable requirements of the Code. As such, they believe the Plan is tax-exempt as of the financial statement date. Accordingly, no provision for income taxes has been recorded.

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MICROSOFT CORPORATION SAVINGS PLUS PLAN

ITEM 27(a) - SUPPLEMENTAL SCHEDULE OF ASSETS HELD FOR INVESTMENT
DECEMBER 31, 1994

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DESCRIPTION OF ASSETS:			
Microsoft Corporation Stock Fund	1,571,326	$ 45,542,299	$ 96,047,305
Fidelity U.S. Equity Index Fund	1,381,912	21,918,218	23,368,129
Fidelity Retirement Money Market Fund	19,881,402	19,881,402	19,881,402
Fidelity Intermediate Bond Fund	1,604,823	16,602,396	15,775,411
Fidelity Magellan Fund	460,955	31,616,996	30,791,846
Fidelity Growth Company Fund	653,490	18,421,938	17,814,128
Fidelity Overseas Fund	413,559	11,132,566	11,290,171
Participant loans receivable		1,867,625	1,867,625
		$166,983,440	$216,836,017

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MICROSOFT CORPORATION SAVINGS PLUS PLAN

ITEM 27(d) - SUPPLEMENTAL SCHEDULE OF REPORTABLE TRANSACTIONS
YEAR ENDED DECEMBER 31, 1994

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	Purchase price	Selling price	Cost of asset	Fair value of asset on transaction date	Net gain (loss)
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SERIES OF TRANSACTIONS:					
Microsoft Corporation Stock Fund	$16,657,341	$8,526,670	$5,020,086	$8,526,670	$3,506,584
Fidelity Magellan Fund	15,318,082	2,938,371	3,001,448	2,938,371	(63,077)
Fidelity Intermediate Bond Fund	5,573,490	3,089,675	3,153,371	3,089,675	(63,696)
Fidelity Overseas Fund	7,510,209	1,227,829	1,164,110	1,227,829	63,719
Fidelity Retirement Money Market Fund	7,921,260	4,816,001	4,816,001	4,816,001	
Fidelity U.S. Equity Index Fund	6,457,870	3,306,876	3,050,705	3,306,876	256,171
Fidelity Growth Company Fund	9,157,878	1,990,665	2,004,396	1,990,665	(13,731)

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CONFORMED PERIOD OF REPORT:    20020930
FILED AS OF DATE:              20021114

FILER:

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		CENTRAL INDEX KEY:                      0000789019
		STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
		IRS NUMBER:                             911144442
		STATE OF INCORPORATION:                 WA
		FISCAL YEAR END:                        0630

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		STREET 2:           NORTH OFFICE 2211
		CITY:               REDMOND
		STATE:              WA
		ZIP:                98052
		BUSINESS PHONE:     4258828080

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FILED AS OF DATE: 20020430

FILER:

COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

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SEC FILE NUMBER: 000-14278
FILM NUMBER: 02625544

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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 4258828080

MAIL ADDRESS:
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STREET 2: NORTH OFFICE 2211
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                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 WA
                FISCAL YEAR END:                        0630

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                STREET 1:               ONE MICROSOFT WAY #BLDG 8
                STREET 2:               NORTH OFFICE 2211
                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         4258828080

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                STREET 1:               ONE MICROSOFT WAY - BLDG 8
                STREET 2:               NORTH OFFICE 2211
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FILED AS OF DATE: 20011026

FILER:

COMPANY DATA:

COMPANY CONFORMED NAME: MICROSOFT CORP

CENTRAL INDEX KEY: 0000789019

STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR

IRS NUMBER: 911144442

STATE OF INCORPORATION: WA

FISCAL YEAR END: 0630

FILING VALUES:

FORM TYPE: 10-Q

SEC ACT: 1934 Act

SEC FILE NUMBER: 000-14278

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BUSINESS ADDRESS:

STREET 1: ONE MICROSOFT WAY #BLDG 8

STREET 2: NORTH OFFICE 2211

CITY: REDMOND

STATE: WA

ZIP: 98052

BUSINESS PHONE: 4258828080

MAIL ADDRESS:

STREET 1:	ONE MICROSOFT WAY - BLDG 8
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STATE:	WA
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FILED AS OF DATE: 20010515

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COMPANY DATA:

COMPANY CONFORMED NAME: MICROSOFT CORP

CENTRAL INDEX KEY: 0000789019

STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR

IRS NUMBER: 911144442

STATE OF INCORPORATION: WA

FISCAL YEAR END: 0630

FILING VALUES:

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BUSINESS ADDRESS:

STREET 1: ONE MICROSOFT WAY #BLDG 8

STREET 2: NORTH OFFICE 2211

CITY: REDMOND

STATE: WA

ZIP: 98052

BUSINESS PHONE: 4258828080

MAIL ADDRESS:

STREET 1:	ONE MICROSOFT WAY - BLDG 8
STREET 2:	NORTH OFFICE 2211
CITY:	REDMOND
STATE:	WA
ZIP:	98052-6399

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COMPANY DATA:

COMPANY CONFORMED NAME:	MICROSOFT CORP
CENTRAL INDEX KEY:	0000789019
STANDARD INDUSTRIAL CLASSIFICATION:	SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER:	911144442
STATE OF INCORPORATION:	WA
FISCAL YEAR END:	0630

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STREET 2:	NORTH OFFICE 2211
CITY:	REDMOND
STATE:	WA
ZIP:	98052
BUSINESS PHONE:	4258828080

MAIL ADDRESS:

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CITY:	REDMOND
STATE:	WA
ZIP:	98052-6399

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COMPANY DATA:

COMPANY CONFORMED NAME: MICROSOFT CORP

CENTRAL INDEX KEY: 0000789019

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IRS NUMBER: 911144442

STATE OF INCORPORATION: WA

FISCAL YEAR END: 0630

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STREET 2: NORTH OFFICE 2211

CITY: REDMOND

STATE: WA

ZIP: 98052

BUSINESS PHONE: 4258828080

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MAIL ADDRESS:

STREET 1: ONE MICROSOFT WAY -

STREET 2: NORTH OFFICE 2211

CITY: REDMOND

STATE: WA

ZIP: 98052-6399

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COMPANY DATA:
COMPANY CONFORMED NAME: MICROSOFT CORP
CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

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FILM NUMBER: 629580

BUSINESS ADDRESS:
STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 4258828080

MAIL ADDRESS:
STREET 1: ONE MICROSOFT WAY - BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052-6399
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2000

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

One Microsoft Way, Redmond, Washington (Address of principal executive office)	98052-6399 (Zip Code)

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

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

The number of shares outstanding of the registrant's common stock as of April 30, 2000 was 5,262,405,409.

==
<PAGE>

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended March 31, 2000

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Part I. Financial Information

<PAGE>

Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

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

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	Three Months Ended Mar. 31	
	1999	2000
<S>	<C>	<C>
Revenue	$4,595	$5,656
Operating expenses:		
Cost of revenue	708	752
Research and development	664	990
Sales and marketing	849	1,042
General and administrative	144	176
Other expenses (income)	1	(32)
Total operating expenses	2,366	2,928
Operating income	2,229	2,728
Investment income	720	885
Gains on sales	0	0
Income before income taxes	2,949	3,613
Provision for income taxes	1,032	1,228
Net income	$1,917	$2,385
Earnings per share:		
Basic	$ 0.38	$ 0.46
Diluted	$ 0.35	$ 0.43

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Balance Sheets
(In millions)

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	June 30 1999	Mar. 3 2000 (
<S>	<C>	<C>
Assets		
Current assets:		
Cash and short-term investments	$17,236	$21,20
Accounts receivable	2,245	2,90
Other	752	1,11
Total current assets	20,233	25,21
Property and equipment	1,611	1,83
Equity and other investments	14,372	21,32
Other assets	940	2,52
Total assets	$37,156	$50,89
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 874	$ 1,0[illegible]
Accrued compensation	396	37
Income taxes payable	1,607	1,93
Unearned revenue	4,239	4,45
Other	1,602	3,26
Total current liabilities	8,718	11,10
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock - shares authorized 100; outstanding 13 and 0	980	
Common stock and paid-in capital - shares authorized 12,000; outstanding 5,109 and 5,242	13,844	20,97
Retained earnings	13,614	18,81
Total stockholders' equity	28,438	39,79
Total liabilities and stockholders' equity	$37,156	$50,89

(1) Unaudited
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See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

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	Nine Months End	
	1999	20
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Operations		
Net income	$ 5,583	$ 7,0
Depreciation and amortization	514	1,0
Gains on sales	(160)	(1
Unearned revenue	4,139	4,2
Recognition of unearned revenue from prior periods	(2,832)	(4,0
Other current liabilities	471	(8
Accounts receivable	(192)	(5
Other current assets	(104)	(3
Net cash from operations	7,419	6,4
Financing		
Common stock issued	1,102	1,7
Common stock repurchased	(1,527)	(4,8
Put warrant proceeds	757	4
Preferred stock dividends	(21)	(
Stock option income tax benefits	2,238	4,0
Net cash from financing	2,549	1,3
Investing		
Additions to property and equipment	(291)	(6
Cash proceeds from sale of Softimage, Inc.	79	
Purchases of investments	(20,556)	(29,2
Maturities of investments	3,175	3,0
Sales of investments	9,950	19,1
Net cash used for investing	(7,643)	(7,5
Net change in cash and equivalents	2,325	1
Effect of exchange rates on cash and equivalents	39	
Cash and equivalents, beginning of period	3,839	4,9
Cash and equivalents, end of period	6,203	5,1
Short-term investments, end of period	15,558	16,0
Cash and short-term investments, end of period	$21,761	$21,2

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See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Stockholders' Equity Statements
(In millions)(Unaudited)

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	Three Months Ended Mar. 31 1999	2000	
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Convertible preferred stock			
Balance, beginning of period	$ 980	$ 0	$
Conversion of preferred to common stock	0	0	
Balance, end of period	980	0	
Common stock and paid-in capital			
Balance, beginning of period	10,443	18,878	
Common stock issued	901	751	
Common stock repurchased	(20)	(20)	
Structured repurchases price differential	(328)	0	
Proceeds from sale of put warrants	402	0	
Stock option income tax benefits	1,020	1,366	
Balance, end of period	12,418	20,975	1
Retained earnings			
Balance, beginning of period	11,155	15,711	
Net income	1,917	2,385	
Net unrealized investments gains	46	583	
Translation adjustments and other	(52)	138	
Comprehensive income	1,911	3,106	
Preferred stock dividends	(7)	0	
Common stock repurchased	(735)	0	(
Balance, end of period	12,324	18,817	1
Total stockholders' equity	$25,722	$39,792	$2

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1999 Form 10-K.

Earnings Per Share

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

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

Earnings Per Share

(In millions, except earnings per share)

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<S>	Three Months Ended Mar. 31 1999 <C>	2000 <C>
Net income (A)	$1,917	$2,385
Preferred stock dividends	(7)	0
Net income available for common shareholders (B)	$1,910	$2,385
Average outstanding shares of common stock (C)	5,055	5,209
Dilutive effect of:		
Common stock under structured repurchases	12	0
Preferred stock	16	0
Employee stock options	429	334
Common stock and common stock equivalents (D)	5,512	5,543
Earnings per share:		
Basic (B/C)	$ 0.38	$ 0.46
Diluted (A/D)	$ 0.35	$ 0.43

</TABLE>

<PAGE>

Unearned Revenue

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

End users receive certain elements of the Company's products over a period of time. These elements include browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. The percentage of revenue recognized ratably ranges from approximately 15% to 25% of Windows desktop operating systems and approximately 10% to 20% of desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three years for Windows operating systems and 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organization license agreements. At March 31, 2000, unearned revenue was $4.46 billion. Windows Platforms products unearned revenue was $2.49 billion and unearned revenue associated with Productivity Applications and Developer products totaled $1.78 billion. Unearned revenue for other miscellaneous programs totaled $191 million.

Stockholders' Equity

During the first three quarters of fiscal 2000, the Company repurchased 54.7 million shares of Microsoft common stock in the open market. In January 2000, the Company announced the termination of its stock buyback program.

To enhance its stock repurchase program, Microsoft sold put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On March 31, 2000, 163 million warrants were outstanding with strike prices ranging from $69 to $78 per share. The put warrants expire between June 2000 and December 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Operational Transactions

In January 2000, the Company merged with Visio Corporation in a transaction that was accounted for as a pooling of interests. Microsoft issued 14 million shares in exchange for the outstanding stock of Visio. Visio's assets and liabilities, which were nominal, are included with those of Microsoft as of March 31, 2000. Operating results for Visio from prior periods were not material to the combined results of the two companies. Accordingly, the financial statements for such periods have not been restated.

In November 1999, Expedia, Inc. completed an initial public offering of its common stock. Expedia, which is majority-owned by Microsoft, is a leading provider of branded online travel services for leisure and small business travelers. Expedia's financial results and financial condition are consolidated with the operations of Microsoft.

In September 1999, the Company sold the entertainment city guide portion of MSN(TM) Sidewalk(R) to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution agreement. Microsoft recognized a gain of $156 million on the sale and will recognize amounts related to the distribution arrangement over the term of the agreement.

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

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. Microsoft received cash of $79 million and securities valued at $85 million. A pretax gain of $160 million was recognized in the first quarter of fiscal 1999.

<PAGE>

Contingencies

On October 7, 1997, Sun Microsystems, Inc. ("Sun") brought suit against Microsoft in the U.S. District Court for the Northern District of California. Sun's complaint alleges several claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology.

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

On November 17, 1998, the Court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims, because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The Court ordered Microsoft to make certain changes in its products that include Sun's Java technology and to make certain changes in its Java software development tools. The Court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit Court of Appeals on December 16, 1998. Microsoft filed a motion on February 5, 1999, seeking clarification of the Court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The Court granted that motion. On July 23, 1999 the Court also granted Microsoft's motion to increase the bond on the preliminary injunction from $15 million to $35 million.

On August 23,1999 the 9th Circuit Court of Appeals vacated the November 1998 preliminary injunction and remanded the case to the district Court for further proceedings. Sun immediately filed two motions to reinstate and expand the scope of the earlier injunction on the basis of copyright infringement and unfair competition. On January 25, 2000, the Court issued rulings on the two motions, denying Sun's motion to reinstate the preliminary injunction on the basis of copyright infringement and granting, in part, Sun's motion to reinstate the preliminary injunction based on unfair competition. Microsoft is in compliance with the terms of the partially reinstated preliminary injunction and will not need to undertake any further action to comply with the terms of the injunction. No other hearing or trial dates have been set.

The parties have filed multiple summary judgment motions on the interpretation of the Agreement and on Sun's copyright and trademark infringement claims. On February 25, 2000, the court entered an order denying both parties' motions for summary judgment as to whether the Agreement authorizes Microsoft to distribute independently developed Java Technology. On April 5, 2000, the trial court entered an order denying Sun's motion for summary judgment regarding the interpretation of Section 2.7(a), which sets forth certain requirements that Sun must meet when they deliver Java Technology to Microsoft. On May 9, 2000, the court entered an order granting Microsoft's motion to dismiss Sun's copyright infringement claim.

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

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted Microsoft's motion for summary judgment as to the states' monopoly leverage claim and permitted the remaining claims to proceed to trial. Trial began on October 19, 1998 and ended with closing arguments on September 21, 1999. On November 5, 1999, Judge Jackson issued his Findings of Fact. On April 3, 2000 the Court entered its Conclusions of Law, determining that Microsoft "tied" Internet Explorer and Windows 95/98 in violation of Section 1 of the Sherman Act, that Microsoft violated Section 2 of the Sherman Act by taking actions to maintain its monopoly in the desktop-PC operating system market, and that Microsoft attempted to monopolize the Internet browser market in violation of Section 2 of the

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Sherman Act. The Court also held that Microsoft did not violate Section 1 of the Sherman Act by entering into a number of contracts challenged by the government. The Court established a schedule for consideration of the remedy to be imposed in a final judgment. On April 28, 2000, the plaintiffs submitted a joint proposed remedy that included a proposed break-up of Microsoft into two companies, an operating systems company, and a company that would own all of Microsoft's other products and businesses. The plaintiffs' proposal also seeks imposition of extensive conduct remedies, applicable for three years after a break-up is completed, or for ten years if Microsoft is not broken up. Microsoft's initial response to this proposal, its proposed remedy, and its proposal for the process the court should adopt in the remedies phase was filed on May 10, 2000. Microsoft also filed a motion asking the court to summarily dismiss break-up as a remedy. Microsoft proposed several schedules for remedy proceedings, depending upon the scope of remedies the court was prepared to consider. The proposed schedules range from entering immediately Microsoft's proposed remedy (conduct restrictions addressing the conduct the court found to violate the law) to a hearing beginning in December, 2000 if the court is going to consider all the remedies sought by the plaintiffs. The plaintiffs will reply on May 17 and the Court will hold a hearing on May 24, 2000. Microsoft intends to appeal from the final judgment when entered. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

A number of antitrust class action lawsuits have been initiated against Microsoft. Microsoft believes the claims are without merit and will vigorously defend the cases.

The Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

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Segment Information
(In millions)

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Three Months Ended Mar. 31	Windows Platforms	Productivity Applications and Developer	Consumer and Other	R
<S>	<C>	<C>	<C>	<C
1999				
Revenue	$2,119	$2,330	$ 421	
Operating income (loss)	1,349	1,434	(363)	
2000				
Revenue	$2,327	$2,479	$ 682	
Operating income (loss)	1,430	1,127	(316)	

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Nine Months Ended Mar. 31	Windows Platforms	Productivity Applications and Developer	Consumer and Other	Re
<S>	<C>	<C>	<C>	<C
1999				
Revenue	$6,443	$6,416	$1,450	
Operating income (loss)	4,275	3,921	(776)	
2000				
Revenue	$6,947	$7,532	$2,054	
Operating income (loss)	4,475	3,909	(677)	

</TABLE>

The Company's organizational structure and fundamental approach to business reflect the needs of its customers. As such, Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer and Other. Windows Platforms includes the Windows Division, which is primarily responsible for developing and marketing Windows NT, Windows 2000, Windows 98, and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and vertical properties. Assets of the segment groups are not relevant for management of the businesses nor for disclosure.

The Company's financial reporting systems present various data for management to run the business, including profit and loss (P&L) statements prepared on a basis not consistent with generally accepted accounting principles. Reconciling items include certain elements of unearned revenue, the treatment of certain channel inventory amounts and estimates, and revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization. In fiscal 2000, the Company's internal P&Ls included the Black-Scholes value of employee stock option grants, amortized over the remaining months of the fiscal year of the grant. Prior year disclosures have been restated for consistent presentation.

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

Results of Operations

Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for intelligent devices, personal computers (PCs), and servers; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN network of Internet products and services and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells PC input devices; trains and certifies system integrators; and researches and develops advanced technologies for future software products.

Revenue

Revenue of $5.66 billion in the March quarter of fiscal 2000 increased 23% over the third quarter of fiscal 1999. The revenue growth was driven by demand for Microsoft(R) Windows(R) 2000 Professional in the retail channel following worldwide availability during the quarter, and licensing of Microsoft Office 2000. Partially offsetting this was slower growth from Windows operating systems sold through the original equipment manufacturer (OEM) channel due to slow demand for business PCs. As described more fully below, reported revenue in the third quarter of fiscal 1999 included adjustments related to the Microsoft Office 2000 Technology Guarantee and the fulfillment of free upgrades to Microsoft SQL Server(TM) 7.0. On a year to date basis, revenue in the first nine months of fiscal 2000 totaled $17.15 billion, an increase of 23% over the first nine months of fiscal 1999.

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

Business Divisions

Microsoft has three major segments: Productivity Applications and Developer; Windows Platforms; and Consumer and Other.

Productivity Applications and Developer products include desktop applications such as Microsoft Office, server applications such as Microsoft Exchange Server and Microsoft SQL Server, and software developer tools. Reported revenue increased 32% to $2.59 billion in the March quarter. For the first three quarters of fiscal 2000, revenue of $7.83 billion grew 33% over the first three quarters of fiscal 1999. Revenue growth from Microsoft Office integrated suites, including the Premium, Professional, Small Business, and Standard Editions was healthy. Reported revenue from Microsoft Office integrated suites in the third quarter of fiscal 1999 excluded $400 million of revenue that was not earned related to the Microsoft Office 2000 Technology Guarantee, of which $64 million was recognized in the second quarter of fiscal 2000 and $150 million was recognized in the first quarter of fiscal 2000 due to fulfillment of the guarantee during the fourth quarter of fiscal 1999 and the first two quarters of fiscal 2000. Revenue from server applications remained solid during the third quarter of fiscal 2000, compared to the third quarter in the prior year, which included $45 million of earned revenue due to the fulfillment of free upgrades to SQL Server 7.0. Software developer tools revenue declined, due to a larger portion of licenses sold through a subscription-based model.

Windows Platforms products include primarily Windows 98, Windows 2000 Professional, Windows 2000 Server, Windows NT Workstation, and Windows NT Server. Revenue of $2.31 billion in the third quarter represented growth of 14% over the prior year. Windows-based desktop operating systems revenue grew moderately. Revenue growth from Windows-based units licensed through the PC original equipment manufacturer (OEM) channel reflected soft demand for business PCs and a decrease in average earned revenue per licensed operating system. Windows operating systems sold through retail channels reflected stronger than expected demand for the newest version of the desktop operating system, Windows 2000 Professional. Windows Platform Server revenue growth was strong. On a year to date basis, Windows Platforms revenue of $7.01 billion grew 12% over the prior year. Second quarter OEM revenue reflected slower growth of corporate PC purchases, moderate consumer PC purchases

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through traditional retail channels, and declining revenue from retail versions of Windows 98. Windows NT Workstation and Windows NT Server revenue growth in the second quarter slowed due to customer anticipation of the next version of the operating system, Windows 2000. First quarter OEM revenue of Windows was relatively strong, particularly for Windows NT Workstation. Revenue from retail packaged product versions of Windows 98 decreased in the first quarter, reflecting the strong comparable quarter of the prior year which included significant revenue from Windows 98 after its launch in June 1998. Windows NT Server revenue growth was robust during the first quarter.

Consumer and Other products include Internet access and online services; learning and entertainment software; PC input devices; consulting; and training and certification. Revenue in the March quarter was $756 million, up 26% from the comparable quarter of fiscal 1999. Online revenue growth was very healthy, but was offset somewhat by the company's lower net prices for Internet access subscriptions compared to the prior year. Hardware product revenue, reflecting strong sales of the Company's new keyboard and PC input device offerings, was robust. Learning and entertainment software revenue grew moderately in the third quarter of fiscal 2000. Consumer and Other revenue of $2.31 billion grew 26% over the first nine months of the prior year. Learning and entertainment software posted superb growth in the second quarter of fiscal 2000, reflecting strong consumer Holiday demand.

Distribution Channels

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

OEM third quarter revenue of $1.67 billion represented an increase of 5% over the comparable quarter of fiscal 1999. The relatively low growth rate was due to soft demand for business PCs. Average earned revenue per license also declined, due in part to a mix shift to the lower-priced Windows operating system reflecting the softness in demand for business PCs and lower prices of certain operating systems licensed through the OEM channel, compared to the third quarter of fiscal 1999. Revenue from Windows 2000 Professional in the OEM channel was modest due to mid-quarter availability of the new operating system, coupled with slow PC shipments to corporations, the primary end-users of Windows 2000. OEM revenue of $5.28 billion in the first three quarters of fiscal 2000 increased 11% over the first three quarters of fiscal 1999. OEM revenue in the second quarter of fiscal 2000 grew 4% over the comparable quarter of fiscal 1999, due to slow growth in business PCs, lower average revenue per license, and slower demand for Windows NT Workstation in anticipation of the launch of Windows 2000 Professional. The OEM revenue grew 27% in the first quarter of fiscal 2000, reflecting strong PC growth and increased penetration of higher-value NT Workstation.

South Pacific and Americas Region revenue in the March quarter increased 32% to $2.02 billion. Revenue for the first nine months of fiscal 2000 grew 25% over the first nine months of fiscal 1999 to $6.09 billion. Windows 2000 retail sales and Office integrated suites were the primary drivers of the revenue growth. Organizational licensing activity of server applications was moderate. Revenue growth was particularly strong in Latin America and Australia, moderate in the United States, and modest in Canada.

Europe, Middle East, and Africa Region third quarter revenue of $1.26 billion was up 28% compared to the third quarter of fiscal 1999. Retail sales of Windows 2000 operating systems and Office licensing produced strong growth in the region. Hardware devices and learning and productivity software exhibited strong results. Revenue growth, measured in constant dollars, was low in the United Kingdom and France, moderate in Germany, and strong in the Middle East. Weakening local currencies negatively impacted translated revenue compared to the prior year quarter. Revenue in the region would have grown 37% if foreign exchange rates were constant with those of the year ago quarter. For the first three quarters of fiscal 2000, revenue in the region totaled $3.87 billion, an increase of 24% over the prior year.

Asia Region revenue in the third quarter increased 44% to $709 million from the third quarter of the prior year, reflecting improved local economic conditions and strong revenue from localized versions of Windows 2000 and Office integrated suites, particularly in Japan. Revenue grew strongly in most countries in the Asia region. Strengthening local currencies positively impacted translated revenue compared to the prior year. Revenue in the region would have grown 32% if foreign exchange rates were constant with those of the year ago quarter. On a year to date basis, revenue in the Asia region was $1.91 billion, up 58% from the comparable period.

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Translated international revenue is affected by foreign exchange rates. The net impact of foreign exchange rates on revenue was negative in the March quarter compared to a year ago, due to weaker European currencies versus the U.S. dollar, offset partially by stronger Japanese yen versus the U.S. dollar. Had the rates from the prior year been in effect in the third quarter of fiscal 2000, translated international revenue billed in local currencies would have been $25 million higher. In the first half of fiscal 2000, the strong Japanese yen more than offset weak European currencies and added $64 million in the first quarter and $35 million in the second quarter to translated revenue. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

Operating Expenses

Microsoft encourages broad-based employee ownership of Microsoft stock through an employee stock option (ESO) program in which most employees are eligible to participate. Microsoft follows Accounting Principals Board Opinion 25 (APB 25) to account for ESOs, which generally does not require income statement recognition of options granted at the market price on the date of issuance, and discloses the Black-Scholes value of option grants. Payroll taxes associated with stock option exercises are recorded as an expense. Other events can also trigger recording expense, such as using the lowest price in the 30 days following an employee's start date to establish the strike price, accelerating the vesting of options, and converting ESOs from one company to another, as occurred with the initial public offering of Expedia, a majority-owned subsidiary of Microsoft. These costs were reflected in each operating expense line item in the income statement in the March quarter of fiscal 2000 and totaled $90 million. These costs totaled $170 million in the second quarter and $100 million in the first quarter of fiscal 2000.

Cost of revenue as a percent of revenue was 13.3% in the third quarter, down from 15.4% in the third quarter of the prior year. The percentage decrease in the third quarter of fiscal 2000 was impacted by the unearned revenue related to the Office 2000 Technology Guarantee in the year ago quarter. For the first nine months of fiscal 2000, the percentage was 12.9%, down from 15.3% for the first nine months of fiscal 1999. The percentage decrease resulted primarily from the trend in mix shift to organizational licenses and lower costs associated with WebTV(R) Networks' operations.

Research and development expenses increased 49% from the third quarter of the prior year to $990 million. For the first three quarters of fiscal 2000, research and development expenses increased 35% to $2.74 billion from the first three quarters of fiscal 1999. These increases were driven primarily by higher development headcount-related costs, including various charges related to employee stock options, and investments in new product initiatives.

Sales and marketing expenses were $1.04 billion in the March quarter, or 18.4% of revenue, compared to 18.5% in the third quarter of the prior year. Sales and marketing expenses as a percent of revenue decreased slightly due to lower relative sales expenses, partially offset by higher relative marketing costs. On a year to date basis, sales and marketing expenses were $2.97 billion, up 27% over the comparable period of the prior year, due primarily to both higher relative marketing costs and certain employee stock option expenses.

General and administrative costs were $176 million in the third quarter compared to $144 million in the prior year. For the first three quarters of fiscal 2000, general and administrative costs were $825 million, compared to $392 million in the first three quarters of fiscal 1999. The second quarter of fiscal 2000 included a charge for the settlement of the lawsuit with Caldera, Inc. General and administrative costs also included increased legal fees and certain stock option-related charges.

Other expenses and income include miscellaneous items, including certain gains and the recognition of Microsoft's share of joint venture activities, including Transpoint, WebTV Networks K.K., and the MSNBC entities.

Investment Income, Gains on Sales, and Income Taxes

Third quarter investment income increased to $885 million from $720 million in the third quarter of the prior year. Year to date investment income totaled $2.06 billion in fiscal 2000, compared to $1.32 billion in fiscal 1999. The increase was due principally to realized gains of approximately $440 million in the third quarter, $400 million in the second quarter and $50 million in the first quarter. The larger investment portfolio generated by cash from operations also contributed to the increase in investment income. Realized gains in the third quarter of fiscal 1999 were approximately $350 million.

During the first quarter of fiscal 2000, Microsoft sold the entertainment city guide portion of MSN(TM) Sidewalk(R) to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants. Microsoft recognized a gain of $156 million.

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During the first quarter of fiscal 1999, Microsoft sold its Softimage, Inc. subsidiary to Avid Technology, Inc for a pretax gain of $160 million.

The effective tax rate for the first nine months of fiscal 2000 was 34%. Excluding the tax impact of the gain on the sale of Softimage, the effective tax rate for fiscal 1999 was 35%.

Financial Condition

The Company's cash and short-term investment portfolio totaled $21.21 billion at

March 31, 2000. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, primarily strategic technology companies. The Company has made large-scale investments in access providers, including cable, telephony, and wireless communications companies. During the first quarter of fiscal 2000, the Company purchased $400 million of Rogers Communications convertible preferred securities and warrants. In connection with AT&T's proposed merger with MediaOne Group, Inc., the Company agreed to acquire MediaOne's interest in Telewest Communications plc, a leading provider of cable television and residential and business cable telephony services in the United Kingdom, subject to certain regulatory approvals and other conditions.

Microsoft and National Broadcasting Company (NBC) operate two MSNBC joint ventures: a 24-hour cable news and information channel, and an online news service. Microsoft is paying $220 million over a five-year period that ends in 2001 for its interest in the cable venture and one-half of the operational funding of both joint ventures. Microsoft guarantees a portion of MSNBC debt.

Microsoft has no material long-term debt and has $163 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at March 31, 2000 was $39.79 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Cash will also be used to fund ventures and strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $377 million on March 31, 2000.

Since fiscal 1990, Microsoft repurchased 764 million common shares while 1.95 billion shares were issued under the Company's employee stock option and purchase plans. Microsoft enhanced its repurchase program by selling put warrants. In January 2000, the Company announced the termination of its stock buyback program. The market value of all outstanding stock options was $80 billion as of March 31, 2000. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next 12 months. The Company's cash and short-term investments are available for strategic investments, mergers and acquisitions, and other potential large-scale cash needs that may arise.

Microsoft has not paid cash dividends on its common stock.

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Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

27. Financial Data Schedule

(B) Reports on Form 8-K

The Company filed no reports on Form 8-K during the quarter ended March 31, 2000.

Items 2, 3, 4, and 5 are not applicable and have been omitted.

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Signature

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

Microsoft Corporation

Date: May 12, 2000 By: /s/ John G. Connors

John G. Connors
Senior Vice President, Finance and Administration;
Chief Financial Officer

(Principal Financial and Accounting Officer and Duly Authorized Officer)

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FILED AS OF DATE: 20000211

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COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT:
SEC FILE NUMBER: 000-14278
FILM NUMBER: 534418

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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 4258828080

MAIL ADDRESS:
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended December 31, 1999

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

One Microsoft Way, Redmond, Washington 98052-6399
(Address of principal executive office) (Zip Code)

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

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

The number of shares outstanding of the registrant's common stock as of January 31, 2000 was 5,204,853,333.

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 1999

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

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

	Three Months Ended Dec. 31		Six Months Ended Dec. 31	
	1998	1999	1998	1999
Revenue	$5,195	$6,112	$9,388	$11,496
Operating expenses:				
Cost of revenue	788	756	1,437	1,468
Research and development	715	911	1,366	1,745
Sales and marketing	794	1,027	1,482	1,930
General and administrative	149	506	248	649
Other expenses (income)	35	(6)	59	19
Total operating expenses	2,481	3,194	4,592	5,811
Operating income	2,714	2,918	4,796	5,685
Investment income	337	773	598	1,170
Gains on sales	0	0	160	156
Income before income taxes	3,051	3,691	5,554	7,011
Provision for income taxes	1,068	1,255	1,888	2,384

Net income	$1,983	$2,436	$3,666	$ 4,627
Earnings per share (1):				
Basic	$ 0.40	$ 0.47	$ 0.73	$ 0.90
Diluted	$ 0.36	$ 0.44	$ 0.67	$ 0.84

(1) Earnings per share amounts for the three and six months ended December 31, 1998 have been restated to reflect a two-for-one stock split in March 1999.

See accompanying notes.

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MICROSOFT CORPORATION

Balance Sheets
(In millions)

	June 30 1999	Dec. 31 1999 (1)
Assets		
Current assets:		
Cash and short-term investments	$17,236	$17,843
Accounts receivable	2,245	3,284
Other	752	893
Total current assets	20,233	22,020
Property and equipment	1,611	1,739
Equity and other investments	14,372	19,801
Other assets	940	1,533
Total assets	$37,156	$45,093
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 874	$ 1,233
Accrued compensation	396	533
Income taxes payable	1,607	2,103
Unearned revenue	4,239	4,259
Other	1,602	2,376
Total current liabilities	8,718	10,504
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock - shares authorized 100; outstanding 13 and 0	980	0
Common stock and paid-in capital - shares authorized 12,000; outstanding 5,020 and 5,177	13,844	18,878
Retained earnings	13,614	15,711

Total stockholders' equity	28,438	34,589
Total liabilities and stockholders' equity	$37,156	$45,093

(1) Unaudited

See accompanying notes.

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MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

	Six Months Ended Dec. 31	
	1998	1999
Operations		
Net income	$ 3,666	$ 4,627
Depreciation and amortization	356	765
Gains on sales	(160)	(156)
Unearned revenue	2,371	2,638
Recognition of unearned revenue from prior periods	(1,707)	(2,618)
Other current liabilities	719	61
Accounts receivable	(486)	(1,030)
Other current assets	(24)	(149)
Net cash from operations	4,735	4,138
Financing		
Common stock issued	614	913
Common stock repurchased	(772)	(4,852)
Put warrant proceeds	355	472
Preferred stock dividends	(14)	(13)
Stock option income tax benefits	1,218	2,636
Net cash from (used for) financing	1,401	(844)
Investing		
Additions to property and equipment	(241)	(371)
Cash proceeds from sale of Softimage, Inc.	79	0
Purchases of investments	(10,220)	(18,759)
Maturities of investments	1,199	950
Sales of investments	5,263	14,923
Net cash used for investing	(3,920)	(3,257)
Net change in cash and equivalents	2,216	37
Effect of exchange rates on cash and equivalents	58	20
Cash and equivalents, beginning of period	3,839	4,975
Cash and equivalents, end of period	6,113	5,032

Short-term investments, end of period	13,124	12,811
Cash and short-term investments, end of period	$19,237	$17,843

See accompanying notes.

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MICROSOFT CORPORATION

<TABLE>
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Stockholders' Equity Statements
(In millions)(Unaudited)

	Three Months Ended Dec. 31		Six Months Ended Dec. 31	
	1998	1999	1998	1999
<S>	<C>	<C>	<C>	<C>
Convertible preferred stock				
Balance, beginning of period	$ 980	$ 980	$ 980	$ 980
Conversion of preferred to common stock	0	(980)	0	(980)
Balance, end of period	980	0	980	0
Common stock and paid-in capital				
Balance, beginning of period	9,161	15,878	8,025	13,844
Common stock issued	536	1,525	870	2,092
Common stock repurchased	(11)	(128)	(25)	(166)
Proceeds from sale of put warrants	130	182	355	472
Stock option income tax benefits	627	1,421	1,218	2,636
Balance, end of period	10,443	18,878	10,443	18,878
Retained earnings				
Balance, beginning of period	8,983	14,482	7,622	13,614
Net income	1,983	2,436	3,666	4,627
Net unrealized investments gains	390	2,485	540	2,141
Translation adjustments and other	63	4	106	28
Comprehensive income	2,436	4,925	4,312	6,796
Preferred stock dividends	(7)	(6)	(14)	(13)
Common stock repurchased	(257)	(3,690)	(765)	(4,686)
Balance, end of period	11,155	15,711	11,155	15,711
Total stockholders' equity	$22,578	$34,589	$22,578	$34,589

</TABLE>

See accompanying notes.

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MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1999 Form 10-K.

Stock Split

In March 1999, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

Earnings Per Share

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

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

EARNINGS PER SHARE

<TABLE>
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(In millions, except earnings per share)

	Three Months Ended Dec. 31		Six Months E Dec. 31	
	1998	1999	1998	19
<S>	<C>	<C>	<C>	<C>
Net income (A)	$1,983	$2,436	$3,666	$4,6
Preferred stock dividends	(7)	(6)	(14)	(
Net income available for common shareholders (B)	$1,976	$2,430	$3,652	$4,6
Average outstanding shares of common stock (C)	4,998	5,163	4,978	5,1

Dilutive effect of:				
Common stock under structured repurchases	22	0	19	
Preferred stock	20	12	22	
Employee stock options	420	363	428	3
Common stock and common stock equivalents (D)	5,460	5,538	5,447	5,5
Earnings per share:				
Basic (B/C)	$ 0.40	$ 0.47	$ 0.73	$ 0.
Diluted (A/D)	$ 0.36	$ 0.44	$ 0.67	$ 0.

</TABLE>

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Unearned Revenue

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

End users receive certain elements of the Company's products over a period of time. These elements include browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. The percentage of revenue recognized ratably ranges from approximately 15% to 25% of Windows desktop operating systems and approximately 10% to 20% of desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three years for Windows operating systems and 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organization license agreements. At December 31, 1999, unearned revenue was $4.26 billion. Windows Platforms products unearned revenue was $2.40 billion and unearned revenue associated with Productivity Applications and Developer products totaled $1.70 billion. Unearned revenue for other miscellaneous programs totaled $161 million at December 31, 1999.

Stockholders' Equity

During the first half of fiscal 2000, the Company repurchased 54.7 million shares of Microsoft common stock in the open market. In January 2000, the Company announced the termination of its stock buyback program.

To enhance its stock repurchase program, Microsoft sold put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On December 31, 1999, 163 million warrants were outstanding with strike prices ranging from $69 to $78 per share. The put warrants expire between June 2000 and December 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Operational Transactions

In November 1999, Expedia, Inc. completed an initial public offering of its common stock. Expedia, which is majority-owned by Microsoft, is a leading provider of branded online travel services for leisure and small business travelers. Expedia's financial results and financial condition are consolidated with the operations of Microsoft.

In September 1999, the Company sold the entertainment city guide portion of MSN(TM) Sidewalk(R) to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution agreement. Microsoft recognized a gain of $156 million on the sale and will recognize amounts related to the distribution arrangement over the term of the agreement.

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

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. Microsoft received cash of $79 million and securities valued at $85 million. A pretax gain of $160 million was recognized in the first quarter of fiscal 1999.

Subsequent Events

In January 2000, the Company merged with Visio Corporation in a transaction that will be accounted for as a pooling of interests. Microsoft issued 14 million shares in exchange for the outstanding stock of Visio.

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Contingencies

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

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

On November 17, 1998, the Court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims, because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The Court ordered Microsoft to make certain changes in its products that include Sun's Java technology and to make certain changes in its Java software development tools. The Court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit Court of Appeals on December 16, 1998. Microsoft complied with the ruling and did not seek a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the Court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The Court granted that motion. On July 23, 1999 the Court also granted Microsoft's motion to increase the bond on the preliminary injunction from $15 million to $35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the Court issued tentative rulings on three of the motions. In the preliminary rulings, the Court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++ (R) 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java Technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java Technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the Court heard oral argument on the three tentative rulings. No final orders have been issued.

On August 23,1999 the 9th Circuit Court of Appeals vacated the November 1998 preliminary injunction and remanded the case to the district Court for further proceedings. Sun immediately filed two motions to reinstate and expand the scope of the earlier injunction on the basis of copyright infringement and unfair competition. Oral argument on these motions was held on October 16, 1999. On January 25, 2000, the Court issued rulings on the two motions, denying Sun's motion to reinstate the preliminary injunction on the basis of copyright infringement and granting, in part, Sun's motion to reinstate the preliminary injunction based on unfair competition. Microsoft is in compliance with the terms of the partially reinstated preliminary injunction and will not need to undertake any further action to comply with the terms of the injunction. No other hearing or trial dates have been set.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of 20 state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-Microsoft Internet browsing software (or other software products); taking or threatening "action adverse" in consequence of a person's failure to license or distribute Microsoft Internet browsing software (or other software

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product) or distributing competing products or cooperating with the government; and restrictions on the screens, boot-up sequence, or functions of Microsoft's operating system products. The state Attorneys General allege largely the same claims and various pendent state claims. The states seek declaratory relief and preliminary and permanent injunctive relief similar to that sought by the DOJ, together with statutory penalties under the state law claims. The foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted Microsoft's motion for summary judgment as to the states' monopoly leverage claim and permitted the remaining claims to proceed to trial. Trial began on October 19, 1998 and ended with closing arguments on September 21, 1999. The Court will first rule on factual issues, and will then rule on legal conclusion On November 5, 1999, Judge Jackson issued his Findings of Fact. The Conclusions of Law in the case are not expected until sometime in 2000. The judge also directed the parties to participate in a mediation process, which is ongoing. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

A number of antitrust class action lawsuits have been initiated against Microsoft. Microsoft believes the claims are without merit and will vigorously defend the cases.

The Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

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Segment Information
(In millions)

<TABLE>
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Three Months Ended Dec. 31	Windows Platforms	Productivity Applications and Developer	Consumer and Other	Reconciling Amounts
<S>	<C>	<C>	<C>	<C>
1998				
Revenue	$2,271	$2,277	$587	$ 60

Operating income (loss)	1,538	1,392	(201)	(15)
1999				
Revenue	$2,412	$2,624	$721	$355
Operating income (loss)	1,584	1,376	(300)	258

<CAPTION>

Six Months Ended Dec. 31	Windows Platforms	Productivity Applications and Developer	Consumer and Other	Reconciling Amounts
<S>	<C>	<C>	<C>	<C>
1998				
Revenue	$4,315	$4,095	$1,029	$(51)
Operating income (loss)	2,944	2,471	(415)	(204)
1999				
Revenue	$4,609	$5,054	$1,382	$451
Operating income (loss)	3,068	2,796	(398)	219

</TABLE>

The Company's organizational structure and fundamental approach to business reflect the needs of its customers. As such, Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for developing and marketing Windows NT and Windows 2000. Windows Platforms also includes the Consumer Windows Division, which develops and markets Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and vertical properties and e-commerce platforms. Assets of the segment groups are not relevant for management of the businesses nor for disclosure.

The Company's financial reporting systems present various data for management to run the business, including profit and loss (P&L) statements prepared on a basis not consistent with generally accepted accounting principles. Reconciling items include certain elements of unearned revenue, the treatment of certain channel inventory amounts and estimates, and revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization. In fiscal 2000, the Company's internal P&Ls included the Black-Scholes value of employee stock option grants, amortized over the remaining months of the fiscal year of the grant. Prior year disclosures have been restated for consistent presentation.

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

Results of Operations

Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for intelligent devices, personal computers

(PCs), and servers; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN network of Internet products and services and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells PC input devices; trains and certifies system integrators; and researches and develops advanced technologies for future software products.

Revenue

Revenue of $6.11 billion in the December quarter of fiscal 2000 increased 18% over the second quarter of fiscal 1999. The revenue growth reflected strong licensing of Microsoft(R) Office 2000. Partially offsetting this growth was moderate growth for Windows(R) operating systems, due to soft corporate demand for PCs and software combined with the expected slowness of demand for Windows NT(R) Server and Windows NT Workstation in anticipation of the launch of Windows 2000. On a year to date basis, revenue in the first half of fiscal 2000 totaled $11.50 billion, an increase of 22% over the first two quarters of fiscal 1999.

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

Business Divisions

Microsoft has three major segments: Productivity Applications and Developer; Windows Platforms; and Consumer and Other.

Productivity Applications and Developer products include desktop applications such as Microsoft Office, server applications such as Microsoft Exchange Server and Microsoft SQL Server(TM), and software developer tools. Revenue increased 28% to $2.80 billion in the December quarter. For the first half of fiscal 2000, revenue of $5.25 billion grew 34% over the first half of fiscal 1999. Revenue from Microsoft Office integrated suites, including the Premium, Professional, Small Business, and Standard Editions was very strong, reflecting healthy demand for Microsoft Office 2000. Revenue included the recognition of $64 million in the second quarter and $150 million in the first quarter of previously unearned revenue, due to fulfillment of the Microsoft Office 2000 Technology Guarantee. Microsoft SQL Server 7.0 revenue continued to be robust. Revenue from Microsoft Exchange Server and software developer tools was steady.

Windows Platforms products include primarily Windows 98, Windows NT Workstation, and Windows NT Server. Revenue of $2.44 billion in the second quarter represented growth of 6% over the prior year. Windows-based desktop operating systems revenue grew slightly. Units licensed through the PC OEM channel reflected slower growth of corporate PC purchases. Additionally, consumer PC purchases through traditional retail channels were moderate and revenue from retail versions of Windows 98 decreased. This decrease reflected the strong comparable quarter of the prior year which included significant revenue from

Windows 98 after its launch in June 1998. Windows NT Workstation and Windows NT Server revenue growth slowed, reflecting customer anticipation of the next version of the operating system, Windows 2000. On a year to date basis, Windows Platforms revenue of $4.69 billion grew 11% over the prior year. First quarter OEM revenue of Windows was relatively strong, particularly for Windows NT Workstation. Revenue from retail packaged product versions of Windows 98 decreased in the first quarter, reflecting the strong comparable quarter of the prior year which included significant revenue from Windows 98 after its launch in June 1998. Windows NT Server revenue growth was robust during the first quarter.

Consumer and Other products include learning and entertainment software; PC input devices; training and certification fees; consulting; and online services such as Expedia. Revenue in the December quarter was $872

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million, up 23% from the comparable quarter of fiscal 1999. Consumer and Other revenue of $1.56 billion grew 26% over the first half of the prior year. Learning and entertainment software posted superb growth, reflecting strong consumer Holiday demand. Hardware product revenue grew moderately. Online advertising and access revenue rose substantially.

Distribution Channels

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

OEM second quarter revenue of $1.87 billion represented an increase of 4% over the comparable quarter of fiscal 1999. There were several reasons for the relatively low growth rate. The second quarter of fiscal 1999 was an unusually high-growth quarter for OEM revenue, having grown 48% over the comparable quarter of fiscal 1998. PC shipment growth was moderate in the December quarter of fiscal 2000, with particular slowness in corporate PC demand. Average revenue per license declined slightly, due in part to a mix shift to high-volume multi-national PC manufacturers from low-volume system builders. Additionally, demand for Windows NT Workstation moderated in anticipation of the launch of Windows 2000 Professional Version. OEM revenue of $3.61 billion in the first two quarters of fiscal 2000 increased 14% over the first two quarters of fiscal 1999. OEM revenue grew 27% in the first quarter of fiscal 2000, reflecting strong PC growth and increased penetration of higher-value NT Workstation.

South Pacific and Americas Region revenue in the December quarter increased 26% to $2.21 billion. Revenue for the first half of fiscal 2000 grew 21% over the first half of fiscal 1999 to $4.08 billion. Several products had strong revenue growth, including Office; SQL Server; learning and entertainment software; and online services. Organizational licensing activity was moderate. Revenue growth was moderate in the South Pacific, the United States and Canada, and Latin America.

Europe, Middle East, and Africa Region second quarter revenue of $1.43 billion was up 14% compared to the second quarter of fiscal 1999. For the first two quarters of fiscal 2000, revenue in the region totaled $2.61 billion, an increase of 22% over the prior year Microsoft Office exhibited the highest absolute revenue growth of the Company's products in the region. Revenue growth, measured in constant dollars, was moderate in the United Kingdom, France, and Germany. Weakening local currencies negatively impacted translated revenue compared to the prior year. Second quarter revenue in the region would have grown 22% if foreign exchange rates were constant with those of a year ago. First quarter revenue in the region would have grown 35% if foreign exchange rates were constant with those of a year ago.

Asia Region revenue in the December quarter of $606 million increased 56% from the second quarter of the prior year. On a year to date basis, revenue in the Asia region was $1.20 billion, up 68% from the comparable period. The growth in the region reflected improved local economic conditions and strong revenue from localized versions of Microsoft Office 2000, particularly in Japan. Revenue grew strongly in most countries in the Asia Region.

Translated international revenue is affected by foreign exchange rates. The impact of foreign exchange rates on revenue was negative in the December quarter compared to a year ago, as European currencies were very weak versus the U.S. dollar, offset partially by stronger Japanese yen versus the U.S. dollar. Had the rates from the prior year been in effect in the second quarter of fiscal 2000, translated international revenue billed in local currencies would have been $35 million higher. In the September quarter, the strong Japanese yen more than offset weak European currencies and added $64 million to translated revenue. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

Operating Expenses

Microsoft encourages broad-based employee ownership of Microsoft stock through an employee stock option (ESO) program in which most employees are eligible to participate. Microsoft follows Accounting Principals Board Opinion 25 (APB 25) to account for ESOs, which generally does not require income statement recognition of options granted at the market price on the date of issuance, and discloses the Black-Scholes value of option grants. A new interpretation of APB 25 requires recognition of the FICA and Medicare expense paid on option exercises. Other

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events can also trigger recording expense, such as using the lowest price in the 30 days following an employee's start date to establish the strike price, accelerating the vesting of options, and converting ESOs from one company to another, as occurred with the initial public offering of Expedia, a majority-owned subsidiary of Microsoft. These costs were reflected in each operating expense line item in the income statement and totaled $170 million in the second quarter and $100 million in the first quarter of fiscal 2000.

Cost of revenue as a percent of revenue was 12.4% in the second quarter, down from 15.2% in the second quarter of the prior year. For the first half of fiscal 2000, the percentage was 12.8%, down from 15.3% for the first half of fiscal 1999. The percentage decrease resulted primarily from the trend in mix shift to organizational licenses and lower costs associated with WebTV(R) Networks' operations.

Research and development expenses increased 27% from the second quarter of the prior year to $911 million. For the first two quarters of fiscal 2000, research and development expenses increased 28% to $1.75 billion from the first two quarters of fiscal 1999. These increases were driven primarily by higher development headcount-related costs, including various charges related to employee stock options.

Sales and marketing expenses were $1.03 billion in the December quarter, which represented 16.8% of revenue, compared to 15.3% in the second quarter of the prior year. On a year to date basis, sales and marketing expenses were $1.93 billion, up 30% over the comparable period of the prior year. Sales and marketing expenses as a percent of revenue increased due primarily to both higher relative marketing costs and certain employee stock option expenses.

General and administrative costs were $506 million in the second quarter compared to $149 million in the December quarter of the prior year. For the first two quarters of fiscal 2000, general and administrative costs were $649 million, compared to $248 million in the first two quarters of fiscal 1999. The second quarter of fiscal 2000 included a charge for the settlement of the lawsuit with Caldera, Inc. General and administrative costs also included increased legal fees and certain stock option-related charges.

Other expenses and income include miscellaneous items, including gains on foreign exchange and the recognition of Microsoft's share of joint venture activities, including Transpoint and the MSNBC entities.

Investment Income, Gains on Sales, and Income Taxes

Second quarter investment income increased to $773 million from $337 million in the second quarter of the prior year. Year to date investment income totaled $1.17 billion in fiscal 2000, compared to $598 million in fiscal 1999. The increase was due principally to realized gains of approximately $400 million in the second quarter and $50 million in the first quarter. The larger investment portfolio generated by cash from operations also contributed to the increase in investment income. Realized gains in the second quarter of fiscal 1999 were approximately $70 million.

During the first quarter of fiscal 2000, Microsoft sold the entertainment city guide portion of MSN(TM) Sidewalk(R) to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants. Microsoft recognized a gain of $156 million.

During the first quarter of fiscal 1999, Microsoft sold its Softimage, Inc. subsidiary to Avid Technology, Inc for a pretax gain of $160 million.

The effective tax rate for fiscal 2000 is 34%. Excluding the tax impact of the gain on the sale of Softimage, the effective tax rate for fiscal 1999 was 35%.

Financial Condition

The Company's cash and short-term investment portfolio totaled $17.84 billion at December 31, 1999. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, primarily strategic technology companies. The Company has made large-scale investments in access providers, including cable, telephony, and wireless communications companies. During the first quarter of fiscal 2000, the Company purchased $400 million of Rogers Communications convertible preferred securities and warrants. In connection with AT&T's proposed merger with MediaOne Group, Inc., the Company agreed to acquire MediaOne's interest in Telewest Communications plc, a leading provider of cable television and

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residential and business cable telephony services in the United Kingdom, subject to certain regulatory approvals and other conditions.

Microsoft and National Broadcasting Company (NBC) operate two MSNBC joint ventures: a 24-hour cable news and information channel, and an online news service. Microsoft is paying $220 million over a five-year period that ends in 2001 for its interest in the cable venture and one-half of the operational funding of both joint ventures. Microsoft guarantees a portion of MSNBC debt.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at December 31, 1999 was $34.59 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Cash will also be used to fund ventures and strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $300 million on December 31, 1999.

Since fiscal 1990, Microsoft repurchased 764 million common shares while 1.90 billion shares were issued under the Company's employee stock option and purchase plans. Microsoft enhanced its repurchase program by selling put warrants. In January 2000, the Company announced the termination of its stock buyback program. The market value of all outstanding stock options was $81 billion as of December 31, 1999. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next 12 months. The Company's cash and short-term investments are available for strategic investments, mergers and acquisitions, and other potential large-scale cash needs that may arise.

Microsoft has not paid cash dividends on its common stock.

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Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

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

At the Annual Meeting of Shareholders held on November 10, 1999, the following proposals were adopted by the margins indicated:

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

	Number of Shares For	Withheld
William H. Gates	4,488,312,569	21,695,760
Paul G. Allen	4,488,088,199	21,920,130
Richard A. Hackborn	4,488,518,818	21,489,511
David F. Marquardt	4,383,706,485	126,301,844
William G. Reed, Jr.	4,488,313,322	21,695,007
Jon A. Shirley	4,481,013,698	28,994,631

2. To approve the adoption of the 1999 Stock Option Plan for Non-Employee Directors, including the reservation of 2,000,000 shares of common stock thereunder.

For	3,235,830,137
Against	1,251,971,667
Abstain	22,203,713
Broker Non-vote	2,812

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

27. Financial Data Schedule

(B) Reports on Form 8-K

The Company filed no reports on Form 8-K during the quarter ended December 31, 1999.

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

<PAGE>

Signature

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

Microsoft Corporation

Date: February 11, 2000 By: /s/ John G. Connors

```
                                        ----------------------------------------
                                        John G. Connors
                                        Senior Vice President, Finance and
                                        Administration; Chief Financial Officer

                                        (Principal Financial and Accounting
                                        Officer and Duly Authorized Officer)

--------------------------------------------------------------------------------

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TO SUCH FINANCIAL STATEMENT.
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CONFORMED SUBMISSION TYPE: 10-Q
PUBLIC DOCUMENT COUNT: 2
CONFORMED PERIOD OF REPORT: 19990930
FILED AS OF DATE: 19991105

FILER:

COMPANY DATA:
COMPANY CONFORMED NAME: MICROSOFT CORP
CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT:
SEC FILE NUMBER: 000-14278
FILM NUMBER: 99741829

BUSINESS ADDRESS:
STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 4258828080

MAIL ADDRESS:
STREET 1: ONE MICROSOFT WAY - BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 1999

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

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

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

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

The number of shares outstanding of the registrant's common stock as of October 31, 1999 was 5,160,024,593.

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended September 30, 1999

INDEX

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Part I. Financial Information

Item 1. Financial Statements

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

Income Statements

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

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	Three Months Ended Sept. 30	
	1998	1999
<S>	<C>	<C>
Revenue	$4,193	$5,384
Operating expenses:		
Cost of revenue	649	712
Research and development	651	834
Sales and marketing	688	903
General and administrative	99	143
Other expenses	24	25
Total operating expenses	2,111	2,617
Operating income	2,082	2,767
Investment income	261	397
Gains on sales	160	156

Income before income taxes	2,503	3,320
Provision for income taxes	820	1,129
Net income	$1,683	$2,191
Earnings per share (1):		
Basic	$ 0.34	$ 0.43
Diluted	$ 0.31	$ 0.40

</TABLE>

(1) Earnings per share amounts for the three months ended September 30, 1998 have been restated to reflect a two-for-one stock split in March 1999.

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Balance Sheets

(In millions)

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Assets
Current assets:
Cash and short-term investments
Accounts receivable
Other
Total current assets
Property and equipment
Equity and other investments
Other assets
Total assets
Liabilities and stockholders' equity
Current liabilities:
Accounts payable
Accrued compensation
Income taxes payable
Unearned revenue
Other

Total current liabilities	
Commitments and contingencies	
Stockholders' equity:	
Convertible preferred stock - shares authorized 100; outstanding 13	
Common stock and paid-in capital - shares authorized 12,000; outstanding 5,109 and 5,148	
Retained earnings	
Total stockholders' equity	
Total liabilities and stockholders' equity	

</TABLE>

(1) Unaudited

See accompanying notes.

2

<PAGE>

MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

<TABLE>
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	Three S 1998
<S>	<C>
Operations	
Net income	$ 1,683
Depreciation and amortization	179
Gains on sales	(160)
Unearned revenue	1,010
Recognition of unearned revenue from prior periods	(765)
Other current liabilities	360
Accounts receivable	341
Other current assets	(64)
Net cash from operations	2,584
Financing	
Common stock issued	316
Common stock repurchased	(504)
Put warrant proceeds	225
Preferred stock dividends	(7)
Stock option income tax benefits	591
Net cash from financing	621
Investing	
Additions to property and equipment	(106)

Cash proceeds from sale of Softimage, Inc.	79
Purchases of investments	(5,042)
Maturities of investments	632
Sales of investments	2,565
Net cash used for investing	(1,872)
Net change in cash and equivalents	1,333
Effect of exchange rates on cash and equivalents	19
Cash and equivalents, beginning of period	3,839
Cash and equivalents, end of period	5,191
Short-term investments, end of period	12,051
Cash and short-term investments, end of period	$17,242

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Stockholders' Equity Statements
(In millions)(Unaudited)

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	Thre
	1998
<S>	<C>
Convertible preferred stock	
Balance	$ 98
Common stock and paid-in capital	
Balance, beginning of period	8,02
Common stock issued	33
Common stock repurchased	(1
Proceeds from sale of put warrants	22
Stock option income tax benefits	59
Balance, end of period	9,16
Retained earnings	
Balance, beginning of period	7,62
Net income	1,68
Other comprehensive income:	

Net unrealized investments gains (losses)	15
Translation adjustments and other	4
Comprehensive income	1,87
Preferred stock dividends	(
Common stock repurchased	(50
Balance, end of period	8,98
Total stockholders' equity	$19,12

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1999 Form 10-K.

Stock Split

In March 1999, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

Earnings Per Share

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

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

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

<TABLE>
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	Three Mont Sept. 1998
<S>	<C>
Net income (A)	$1,683
Preferred stock dividends	(7)
Net income available for common shareholders (B)	$1,676
Average outstanding shares of common stock (C)	4,958
Dilutive effect of:	
Common stock under structured repurchases	16
Preferred stock	24
Employee stock options	436
Common stock and common stock equivalents (D)	5,434
Earnings per share:	
Basic (B/C)	$ 0.34
Diluted (A/D)	$ 0.31

</TABLE>

<PAGE>

Unearned Revenue

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

End users receive certain elements of the Company's products over a period of time. These elements include browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. The percentage of revenue recognized ratably ranges from approximately 15% to 25% of Windows desktop operating systems and approximately 10% to 20 % of desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three years for Windows operating systems and 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organization license agreements. At September 30, 1999, Windows Platforms products unearned revenue was $2.25 billion and unearned revenue associated with Productivity Applications and Developer products totaled $1.72 billion. Unearned revenue for other miscellaneous programs totaled $154 million at September 30, 1999.

Stockholders' Equity

Microsoft repurchases its common stock in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During the first quarter of fiscal 2000, the Company repurchased 12.1 million shares of Microsoft common stock in the open market.

To enhance its stock repurchase program, Microsoft sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On September 30, 1999, 163 million warrants were outstanding with strike prices ranging from $64 to $73 per share. The put warrants expire between March 2000 and September 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred shareholders have preference over common stockholders in dividends and liquidation rights. In December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of $79.875 and a cap of $102.24 per preferred share, equivalent to $19.97 and $25.56 per common share. Net proceeds of $980 million were used to repurchase common shares.

Operational Transactions

In September 1999, the Company sold the entertainment city guide portion of MSN(TM) Sidewalk(R) to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution agreement. Microsoft recognized a gain of $156 million on the sale and will recognize amounts related to the distribution arrangement over the term of the agreement.

In September 1999, the Company announced that Visio Corporation, a leading supplier of business diagramming and technical drawing software, would be combined with Microsoft. Each share of Visio common stock will be exchanged for 0.45 shares of Microsoft common stock, and the merger is expected to be accounted for as a pooling of interests. The transaction, subject to regulatory review and the approval of Visio shareholders, is expected to close in December 1999.

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. Microsoft received cash of $79 million and securities valued at $85 million. A pretax gain of $160 million was recognized in the first quarter of fiscal 1999.

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Contingencies

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

On March 24, 1998, the Court entered an order enjoining Microsoft from using the

Java Compatibility logo on Internet Explorer 4.0 and the Microsoft Software Developers Kit (SDK) for Java 2.0. Microsoft has taken steps to fully comply with the order.

On November 17, 1998, the Court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims, because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The Court ordered Microsoft to make certain changes in its products that include Sun's Java technology and to make certain changes in its Java software development tools. The Court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit Court of Appeals on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the Court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The Court granted that motion. On July 23, 1999 the Court also granted Microsoft's motion to increase the bond on the preliminary injunction from $15 million to $35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the Court issued tentative rulings on three of the motions. In the preliminary rulings, the Court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++ (R) 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java Technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java Technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the Court heard oral argument on the three tentative rulings. No final orders have been issued.

On August 23,1999 the 9th Circuit Court of Appeals vacated the November 1998 preliminary injunction and remanded the case to the district Court for further proceedings. Sun immediately filed two motions to reinstate and expand the scope of the earlier injunction on the basis of copyright infringement and unfair competition. Oral argument on these motions was held on October 16, 1999. There are no other hearing or trial dates set.

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

<PAGE>

foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted Microsoft's motion for summary judgment as to the states' monopoly leverage claim and permitted the remaining claims to proceed to trial. Trial began on October 19, 1998 and ended with closing arguments on September 21, 1999. The Court will first rule on factual issues, and will then rule on legal conclusions. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS(R) operating system and Windows in the late 80s and early 90s - essentially the same complaints that resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

The Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

<PAGE>

Segment Information
(In millions)

<TABLE>
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Three Months Ended Sept. 30	Windows Platforms	Productivity Applications and Developer	Consumer, Commerce, and Other
<S>	<C>	<C>	<C>

1998			
Revenue	$2,025	$1,833	$ 442
Operating income	1,387	1,095	(214)
1999			
Revenue	$2,197	$2,430	$ 661
Operating income	1,484	1,420	(98)

</TABLE>

The Company's organizational structure and fundamental approach to business reflect the needs of its customers. As such, Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer, Commerce and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and vertical properties and e-commerce platforms. Assets of the segment groups are not relevant for management of the businesses nor for disclosure.

The Company's financial reporting systems present various data for management to run the business, including profit and loss (P&L) statements prepared on a basis not consistent with generally accepted accounting principles. Reconciling items include certain elements of unearned revenue, the treatment of certain channel inventory amounts and estimates, and revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization. In fiscal 2000, the Company's internal P&Ls included the Black-Scholes value of employee stock option grants, amortized over the remaining months of the fiscal year of the grant. Prior year disclosures have been restated for consistent presentation.

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

Results of Operations

Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for intelligent devices, personal computers (PCs), and servers; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN network of Internet products and services; e-commerce platforms; and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells PC input devices; trains and certifies system integrators; and researches and develops advanced technologies for future software products.

Revenue

Revenue of $5.38 billion in the September quarter of fiscal 2000 increased 28% over the first quarter of fiscal 1999. Revenue growth reflected the continued adoption of Microsoft(R) Windows(R) operating systems, including Windows 98, Windows NT(R) Workstation, and Windows NT Server; along with the Company's server applications. Microsoft Office also continued its strong growth after the recent launch of the latest versions of desktop applications, particularly Microsoft Office 2000. Reported revenue also included $150 million related to fulfillment of the Microsoft Office 2000 Technology Guarantee. Certain customers acquiring Microsoft Office 97 or related applications were entitled to a free upgrade to the corresponding Microsoft Office 2000 application. The value of the upgrade expected to be redeemed by the customer was treated as unearned revenue until fulfillment of the upgrade.

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

Business Divisions

Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer, Commerce, and Other.

Windows Platforms products, developed and marketed by the Consumer Windows Division and the Business and Enterprise Division, include primarily Windows 98, Windows NT Workstation, and Windows NT Server. Revenue of $2.25 billion in the first quarter represented growth of 17% over the prior year. Windows-based units licensed through the PC original equipment manufacturer (OEM) channel, particularly Windows NT Workstation, increased strongly over the prior year. Windows NT Server revenue growth was robust during the September quarter. Partially offsetting the healthy growth of Windows NT operating systems was less revenue from retail packaged product versions of Windows 98 in the first quarter of fiscal 2000 compared to the first quarter of fiscal 1999. The decrease reflected the strong comparable quarter of the prior year which included significant revenue from Windows 98 after its launch in June 1998.

Productivity Applications and Developer products include desktop applications such as Microsoft Office, server applications such as Microsoft Exchange Server and Microsoft SQL Server(TM), and software developer tools. Revenue increased 40% to $2.45 billion in the September quarter. Revenue from Microsoft Office integrated suites, including the Premium, Professional, Small Business, and Standard Editions was very strong, reflecting the recent launch of Microsoft Office 2000. Revenue also included the recognition of $150 million of previously unearned revenue, due to the impact of the Microsoft Office 2000 Technology Guarantee noted above. Microsoft SQL Server 7.0 revenue was particularly robust. Revenue from Microsoft Exchange Server and software developer tools was steady.

Consumer, Commerce, and Other products include learning and entertainment software; PC input devices; training and certification fees; consulting; and the online services. Revenue in the September quarter was $685 million, up

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30% from the comparable quarter of fiscal 1999. Online advertising and access revenue rose substantially while revenue from hardware products and consumer software grew moderately.

Distribution Channels

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

OEM first quarter revenue of $1.74 billion represented an increase of 27% over the comparable quarter of fiscal 1999. PC shipment growth coupled with an increased penetration of higher value 32-bit operating systems and Microsoft Office drove the OEM revenue increase over the prior year.

South Pacific and Americas Region revenue in the September quarter increased 16% to $1.87 billion. Office revenue grew moderately, while Windows NT Server and server applications showed strong growth. Organizational licensing activity exhibited a seasonal slowdown. Revenue growth was particularly strong in Latin America but slower in the United States and the South Pacific.

Europe, Middle East, and Africa Region first quarter revenue of $1.18 billion was up 32% compared to the first quarter of fiscal 1999. Windows NT Server, Microsoft Office, and server applications grew strongly compared to the prior year, particularly via organizational licensing. Revenue growth was solid in the United Kingdom and France, and was particularly high in Germany.

Asia Region revenue in the September quarter of $593 million increased 82% from the first quarter of the prior year, reflecting better local economic conditions and the launch of localized versions of Microsoft Office 2000, particularly in Japan. Revenue grew very strongly in most countries in the Asia Region. As discussed below, strengthening local currencies positively impacted translated revenue compared to the prior year, particularly in Japan.

Translated international revenue is affected by foreign exchange rates. The impact of foreign exchange rates on revenue was positive in the September quarter compared to a year ago, as the Japanese yen was very strong versus the U.S. dollar, offset partially by weaker European currencies versus the U.S. dollar. Had the rates from the prior year been in effect in the first quarter of fiscal 2000, translated international revenue billed in local currencies would have been $65 million lower. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

Operating Expenses

Cost of revenue as a percent of revenue was 13.2% in the first quarter, down from 15.5% in the first quarter of the prior year. The percentage decrease resulted primarily from the trend in mix shift to organizational licenses, lower costs associated with WebTV(R) operations, and the recognition of previously unearned revenue related to the Office 2000 Technology Guarantee.

Research and development expenses increased 28% from the first quarter of the prior year to $834 million, driven primarily by higher development headcount-related costs and third-party development costs.

Sales and marketing expenses were $903 million in the September quarter, which represented 16.8% of revenue, compared to 16.4% in the first quarter of the prior year. Sales and marketing expenses as a percent of revenue increased slightly due to higher relative marketing costs offset partially by lower relative sales expenses.

General and administrative costs were $143 million in the first quarter compared to $99 million in the September quarter of the prior year. The increase for the quarter was due primarily to higher legal fees and certain stock option-related charges.

Other expenses include primarily the recognition of Microsoft's share of joint venture activities, including Transpoint and the MSNBC entities.

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Investment Income, Gains on Sales, and Income Taxes

First quarter investment income increased to $397 million from $261 million in the first quarter of the prior year. The increase was due to realized gains of approximately $50 million and the larger investment portfolio generated by cash from operations.

During the first quarter of fiscal 2000, Microsoft sold the entertainment city guide portion of MSN(TM) Sidewalk(R) to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants. Microsoft recognized a gain of $156 million.

During the first quarter of fiscal 1999, Microsoft sold its Softimage, Inc. subsidiary to Avid Technology, Inc for a pretax gain of $160 million.

The effective tax rate for fiscal 2000 is 34%. Excluding the tax impact of the gain on the sale of Softimage, the effective tax rate for fiscal 1999 was 35%.

Financial Condition

The Company's cash and short-term investment portfolio totaled $18.90 billion at September 30, 1999. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, primarily strategic technology companies. The Company has made large-scale investments in access providers, including cable, telephony, and wireless communications companies. During the first quarter of fiscal 2000, the Company purchased $400 million of Rogers Communications convertible preferred securities and warrants. In connection with

AT&T's proposed merger with MediaOne Group, Inc., the Company agreed to acquire MediaOne's interest in Telewest Communications plc, a leading provider of cable television and residential and business cable telephony services in the United Kingdom, subject to certain regulatory approvals and other conditions.

Microsoft and National Broadcasting Company (NBC) operate two MSNBC joint ventures: a 24-hour cable news and information channel, and an online news service. Microsoft is paying $220 million over a five-year period that ends in 2001 for its interest in the cable venture and one-half of the operational funding of both joint ventures. Microsoft guarantees a portion of MSNBC debt.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at September 30, 1999 was $31.34 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Cash will also be used to fund ventures and strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $300 million on September 30, 1999.

In addition, cash will be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 722 million common shares while 1.84 billion shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $68 billion as of September 30, 1999. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable preferred stock. Net proceeds of $980 million were used to repurchase common shares. In December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of $79.875 and a cap of $102.24 per preferred share, equivalent to $19.97 and $25.56 per common share.

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

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

<PAGE>

Year 2000

The Year 2000 presents potential concerns for business and consumer computing. In addition to the well-known calculation problems with the use of 2-digit date formats as the year changes from 1999 to 2000, the Year 2000 is a special case leap year and in many organizations using older technology, dates were used for special programmatic functions. The problem exists for many kinds of software and hardware, including mainframes, mini computers, PCs, and embedded systems. The consequences of this issue may include systems failures and business process interruption.

Microsoft has tested more than 3000 versions/languages of its products. The vast majority of these tested products are Year 2000 compliant, as defined by Microsoft. There are a small number of older products that are identified as being non-compliant, and Microsoft will provide recommendations regarding these products. Not all versions of products or all products will be tested. All Year 2000 software updates, resources, and tools are available to customers at no charge from the Microsoft Year 2000 Portal Page or Microsoft Year 2000 Resource CD.

Current information needed to evaluate the impact of the Year 2000 on organizational and home computing environments is available at the Microsoft Year 2000 Portal Page (www.microsoft.com/year2000) and the Microsoft Year 2000 Resource CD, which is released on a quarterly basis. The Web site and Microsoft Year 2000 Resource CD detail specific Year 2000 information concerning Microsoft products and technologies for large organizations. The detailed information available on the Web site and Microsoft Year 2000 Resource CD is presented to assist information technology (IT) professionals in planning their transition to the Year 2000. The Microsoft Year 2000 Portal Page also contains information for small business and home PC users, including in-depth product information, answers to frequently asked questions, and links to other Year 2000 sites.

Variability of definitions of "compliance" with the Year 2000 and of different combinations of software, firmware, and hardware will likely lead to lawsuits against the Company. The outcome of such lawsuits and the impact on the Company are not estimable at this time.

The Year 2000 issue also affects the Company's internal systems, including IT and non-IT systems. Microsoft has assessed the readiness of its mission-critical systems for handling the Year 2000. Although testing and remediation of all systems have not been completed, management currently believes that all mission critical-systems will be compliant by the Year 2000 and that the cost to address the issues is not material. Nevertheless, Microsoft is creating contingency plans for certain internal systems.

Microsoft is addressing the effect this issue will have on its third-party supply chain and has undertaken steps to formulate a system of working with key third parties to understand their ability to continue providing services and products through the change to 2000. Microsoft is working directly with its key vendors, distributors, and resellers to avoid material business interruptions in 2000. Contingency plans are being developed where practicable for these key third parties.

Resolving Year 2000 issues is a worldwide phenomenon that is absorbing a substantial portion of IT budgets and attention. Certain industry analysts believe that Year 2000 concerns will cause IT managers to lock down their desktops and systems, creating less demand for computer hardware and software, which could negatively impact Microsoft. Others believe major remediation efforts at large organizations are completed or that small organizations are solving Year 2000 issues by purchasing new PCs. The impact of the Year 2000 on future Microsoft revenue is difficult to discern, but is a risk to be considered in evaluating the future growth of the Company.

<PAGE>

Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

Item 2. Changes in Securities and Use of Proceeds

During the first quarter of fiscal 2000, the Company issued an aggregate of 663,895 of its common shares pursuant to a merger in exchange for the outstanding capital shares of Intrinsa Corporation held by 65 shareholders. The shares were issued pursuant to an exemption by reason of Section 4(2) of the Securities Act of 1933. These sales were made without general solicitation or advertising. In connection with this merger, 41 of the former Intrinsa Corporation shareholders represented that he, she, or it was an accredited investor. Shareholders who signified that they were not accredited investors were represented by a qualified purchaser's representative. The Company has filed a Registration Statement on Form S-3 covering the resale of such securities. All net proceeds from the sale of such securities will go to the selling shareholders who offer and sell their shares. The Company has not received and will not receive any proceeds from the sale of these common shares other than the assets and liabilities of the acquired companies.

Reference is also made to the information on sales of put warrants described in the accompanying notes to financial statements. All such transactions are exempt from registration under Section 4 (2) of the Securities Act of 1933. Each transaction was privately negotiated and each offeree and purchaser was an accredited investor/qualified institutional buyer. No public offering or public solicitation was used by Microsoft in the placement of these securities.

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

27. Financial Data Schedule

(B) Reports on Form 8-K

The Company filed one report on Form 8-K during the quarter ended September 30, 1999. On July 19, 1999, the Company disclosed its reclassified quarterly income statements to reflect changes in the way it reports revenue and costs associated with product support, consulting, Internet access, and certification of system integrators. Henceforth, amounts received from customers from these activities will be classified as revenue in a manner consistent with Microsoft's primary businesses. Direct costs of these activities will be classified as cost of revenue. Additionally, the Company announced that the Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices.

Items 3, 4, and 5 are not applicable and have been omitted.

<PAGE>

Signature

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

Microsoft Corporation

Date: November 5, 1999 By: /s/ Gregory B. Maffei

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

(Principal Financial and Accounting Officer and Duly Authorized Officer)

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CONFORMED PERIOD OF REPORT:     19990331
FILED AS OF DATE:               19990514

FILER:

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                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 WA
                FISCAL YEAR END:                        0630

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                STREET 2:               NORTH OFFICE 2211
                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         2068828080

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 1999

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

One Microsoft Way, Redmond, Washington (Address of principal executive office)	98052-6399 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [_]

The number of shares outstanding of the registrant's common stock as of April 30, 1999 was 5,103,859,232.

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended March 31, 1999

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Part I. Financial Information

Item 1. Financial Statements

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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	Three Months Ended Mar. 31	
	1998	1999
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Revenue	$3,774	$4,331
Operating expenses:		
Cost of revenue	317	350
Research and development	597	611
Acquired in-process technology	0	0
Sales and marketing	829	996

General and administrative	104	144
Other expenses	60	1
Total operating expenses	1,907	2,102
Operating income	1,867	2,229
Investment income	190	720
Gain on sale	0	0
Income before income taxes	2,057	2,949
Provision for income taxes	720	1,032
Net income	$1,337	$1,917
Earnings per share (1):		
Basic	$ 0.27	$ 0.38
Diluted	$ 0.25	$ 0.35

</TABLE>

(1) Earnings per share amounts for the three and nine months ended March 31, 1998 have been restated to reflect a two-for-one stock split in March 1999.

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

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<S>	June 30 1998 <C>
Assets	
Current assets:	
Cash and short-term investments	$13,927
Accounts receivable	1,460
Other	502
Total current assets	15,889
Property and equipment	1,505
Equity investments	4,703
Other assets	260
Total assets	$22,357
Liabilities and stockholders' equity	
Current liabilities:	
Accounts payable	$ 759
Accrued compensation	359
Income taxes payable	915
Unearned revenue	2,888

Other	809
Total current liabilities	5,730
Commitments and contingencies	
Stockholders' equity:	
Convertible preferred stock -	
shares authorized 100; outstanding 13	980
Common stock and paid-in capital -	
shares authorized 12,000; outstanding 4,940 and 5,091	8,025
Retained earnings	7,622
Total stockholders' equity	16,627
Total liabilities and stockholders' equity	$22,357

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(1) Unaudited

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

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	Nine Months Mar. 3 1998
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Operations	
Net income	$ 3,133
Depreciation and amortization	776
Write-off of acquired in-process technology	296
Gain on sale	0
Unearned revenue	2,139
Recognition of unearned revenue from prior periods	(1,094)
Other current liabilities	266
Accounts receivable	(123)
Other current assets	53
Net cash from operations	5,446
Financing	
Common stock issued	650
Common stock repurchased	(1,605)
Put warrant proceeds	388
Preferred stock dividends	(21)
Stock option income tax benefits	910
Net cash from financing	322
Investments	

Additions to property and equipment	(415)
Cash portion of WebTV purchase price	(190)
Cash proceeds from sale of Softimage	0
Equity investments and other	(1,756)
Short-term investments	(2,952)
Net cash used for investments	(5,313)
Net change in cash and equivalents	455
Effect of exchange rates on cash and equivalents	(51)
Cash and equivalents, beginning of period	3,706
Cash and equivalents, end of period	4,110
Short-term investments, end of period	8,212
Cash and short-term investments, end of period	$12,322

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See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

STOCKHOLDERS' EQUITY STATEMENTS
(In millions)(Unaudited)

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	Three Months Ended Mar. 31 1998	1999
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Convertible preferred stock		
Balance	$ 980	$ 980
Common stock and paid-in capital		
Balance, beginning of period	6,104	10,443
Common stock issued	323	901
Common stock repurchased	(9)	(20)
Structured repurchases price differential	0	(328)
Proceeds from sale of put warrants	63	402
Stock option income tax benefits	503	1,020
Balance, end of period	6,984	12,418
Retained earnings		
Balance, beginning of period	5,260	11,155
Net income	1,337	1,917
Net unrealized investments gains	167	46
Translation adjustments and other	(45)	(52)
Comprehensive income	1,459	1,911
Preferred stock dividends	(7)	(7)
Common stock repurchased	0	(735)

Balance, end of period	6,712	12,324
Total stockholders' equity	$14,676	$25,722

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

Basis of Presentation

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

Stock Split

In March 1999, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

Earnings Per Share

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

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

EARNINGS PER SHARE
(In millions, except earnings per share)

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	Three Months Ended Mar. 31	
	1998	1999
<S>	<C>	<C>

Net income (A)	$1,337	$1,917
Preferred stock dividends	(7)	(7)
Net income available for common shareholders (B)	$1,330	$1,910
Average outstanding shares of common stock (C)	4,866	5,055
Dilutive effect of:		
Common stock under structured repurchases	10	12
Preferred stock	30	16
Employee stock options	464	429
Common stock and common stock equivalents (D)	5,370	5,512
Earnings per share:		
Basic (B/C)	$ 0.27	$ 0.38
Diluted (A/D)	$ 0.25	$ 0.35

</TABLE>

<PAGE>

Unearned Revenue

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

End-users receive certain elements of the Company's platform products over a period of time. These elements include browser and other Internet technologies, telephone support, Internet-based technical support, and service releases. Consequently, Microsoft recognizes the fair value of these elements, currently approximately 20% of Windows 98 and Windows 95 desktop operating systems OEM revenue and approximately 35% of retail version revenue, over the product's life cycle. Approximately 20% of Windows NT Workstation and Windows NT Server revenue is also recognized ratably. Product life cycles are currently estimated at two years. The Company also sells subscriptions to platforms products via maintenance and certain organizational license agreements. At March 31, 1999, platform products unearned revenue was $2.06 billion.

Likewise, end-users of the Company's applications products receive elements over time, including telephone support, new Internet technologies, and service releases. The fair value of these elements, which is currently approximately 20% of Office 97 applications revenue, is recognized ratably over the estimated 18-month product life cycle. The Company also sells subscriptions to applications and tools products, including maintenance and certain organizational license programs. Unearned revenue associated with applications and tools products totaled $2.02 billion at March 31, 1999.

Unearned revenue associated with other miscellaneous programs totaled $113 million at March 31, 1999.

Stockholders' Equity

Microsoft repurchases its common stock in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During the first three quarters of fiscal 1999, the Company repurchased 25.6 million shares of Microsoft common stock in the open market. During fiscal 1998, the Company repurchased 42 million shares under forward settlement structured repurchases and paid cash for a portion of the purchase price. In the March quarter of fiscal 1999, the Company settled the remainder by returning 28 million shares, based upon the stock price on the date of settlement. The timing and method of settlement was at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the date of the agreement was originally reflected in common stock and paid-in capital.

To enhance its stock repurchase program, Microsoft sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices, and permit a net-share settlement at the Company's option. On March 31, 1999, 163 million warrants were outstanding. The outstanding put warrants have strike prices ranging from $59 to $65 per share and maturities ranging from 6 to 36 months.

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

Acquisitions

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

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

Sale of Softimage

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

<PAGE>

Contingencies

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

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

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

On November 17, 1998, the court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The court ordered Microsoft to make certain changes in its products that include Sun's Java Technology and to make certain changes in its Java software development tools. The court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit on December 16, 1998. Oral argument on that appeal is set for June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. There are no other hearing or trial dates set.

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

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

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Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of MS-DOS and Windows in the late 80's and early 90's essentially the same complaints that resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

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

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

<PAGE>

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

Results of Operations

Microsoft develops, manufactures, licenses, and supports a wide range of software products, including scalable operating systems for intelligent devices, personal computers (PCs), and servers; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN(TM) network of Internet products and services; e-commerce platforms; and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs, sells PC input devices and books, and researches and develops advanced technologies for future software products.

Revenue

Revenue of $4.33 billion in the March quarter of fiscal 1999 increased 15% over the third quarter of fiscal 1998. Reported revenue did not include unearned revenue of $400 million related to the Microsoft(R) Office 2000 Technology Guarantee. Certain customers acquiring Office 97 or related applications are entitled to a free upgrade to the corresponding Office 2000 application when available. This revenue will be earned upon fulfillment of the related upgrade. Revenue growth reflected the continued adoption of Microsoft Windows(R) operating systems, including Windows 98, Windows NT(R) Server, and Windows NT Workstation; along with the Company's server applications. On a year to date basis, revenue in the first three quarters of fiscal 1999 totaled $13.2 billion, an increase of 26% over the first three quarters of fiscal 1998. Year to date revenue growth reflected the continued adoption of Microsoft(R) Windows(R) operating systems and Microsoft Office.

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

Product Groups

Platforms product revenue grew 26% to $2.05 billion in the third quarter. Revenue of $6.30 billion for the first three quarters of fiscal 1999 grew 38% over the first three quarters of fiscal 1998. Windows-based units licensed through the OEM channel, particularly Windows NT Workstation, increased strongly. Organizational licensing of Windows NT Workstation and Windows 98 also contributed to the growth. Windows NT Server revenue was healthy, although the growth rate slowed from growth percentages in prior quarters. Windows CE and Microsoft WebTV Network(TM) service continued to show strong revenue growth, albeit small in amount.

Applications and Tools product revenue increased 4% to $1.94 billion in the March quarter. Underlying shipments of desktop applications were strong, led by Microsoft Office integrated suites, including the Standard, Professional, and Small Business Editions. However, desktop applications earned revenue actually decreased from a year ago, due to the impact of the Office 2000 Technology Guarantee noted above. Server applications revenue, principally Microsoft Exchange Server and Microsoft SQL Server(TM), increased strongly over the comparable quarter of the prior year. SQL Server revenue in the March quarter was very healthy, and also included earned revenue of $45 million related to fulfillment of free upgrades to SQL Server 7.0, which was treated as unearned the prior quarter. The Visual Studio(R) 6.0 development system, an integrated set of software development tools, drove moderate tools revenue growth. Applications and Tools revenue for the first three quarters of fiscal 1999 grew 17% over the prior year, reflecting strong shipments of Microsoft Office (offset by the Office 2000 Technology Guarantee) and strong shipments of server applications.

Interactive Media and Other revenue was $341 million in the third quarter, up 22% from the comparable quarter of fiscal 1998. Online advertising revenue rose substantially, while revenue from hardware, consumer software, and Microsoft Press was relatively flat. Year to date revenue was $1.12 billion, up 19% over the prior year. The year to date increase reflected increased shipments of hardware products and escalated online advertising.

<PAGE>

Sales Channels

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

Third quarter revenue from OEMs of $1.59 billion represented an increase of 29% over the comparable quarter of fiscal 1998. OEM revenue of $4.75 billion in the first three quarters of fiscal 1999 increased 39% over the first three quarters of fiscal 1998. PC shipment growth coupled with an increased penetration of higher value 32-bit operating systems drove the OEM revenue increase over the prior year.

For the March quarter, revenue in the South Pacific and Americas Region increased 6% to $1.33 billion. Growth from Windows NT Server, Windows NT Workstation, server applications, and online services offset lower earned revenue from desktop applications. Organization licensing activity was strong. Revenue growth in the U.S. was moderate, but was relatively flat in Latin America and the South Pacific. Revenue for the first three quarters of fiscal 1999 grew 23% to $4.34 billion, reflecting strong licensing of Microsoft Office, Windows NT Server, Windows NT Workstation, Windows 98, and server applications.

In the Europe, Middle East, and Africa Region, third quarter revenue of $932 million was up 4% compared to the third quarter of fiscal 1998. Organizational licensing of Windows NT Server, Windows NT Workstation, and server applications grew strongly compared to the prior year, offsetting the decline in desktop applications earned revenue. Revenue growth continued to be solid in France and Germany, and was particularly high in the United Kingdom, Sweden, the Netherlands, and the Middle East. For the first three quarters of fiscal 1999, revenue in the region totaled $2.97 billion, an increase of 21% over the prior year. Organizational licensing of Microsoft Office, Windows NT Server, Windows NT Workstation, and server applications grew strongly compared to the prior year.

Revenue in the Asia Region in the March quarter of $475 million increased 22% from the third quarter of the prior year. Desktop applications revenue was particularly strong. Revenue growth was solid in Japan. Certain areas exhibited superb growth, including China, India, and Southeast Asia. On a year to date basis, revenue in the Asia Region was $1.15 billion, up 9% over the comparable period of the prior year. As discussed below, strengthening local currencies positively impacted translated revenue compared to the prior year, particularly in Japan.

Translated international revenue is affected by foreign exchange rates. The impact of foreign exchange rates on third quarter revenue was positive, as most local currencies were strong versus the U.S. dollar. Had the rates from the prior year been in effect in the third quarter of fiscal 1999, translated international revenue billed in local currencies would have been $55 million lower. The impact of foreign exchange rates on second quarter revenue was nominal, as weaknesses in Japanese, Australian, and Southeast Asian currencies versus the U.S. dollar were offset by the relative strength of European currencies. Had the rates from the prior year been in effect in the first quarter, international revenue would have been $100 million higher, due to weaknesses in currencies versus the U.S. dollar. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

Operating Expenses, Nonoperating Items, and Income Taxes

Cost of revenue as a percent of revenue was 8.1% in the third quarter, down slightly from the percent of revenue the prior year. On a year to date basis, the percentage was 8.2%, which also was slightly less than the percentage the prior year. The impact of the trend in mix shift to OEM and organizational licenses on the cost of revenue percentage was offset somewhat by the impact of unearned revenue related to the Office 2000 Technology Guarantee and increased costs related to online services.

Research and development expenses increased 2% in the third quarter to $611 million, driven primarily by higher development headcount-related costs offset by lower infrastructure costs. On a year to date basis, research and development expenses grew 5% to $1.89 billion, reflecting higher development headcount-related costs, offset by lower infrastructure costs and third-party development costs.

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

<PAGE>

Sales and marketing expenses were $996 million in the March quarter, which represented 23.0% of revenue, compared to 22.0% in the third quarter of the prior year. Total sales and marketing expense as a percent of revenue increased due to higher relative sales expenses offset by lower relative marketing costs. On a year to date basis, sales and marketing expenses were $2.77 billion, which represented 20.9% of revenue, down from 23.8% of revenue for the first three quarters of fiscal 1998. Expenses as a percent of revenue decreased due to lower relative sales expenses and marketing costs.

General and administrative costs were $144 million in the third quarter compared to $104 million in the March quarter of the prior year. Year to date general and administrative costs were $392 million, up 29% from $305 million the prior year. The increases were due, in part, to higher legal costs.

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

Third quarter investment income increased to $720 million from $190 million in the third quarter of the prior year. Year to date investment income totaled $1.32 billion in fiscal 1999, compared to $489 million the prior year. The increase was due to the larger investment portfolio generated by cash from operations, coupled with realized gains of more than $400 million from the sale of certain bond and equity securities.

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

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

Financial Condition

Microsoft's cash and short-term investment portfolio totaled $21.76 billion at March 31, 1999. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

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

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at March 31, 1999 was $25.72 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $360 million on March 31, 1999. Cash will also be used to fund ventures and other strategic opportunities.

In May 1999, the Company agreed to purchase $5 billion of convertible securities and warrants of AT&T, a premier provider of voice and data communications. In addition to various technology licensing agreements with AT&T and in connection with AT&T's proposed merger with MediaOne Group Inc., the Company agreed to acquire MediaOne's interest in Telewest Communications plc. Telewest is leading provider of cable television and residential and business cable telephony services in the United Kingdom. Also, the Company announced its intention to purchase $600 million of Nextel Communications Inc. common stock. Nextel is a leading provider of integrated wireless communications in the United States. The transactions are subject to certain regulatory approvals and other conditions. In addition to previous investments in broadband service providers such as Comcast Corporation and NTL Inc., the Company's strategy may include future investments in broadband and wireless service providers around the world.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 691 million common shares while 1.76 billion shares were issued under the Company's

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employee stock option and purchase plans. The market value of all outstanding stock options was $72 billion as of March 31, 1999. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

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

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

New Accounting Pronouncement

During December 1998, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants issued Statement of Position (SOP) 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. The SOP is effective for transactions entered into in fiscal years beginning after March 15, 1999. Management of the Company is evaluating the new SOP and related interpretive guidance. The impact on the future financial results of the Company has not been determined.

Year 2000

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

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

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

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

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended December 31, 1998

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

For the Transition Period From _____ to _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

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

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

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

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

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<PAGE>

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 1998

INDEX

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                STATE OF INCORPORATION:                 WA
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                STREET 2:               NORTH OFFICE 2211
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                ZIP:                    98052
                BUSINESS PHONE:         2068828080

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SECURITIES AND EXCHANGE COMMISSION

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During the quarter, the Company issued an aggregate of 28,025,414 of its common shares to a major institutional investor in satisfaction of outstanding financial obligations of the Company, as described in the accompanying notes to financial statements. The shares were issued pursuant to an exemption by reason of Section 4(2) of the Securities Act of 1933. These sales were made without general solicitation or advertising. The institutional investor is an accredited investor with access to all relevant information necessary. The Company has entered into an agreement that grants registration rights to the institutional investor on Form S-3.

Reference is also made to the information on sales of put warrants described in the accompanying notes to financial statements. All such transactions are exempt from registration under Section 4(2) of the Securities Act of 1933. Each transaction was privately negotiated and each offeree and purchaser was an accredited investor/qualified institutional buyer. No public offering or public solicitation was used by the registrant in the placement of these securities.

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

At a Special Meeting of Shareholders held on March 12, 1999, the following proposal was adopted by the margin indicated:

To amend the Company's Articles of Incorporation to increase the authorized common stock from 4,000,000,000 shares to 12,000,000,000 shares and halve the par value of the common stock from $.000025 per share to $.0000125 per share in order to accommodate the proposed two-for-one split of the Company's common stock.

Shares voting:

For	2,191,343,759
Against	31,891,442
Abstain	4,577,616

Item 6. Exhibits and Reports on Form 8-K

(A) EXHIBITS
27. Financial Data Schedule

(B) REPORTS ON FORM 8-K
Microsoft filed no reports on Form 8-K during the quarter ended March 31, 1999.

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

<PAGE>

Signature

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

Microsoft Corporation

Date: May 12, 1999

By: /s/ Gregory B. Maffei

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

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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

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

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

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

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

<PAGE>

Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

Item 2. Changes in Securities and Use of Proceeds

During the quarter, the Company issued an aggregate of 918,702 of its common shares pursuant to a merger in exchange for the outstanding capital shares of Compare Net, Inc. held by 16 shareholders. The shares were issued pursuant to an exemption by reason of Section 4(2) of the Securities Act of 1933. These sales were made without general solicitation or advertising. Each purchaser represented that he, she, or it was an accredited investor with access to all relevant information necessary. The Company has filed a Registration Statement on Form S-3 covering the resale of such securities.

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Part I. Financial Information

Item 1. Financial Statements

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

Income Statements
(In millions, except earnings per share)(Unaudited)
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	Three Months Ended Dec. 31 1997	1998
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Revenue	$3,585	$4,938
Operating expenses:		
Cost of revenue	313	433
Research and development	627	667
Acquired in-process technology	0	0
Sales and marketing	876	940

General and administrative	106	149
Other expenses	50	35
Total operating expenses	1,972	2,224
Operating income	1,613	2,714
Investment income	157	337
Gain on sale	0	0
Income before income taxes	1,770	3,051
Provision for income taxes	637	1,068
Net income	$1,133	$1,983
Earnings per share (1):		
Basic	$ 0.47	$ 0.79
Diluted	$ 0.42	$ 0.73

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

See accompanying notes.

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MICROSOFT CORPORATION

Balance Sheets
(In millions)
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	June 30 1998
<S>	<C>
Assets	
Current assets:	
Cash and short-term investments	$13,927
Accounts receivable	1,460
Other	502
Total current assets	15,889
Property and equipment	1,505
Equity investments	4,703
Other assets	260
Total assets	$22,357

Liabilities and stockholders' equity

Current liabilities:	
Accounts payable	$ 759
Accrued compensation	359
Income taxes payable	915
Unearned revenue	2,888
Other	809
Total current liabilities	5,730
Commitments and contingencies	
Stockholders' equity:	
Convertible preferred stock - shares authorized 100; outstanding 13	980
Common stock and paid-in capital - shares authorized 4,000; outstanding 2,470 and 2,510	8,025
Retained earnings	7,622
Total stockholders' equity	16,627
Total liabilities and stockholders' equity	$22,357

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(1) Unaudited

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)
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Operations	
Net income	$ 1,79
Depreciation and amortization	49
Write-off of acquired in-process technology	29
Gain on sale	
Unearned revenue	1,25
Recognition of unearned revenue from prior periods	(63
Other current liabilities	29
Accounts receivable	(12
Other current assets	(3
Net cash from operations	3,34
Financing	
Common stock issued	32

Common stock repurchased	(1,59
Put warrant proceeds	32
Preferred stock dividends	(1
Stock option income tax benefits	40
Net cash from (used for) financing	(55
Investments	
Additions to property and equipment	(26
Cash portion of WebTV purchase price	(19
Cash proceeds from sale of Softimage	
Equity investments and other	(1,16
Short-term investments	(2,26
Net cash used for investments	(3,88
Net change in cash and equivalents	(1,09
Effect of exchange rates on cash and equivalents	(3
Cash and equivalents, beginning of period	3,70
Cash and equivalents, end of period	2,58
Short-term investments, end of period	7,52
Cash and short-term investments, end of period	$10,10

See accompanying notes.

</TABLE>

<PAGE>

MICROSOFT CORPORATION

Stockholders' Equity Statements
(In millions)(Unaudited)
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	Three Months Ended Dec. 31 1997	1998	S 1
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Convertible preferred stock			
Balance	$ 980	$ 980	$
Common stock and paid-in capital			
Balance, beginning of period	5,630	9,161	4
Common stock issued	100	536	
Common stock repurchased	(41)	(11)	
Structured repurchases price differential	162	0	
Proceeds from sale of put warrants	45	130	
Stock option income tax benefits	208	627	
Balance, end of period	6,104	10,443	6
Retained earnings			
Balance, beginning of period	4,854	8,983	5

Net income	1,133	1,983	1
Net unrealized investments gains	74	390	
Translation adjustments and other	10	63	
Comprehensive income	1,217	2,436	1
Preferred stock dividends	(7)	(7)	
Common stock repurchased	(804)	(257)	(1
Balance, end of period	5,260	11,155	5
Total stockholders' equity	$12,344	$22,578	$12

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

Basis of Presentation

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

Stock Splits

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

Earnings Per Share

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

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

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

<TABLE>
<CAPTION>

	Three Months Ended Dec. 31		S
	1997	1998	
<S>	<C>	<C>	<
Net income (A)	$1,133	$1,983	$
Preferred stock dividends	(7)	(7)	
Net income available for common shareholders (B)	$1,126	$1,976	$
Average outstanding shares of common stock (C)	2,421	2,499	
Dilutive effect of:			
Common stock under structured repurchases	0	11	
Preferred stock	19	10	
Employee stock options	227	210	
Common stock and common stock equivalents (D)	2,667	2,730	
Earnings per share:			
Basic (B/C)	$ 0.47	$ 0.79	$
Diluted (A/D)	$ 0.42	$ 0.73	$

</TABLE>

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Unearned Revenue

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

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

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

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

Stockholders' Equity

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

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

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

Acquisitions

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

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

Sale of Softimage

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

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Contingencies

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

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

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

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

of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-Microsoft Internet browsing software (or other software products); taking or threatening "action adverse" in consequence of a person's failure to license or distribute Microsoft Internet browsing software (or other software product) or distributing competing products or cooperating with the government; and restrictions on the screens, boot-up sequence, or functions of Microsoft's operating system products. The state Attorneys General allege largely the same claims, and various pendent state claims. The states seek declaratory relief, and preliminary and permanent injunctive relief similar to that sought by the DOJ, together with statutory penalties under the state law claims. The foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

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

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

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

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

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

Results of Operations

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

Revenue

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

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

Product Groups

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

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

Interactive Media and Other revenue was $467 million in the December quarter, up

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

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

Microsoft immediately appealed the preliminary injunction to the District of Columbia Circuit Court of Appeals. On May 5, 1998, Microsoft also sought a stay of the District Court's injunction insofar as it applied to Windows 98. On May 12, 1998, the Court of Appeals granted Microsoft's request for a stay. The Court of Appeals issued an opinion on Microsoft's appeal on June 23, 1998. It unanimously reversed the trial court, both as to the entry of the

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injunction and the reference to the special master. The opinion both cited procedural errors in the issuance of the injunction and errors of substantive law in the interpretation of the consent decree. The court remanded the case to Judge Jackson for further proceedings consistent with the Court's opinion. There has been no further action in that case since the Court of Appeals' decision.

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

On May 18, 1998, the DOJ and a group of 20 state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion

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

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Sales Channels

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

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

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

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

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

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

Operating Expenses, Nonoperating Items, and Income Taxes

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

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

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

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

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

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

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

In August 1998, Microsoft sold its Softimage subsidiary to Avid Technology, Inc.

A pretax gain of $160 million was recorded in the first quarter of fiscal 1999.

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

Financial Condition

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

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

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

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

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

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

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

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Year 2000

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

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

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

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

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

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

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

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

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

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Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

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

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

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

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

</TABLE>

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

27. Financial Data Schedule

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

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

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Signature

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

Microsoft Corporation

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

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

(Principal Financial and Accounting Officer
and Duly Authorized Officer)

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CONFORMED SUBMISSION TYPE:      10-Q
PUBLIC DOCUMENT COUNT:          2
CONFORMED PERIOD OF REPORT:     19980930
FILED AS OF DATE:               19981112

FILER:

        COMPANY DATA:
                COMPANY CONFORMED NAME:                 MICROSOFT CORP
                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 WA
                FISCAL YEAR END:                        0630

        FILING VALUES:
                FORM TYPE:              10-Q
                SEC ACT:
                SEC FILE NUMBER:        000-14278
                FILM NUMBER:            98745910

        BUSINESS ADDRESS:
                STREET 1:               ONE MICROSOFT WAY #BLDG 8
                STREET 2:               NORTH OFFICE 2211
                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         2068828080

        MAIL ADDRESS:
                STREET 1:               ONE MICROSOFT WAY - BLDG 8
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 1998

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON	98052-6399
(Address of principal executive office)	(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X]   No [_]

The number of shares outstanding of the registrant's common stock as of October 31, 1998 was 2,493,566,949.
<PAGE>

MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 1998

INDEX

PART I. FINANCIAL INFORMATION

<TABLE>

<CAPTION>

</TABLE>
<PAGE>

Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

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

<TABLE>
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	Three Months Ended Sept. 30	
	1997	
<S>	<C>	<
Revenue	$3,130	$
Operating expenses:		
Cost of revenue	253	
Research and development	567	
Acquired in-process technology	296	
Sales and marketing	788	
General and administrative	95	
Other expenses	71	
Total operating expenses	2,070	
Operating income	1,060	
Investment income	142	
Gain on sale	0	
Income before income taxes	1,202	
Provision for income taxes	539	

Net income	663	
Preferred stock dividends	7	
Net income available for common shareholders	$ 656	$
Earnings per share (1):		
Basic	$ 0.27	$
Diluted	$ 0.25	$

</TABLE>

(1) Earnings per share amounts for the three months ended September 30, 1997 have been restated to reflect a two-for-one stock split in February 1998.

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Balance Sheets
(In millions)

<TABLE>
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	Ju 1
<S>	<C
ASSETS	
Current assets:	
Cash and short-term investments	$1
Accounts receivable	
Other	
Total current assets	1
Property and equipment	
Equity investments	
Other assets	
Total assets	$2
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$
Accrued compensation	
Income taxes payable	
Unearned revenue	
Other	
Total current liabilities	
Commitments and contingencies	
Stockholders' equity:	
Convertible preferred stock -	

```
    shares authorized 100; outstanding 13
  Common stock and paid-in capital -
    shares authorized 8,000; outstanding 2,470 and 2,488
  Retained earnings
- ------------------------------------------------------------------------------------
    Total stockholders' equity                                                      1
- ------------------------------------------------------------------------------------
      Total liabilities and stockholders' equity                                   $2
- ------------------------------------------------------------------------------------
</TABLE>

(1)  Unaudited

                                  See accompanying notes.

                                              2
<PAGE>

MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

<TABLE>
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- ------------------------------------------------------------------------------------
<S>                                                                               <C
OPERATIONS
  Net income                                                                       $
  Depreciation and amortization
  Write-off of acquired in-process technology
  Gain on sale
  Unearned revenue
  Recognition of unearned revenue from prior periods
  Other current liabilities
  Accounts receivable
  Other current assets
- ------------------------------------------------------------------------------------
    Net cash from operations
- ------------------------------------------------------------------------------------
FINANCING
  Common stock issued
  Common stock repurchased
  Put warrant proceeds
  Preferred stock dividends
  Stock option income tax benefits
- ------------------------------------------------------------------------------------
    Net cash from (used for) financing
- ------------------------------------------------------------------------------------
INVESTMENTS
  Additions to property and equipment
  Cash portion of WebTV purchase price
  Cash proceeds from sale of Softimage
  Equity investments and other
  Short-term investments
- ------------------------------------------------------------------------------------
    Net cash used for investments                                                   (
```

- ---
Net change in cash and equivalents
Effect of exchange rates on cash and equivalents
Cash and equivalents, beginning of period
- ---
Cash and equivalents, end of period
Short-term investments, end of period
- ---
Cash and short-term investments, end of period $
- ---
</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Stockholders' Equity Statements
(In millions)(Unaudited)

<TABLE>
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- ---
<S> <C
CONVERTIBLE PREFERRED STOCK $
- ---
COMMON STOCK AND PAID-IN CAPITAL
  Balance, beginning of period
  Common stock issued
  Common stock repurchased
  Structured repurchases price differential
  Proceeds from sale of put warrants
  Stock option income tax benefits
- ---
    Balance, end of period
- ---
RETAINED EARNINGS
  Balance, beginning of period
- ---
  Net income
  Net unrealized investments gains
  Translation adjustments and other
- ---
    Comprehensive income
  Preferred stock dividends
  Common stock repurchased (
- ---
    Balance, end of period
- ---
      Total stockholders' equity $1
- ---
</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

BASIS OF PRESENTATION

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

STOCK SPLIT

In February 1998, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

EARNINGS PER SHARE

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

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

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

<TABLE>
<CAPTION>

<S>	1997 <C>
Net income (A)	$ 66
Preferred stock dividends	(
Net income available for common shareholders (B)	$ 65
Average outstanding shares of common stock (C)	2,41
Dilutive effect of:	
Common stock under structured repurchases	
Preferred stock	1
Employee stock options	23

Common stock and common stock equivalents (D)	2,66
Earnings per share:	
Basic (B/C)	$ 0.2
Diluted (A/D)	$ 0.2

</TABLE>

<PAGE>

UNEARNED REVENUE

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

End-users receive certain elements of the Company's platform products over a period of time. These elements include browser and other Internet technologies, technical support, and unspecified product enhancements such as service releases, new device drivers, and patches. Consequently, the Company recognizes the fair value of these elements, currently approximately 20% of Microsoft(R) Windows(R) 98 and Windows 95 desktop operating systems OEM revenue, and approximately 35% of retail version revenue, over the product's life cycle. Approximately 20% of Microsoft Windows NT(R) Workstation and Windows NT Server revenue is also recognized ratably. Product life cycles are currently estimated at two years. The Company also sells subscriptions to platforms products via maintenance and organization license agreements. At September 30, 1998, platform products unearned revenue was $1.70 billion.

Likewise, end-users of the Company's applications products receive elements over time, including telephone support, new Internet technologies, service releases, and patches. Fair value of these elements, which is currently approximately 20% of Office 97 applications and server applications revenue, is recognized ratably over the estimated 18-month product life cycle. The Company also sells subscriptions to applications and tools products, including maintenance and organization license programs. Unearned revenue associated with applications and tools products totaled $1.38 billion at September 30, 1998.

Unearned revenue associated with other miscellaneous programs totaled $52 million at September 30, 1998.

STOCKHOLDERS' EQUITY

Microsoft repurchases its common stock in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During the first quarter of fiscal 1999, the Company repurchased 5.1 million shares of Microsoft common stock in the open market. In addition, the Company has executed structured repurchases with an independent third party. Under these arrangements, a portion of the purchase price will be paid in the next five or six years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net-share or cash) is at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the date of the agreement is reflected in common stock and paid-in capital. There were no structured repurchases during the first quarter of fiscal 1999, and 11.7 million shares were purchased under these arrangements during the first quarter of fiscal 1998.

To enhance its stock repurchase program, Microsoft sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices, and permit a net-share settlement at the Company's option. On September 30, 1998, 75 million warrants were outstanding. The outstanding put warrants expire between March 1999 and September 2001 and have strike prices ranging from $76 to $88 per share.

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

ACQUISITION OF WEBTV

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

SALE OF SOFTIMAGE

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

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CONTINGENCIES

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

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

On May 12, 1998, Sun filed companion motions seeking a preliminary injunction based on allegations of copyright infringement and unfair competition. Sun requested an order enjoining Microsoft from distributing any Java-based technology in any operating system, browser, or developers tools, including

Windows 98, Internet Explorer 4.0 software, and the Visual J++(TM) 6.0 development system for the Java language, unless and until Microsoft includes with each such product an implementation of the Java run-time environment that passes Sun's compatibility test suite or an operable implementation of Sun's current Java run-time environment. Hearings on these motions were held in September 1998. A decision on the motions is still pending. The parties are also currently scheduled to file summary judgment motions regarding the interpretation of the Agreement on January 23, 1999 that will be scheduled for hearing after February 26, 1999.

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

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

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

Although the Court of Appeals could have reversed the district court solely on procedural grounds, it chose to address at length the central issue in both the consent decree case and in the new Sherman Act case brought by the DOJ and 20 state Attorneys General: whether Microsoft is unlawfully "tying" a "separate product" known as Microsoft Internet Explorer to the Windows operating system. Two members of the

<PAGE>

Court rejected the DOJ's main argument that Internet Explorer constitutes a separate product because Microsoft treats it separately in some circumstances. (One judge dissented in part from the reasoning in this part of the opinion.) The Court's discussion of antitrust tying law, although made in the context of the consent decree case, clearly provides guidance on many of the issues raised in the new Sherman Act case.

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

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

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of MS-DOS and Windows in the late 80's and early 90's essentially the same complaints that resulted in the 1994 consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Fact discovery is scheduled to end in November 1998, and trial is scheduled for June 1999. Microsoft is vigorously defending the case.

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

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

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

RESULTS OF OPERATIONS

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

REVENUE

Revenue of $3.95 billion in the September quarter of fiscal 1999 increased 26% over the first quarter of fiscal 1998. Revenue growth, while slowing, reflected the continued adoption of Microsoft Windows 32-bit operating systems and Microsoft Office 97, particularly as Microsoft software is deployed across entire organizations.

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

Quarterly revenue is categorized by new product group and channel classifications that correspond to internal reporting alignments. Prior period revenue has been restated to conform to the new presentation and to provide a basis for comparisons. Revenue is presented for three product groups: Platforms; Applications and Tools; and Interactive Media and Other. Sales channels are Original Equipment Manufacturers (OEM); the South Pacific and Americas Region; the Europe, Middle East, and Africa Region; and the Asia Region.

PRODUCT GROUPS

Platform product revenue grew 38% to $1.93 billion in the first quarter. Windows units licensed through the OEM channel, including Windows 95, Windows 98, and Windows NT Workstation, increased strongly over the prior year. Retail versions of Windows 98, which was released in June 1998, also contributed to the growth. The revenue growth rate for Windows NT Server was healthy, but continued to slow. Although revenue was not significant, sales of WebTV-based Internet X terminals and WebTV service and preinstallations of Windows CE by OEMs on intelligent devices were strong in 1998.

Applications and Tools product revenue increased 21% to $1.71 billion in the September quarter. Desktop applications revenue growth was strong, led by Microsoft Office integrated suites, including the Standard, Professional, and Small Business Editions. The primary programs in Microsoft Office are the word processor Microsoft Word, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for 32-bit versions of Windows, 16-bit versions of Windows, and Macintosh operating systems, also include Microsoft Access database management program, Microsoft Outlook(R) messaging and collaboration client, or other programs. Microsoft Project 98 also contributed to the quarterly desktop applications growth. Server applications revenue, including Microsoft Exchange Server and Microsoft SQL Server(TM), continued to slow from the rapid growth rates experienced in prior quarters. The Visual Studio(R) 6.0 development system, an integrated set of software development tools, was recently released, leading to healthy tools shipments.

Interactive Media and Other revenue was $316 million, down slightly from the comparable quarter of fiscal 1998. Revenue from Microsoft Press; hardware; and learning, entertainment, and productivity titles was relatively flat. Although not material, revenue from desktop finance products and interactive online services increased from the prior year.

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SALES CHANNELS

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

First quarter revenue from OEMs of $1.37 billion represented an increase of 39% over the comparable quarter of fiscal 1998. PC shipment growth coupled with an increased penetration of higher value 32-bit operating systems drove the OEM revenue increase over the prior year.

For the September quarter, revenue in the South Pacific and Americas Region increased 29% to $1.44 billion. This high growth rate reflected the launch of Windows 98 and strong sales of integrated suites of desktop applications, particularly through organization license programs. In addition to steady growth in the U.S., revenue increased strongly in Brazil and Australia.

In the Europe, Middle East, and Africa Region, first quarter revenue of $839 million was up 23% compared to the first quarter of fiscal 1998. Organizational licensing of desktop applications grew strongly when compared to the prior year. Revenue growth was solid in Germany, the United Kingdom, and France, and particularly high in Sweden, Spain, and Poland.

Revenue in the Asia Region in the September quarter of $307 million decreased 11% from the first quarter of the prior year. Revenue was flat in Japan and decreased in Southeast Asia due to economic issues and weak currencies. As discussed below, the strengthening U.S. dollar negatively impacted translated revenue compared to the prior year, particularly in Japan.

Translated international revenue is effected by foreign exchange rates. Had the rates from the prior year been in effect in the first quarter of fiscal 1999, international revenue billed in local currencies would have been $100 million higher, due to weaknesses in currencies versus the U.S. dollar. Certain manufacturing, marketing, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenue as a percent of revenue decreased to 7.8% in the first quarter from 8.1% in the prior year. The decrease was due to the shifts in mix to CD-

ROMs (which carry lower cost of goods than disks), licenses to OEMs and organizations, and higher-margin servers and client access licenses in the BackOffice(R) product family, offset by costs of WebTV.

Research and development expenses increased 8% in the first quarter to $611 million, driven primarily by higher development headcount-related costs, offset by lower third-party development costs.

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

Sales and marketing expenses were $830 million in the September quarter which represented 21.0% of revenue, compared to 25.2% in the first quarter of the prior year. The total expense as a percent of revenue decreased due to lower relative sales expenses and marketing.

General and administrative costs were $99 million in the first quarter compared to $95 million in the September quarter of the prior year, increasing, in part, due to higher legal costs.

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

First quarter investment income increased to $261 million from $142 million in the first quarter of the prior year. The increase was due to the larger investment portfolio generated by cash from operations.

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

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Excluding the tax impact of the gain on the sale of Softimage, the effective tax rate for the September quarter was 35%, less than the 45% rate in the first quarter of fiscal 1998 due to a legislative clarification of the foreign sales corporation rules as they apply to software and the nondeductible write-off of WebTV in-process technologies.

NET INCOME

Net income for the first quarter of fiscal 1999 was $1.68 billion. Excluding the gain on the sale of Softimage in the first quarter fiscal 1999, net income of $1.52 billion represented 38.5% of revenue. Excluding the write-off of WebTV in-process technologies in the first quarter of fiscal 1998, net income of $959 million represented 30.6% of revenue. The increase in net income as a percent of revenue was due to lower relative operating expenses and higher investment income.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $17.24 billion at September 30, 1998. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, including financial investments and strategic technology companies in many areas. During 1997, Microsoft invested $1.0 billion in Comcast Corporation, a cable television and diversified telecommunications company. Comcast Special Class A common stock and convertible preferred stock are included in equity investments at fair market value on the balance sheet.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at September 30, 1998 was $19.12 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $360 million on September 30, 1998.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 352 million common shares while 830 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $50 billion as of September 30, 1998. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

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

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

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YEAR 2000

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

Microsoft is continuing to test its products and gather and produce information about Microsoft technologies impacted by the Year 2000 transition. Certain older products will not be tested. First, Microsoft is classifying its tested products into categories of compliance: compliant, compliant with minor issues, and not compliant. Most of the products tested are either compliant or compliant with minor issues, as defined. Second, if a product is stated to be non-compliant, Microsoft plans to provide information as to how an organization could avoid possible Year 2000 issues regarding that product. Microsoft is issuing patches and/or workarounds (at no additional charge) for most, but not all, known issues. Third, Microsoft is working to help organizations find solutions to Year 2000 problems, including technologies and services offered by Microsoft and other companies. Microsoft is assisting companies with the task of recognizing how disparate technologies can fit together to create a viable solution set.

Current information about the Company's products and business and technical issues is available at the Microsoft Year 2000 Resource Center web site (www.microsoft.com/year2000). The web site also contains information about
- ---------------------------
obtaining software patches to resolve various Year 2000 issues in certain Microsoft products. Information on the Company's web site is provided to customers for the sole purpose of assisting in planning for the transition to the Year 2000. Such information is the most currently available concerning the behavior of the Company's products in the next century and is provided "as is" without warranty of any kind. However, variability of definitions of "compliance" with the Year 2000 and of different combinations of software, firmware, and hardware will likely lead to lawsuits against the Company. The outcome of such lawsuits and the impact on the Company are not estimable at this time.

The Year 2000 issue also affects the Company's internal systems, including information technology (IT) and non-IT systems. Microsoft is assessing the readiness of its systems for handling the Year 2000, and has started the remediation and certification process. Although assessment, testing, and remediation is still underway, management currently believes that all material systems will be compliant by the Year 2000 and that the cost to address the issues is not material. Nevertheless, Microsoft is creating contingency plans for critical processes that rely on internal systems.

Microsoft is undertaking steps to identify its third-party supply chain and vendors and to understand their ability to continue providing services and products through the change to 2000. Microsoft will work directly with its key vendors, distributors, and direct resellers to avoid any business interruptions in 2000. For major third-parties with known issues, contingency plans will be developed.

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

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See notes to financial statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

27. Financial Data Schedule

(B) Reports on Form 8-K

Microsoft filed no reports on Form 8-K during the quarter ended September 30, 1998.

ITEMS 2, 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

<PAGE>

Signature

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

Microsoft Corporation

Date: November 12, 1998

By: /s/ Gregory B. Maffei

Gregory B. Maffei,
Vice President, Finance;
Chief Financial Officer
(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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FILED AS OF DATE: 19980515
SROS: NASD

FILER:

COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT:
SEC FILE NUMBER: 000-14278
FILM NUMBER: 98624938

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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 1998

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON (Address of principal executive office)	98052-6399 (Zip Code)

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

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

The number of shares outstanding of the registrant's common stock as of April 30, 1998 was 2,464,072,255.

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 1998

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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	Three Months Ended Mar. 31	
	1997	1998
<S>	<C>	<C>
Revenue	$ 3,208	$ 3,774
Operating expenses:		
Cost of revenue	297	317
Research and development	492	597
Acquired in-process technology	0	0
Sales and marketing	750	829
General and administrative	101	104
Total operating expenses	1,640	1,847
Operating income	1,568	1,927
Interest income	119	190
Other expenses	(84)	(60)
Income before income taxes	1,603	2,057
Provision for income taxes	561	720
Net income	1,042	1,337
Preferred stock dividends	7	7

Net income available for common shareholders	$ 1,035	$ 1,330
Earnings per share(1):		
Basic	$ 0.43	$ 0.55
Diluted	$ 0.40	$ 0.50

</TABLE>

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

See accompanying notes.

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MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

	June 30 1997	Mar. 31 1998(1)
ASSETS		
Current assets:		
Cash and short-term investments	$ 8,966	$12,322
Accounts receivable	980	1,055
Other	427	358
Total current assets	10,373	13,735
Property, plant, and equipment	1,465	1,416
Equity investments	2,346	4,122
Other assets	203	272
Total assets	$14,387	$19,545
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 721	$ 908
Accrued compensation	336	225
Income taxes payable	466	527
Unearned revenue	1,418	2,463
Other	669	746
Total current liabilities	3,610	4,869
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock - shares authorized 100; outstanding 13	980	980
Common stock and paid-in capital - shares authorized 8,000; outstanding 2,408 and 2,454	4,509	6,984
Retained earnings	5,288	6,712

Total stockholders' equity	10,777	14,676
Total liabilities and stockholders' equity	$14,387	$19,545

(1) Unaudited

See accompanying notes.

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MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

	Nine Months Ended Mar. 31	
	1997	1998
CASH FLOWS FROM OPERATIONS		
Net income	$ 2,397	$ 3,133
Depreciation and amortization	414	776
Write-off of acquired in-process technology	0	296
Unearned revenue	1,054	2,139
Recognition of unearned revenue from prior periods	(353)	(1,094)
Other current liabilities	377	266
Accounts receivable	(252)	(123)
Other current assets	(18)	53
Net cash from operations	3,619	5,446
CASH FLOWS USED FOR FINANCING		
Common stock issued	553	650
Common stock repurchased	(3,101)	(1,605)
Put warrant proceeds	126	388
Preferred stock issued	980	0
Preferred stock dividends	(7)	(21)
Stock option income tax benefits	482	910
Net cash used for financing	(967)	322
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(326)	(415)
Cash portion of WebTV purchase price	0	(190)
Equity investments and other	(155)	(1,756)
Short-term investments	(895)	(2,952)
Net cash used for investments	(1,376)	(5,313)
Net change in cash and equivalents	1,276	455
Effect of exchange rates on cash and equivalents	(25)	(51)
Cash and equivalents, beginning of period	2,601	3,706

Cash and equivalents, end of period	3,852	4,110
Short-term investments, end of period	5,234	8,212
Cash and short-term investments, end of period	$9,086	$12,322

See accompanying notes.

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MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1997 Form 10-K.

STOCK SPLIT

In February 1998, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

EARNINGS PER SHARE

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

Earnings Per Share
(In millions)

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	Three Months Ended Mar. 31	
	1997	1998
<S>	<C>	<C>

Net income (A)	$1,042	$1,337
Preferred stock dividends	(7)	(7)
Net income available for common shareholders (B)	$1,035	$1,330
Average outstanding:		
Common stock (C)	2,389	2,433
Common stock under forward purchase arrangements	0	5
Preferred stock	25	15
Employee stock options	223	232
Common stock and common stock equivalents (D)	2,637	2,685
Earnings per share:		
Basic (B/C)	$ 0.43	$ 0.55
Diluted (A/D)	$ 0.40	$ 0.50

</TABLE>

UNEARNED REVENUE

Microsoft believes that Internet technologies are integral to its products and has committed to integrating these technologies, such as its browser, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other support commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating

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systems revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was $860 million at June 30, 1997 and $1.10 billion at March 31, 1998.

Since Office 97 is also tightly integrated with the rapidly evolving Internet, and in the view of subsequent delivery of new Internet technologies, enhancements, and other support, a ratable revenue recognition policy became effective for Office 97 licenses beginning in the third quarter of fiscal 1997. Approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled $300 million at June 30, 1997 and $700 million at March 31, 1998.

Unearned revenue also includes maintenance and other subscription contracts, including custom enterprise license agreements.

STOCKHOLDERS' EQUITY

Microsoft repurchases its common stock on the open market. This program provides shares for issuance to employees under the Company's stock option and stock purchase plans. During the first three quarters of fiscal 1998, the Company repurchased 7.4 million shares of Microsoft common stock in the open market. In addition, under agreements with an independent third party, the Company purchased 21.2 million shares of stock through forward purchase arrangements. Under these arrangements, a portion of the purchase price will be paid in the next five or six years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net-share or cash) is at the discretion of the Company. The difference between the cash paid and the price of Microsoft common stock on the date of the agreement is reflected in stockholders' equity.

To enhance its stock repurchase program, Microsoft sells equity put warrants to independent third parties. These put warrants entitle the purchasers to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On March 31, 1998, 46 million warrants were outstanding with strike prices ranging from $67 to $70 per share. The warrants expire at various dates between the first quarter of fiscal 1999 and the third quarter of fiscal 2000 and are exercisable only at maturity. These put warrant contracts permit a net-share settlement at the Company's option, and do not result in a put warrant liability on the balance sheet.

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

ACQUISITION OF WEBTV

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $190 million in cash and $235 million of common stock for WebTV. The acquired net working capital of WebTV was not material. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV of $296 million.

CONTINGENCIES

On October 7, 1997, Sun Microsystems, Inc. brought suit against Microsoft in the U.S. District Court for the Northern District of California. On October 14, 1997, Sun filed a First Amended Complaint (Complaint). The Complaint alleges several claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology. The Complaint alleges: statutory and contractual trademark claims related to Microsoft's alleged improper use of the Java Compatibility logo; a false advertising claim related to statements Microsoft allegedly has made about its Java support and products; a claim that Microsoft has breached the Agreement in several respects; a claim that Microsoft allegedly made Sun's source code generally available to the public; a claim for breach of the covenant of good faith and fair dealing; a claim for unfair competition; a claim for intentional interference with contractual relations between Sun and its customers or prospective customers; and a claim that Microsoft induced software developers to breach their license agreements with Sun. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java Compatibility logo, and against distributing Internet Explorer 4.0 unless certain alleged obligations are met; an order compelling Microsoft to perform

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certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary and punitive damages, and liquidated damages of $35 million for the alleged source code disclosure.

On October 27, 1997, Microsoft filed its Answer, Affirmative Defenses, and Counterclaims (Answer). In its Answer, Microsoft denies Sun's claims, and denies that Sun is entitled to any relief. Microsoft alleges that Sun agreed to limit its remedies for all claims such as those alleged in the Complaint to compensatory damages capped by the total license fees paid ($17.5 million over the life of the Agreement). Microsoft specifically denies that Sun is entitled to any injunctive relief. Although the Agreement does provide for liquidated damages of $35 million if Microsoft makes Sun's Source Code generally available to the public under certain conditions, Microsoft denies that there is any basis for such a claim. Microsoft asserts other defenses to each of Sun's claims. In addition, Microsoft alleges counterclaims against Sun, including claims that: Sun has breached the Agreement in many respects; Microsoft is entitled to a court order that Microsoft may terminate Sun's license under the Agreement to certain Microsoft technology and otherwise determining the parties' rights and responsibilities; Sun has breached the covenant of good faith and fair dealing; and Sun has violated California's unfair competition statute. Microsoft also alleges that it has put Sun on notice of other breaches of contract and that Microsoft will seek to amend its counterclaim to state additional claims if those breaches are not timely cured. Microsoft seeks a declaratory judgment consistent with its claims and seeks compensatory damages consistent with the limitations in the Agreement. On November 17, 1997, Sun filed a motion for preliminary injunction seeking to enjoin Microsoft from using the Java compatibility logo on IE 4.0 during the pendency of the litigation on the basis that IE 4.0 does not pass certain Java compatibility tests. A hearing on this motion was held on February 27, 1998. At the hearing, the court set September 4, 1998 as the date on which the court will hear all motions relating to the interpretation of the parties' agreement.

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

On May 12, 1998, Sun filed companion motions seeking a preliminary injunction based on allegations of copyright infringement and unfair competition. Sun requested an order enjoining Microsoft from distributing any Java Technology in any operating system, browser, or developers tools, including Windows 98, IE 4.0 and JV++ 6.0, unless and until Microsoft includes with each such product an implementation of the Java runtime environment that passes Sun's compatibility test suite or an operable implementation of Sun's current Java runtime environment. Sun also filed a motion to amend its complaint to include a claim of copyright infringement. The new allegation alleges that Microsoft has infringed Sun's copyrights in the Java Technology because it has used the technology outside of the scope of the license agreement. The hearing for these motions is set for July 31, 1998.

The parties are engaged in ongoing discovery in anticipation of the July 31 and September 4 hearings.

On October 20, 1997, the Antitrust Division of the U.S. Department of Justice (DOJ) filed a Petition for An Order To Show Cause in United States District Court for the District of Columbia. The DOJ contends that Microsoft has violated a consent decree that was entered into by the DOJ and Microsoft on July 15, 1994, and approved by the Court on August 18, 1995, to conclude an earlier investigation by the DOJ. In its petition, the DOJ contends that Microsoft has violated the consent decree by including Internet Explorer technology in Windows 95, and by preventing original equipment manufacturers (OEMs) from removing Internet Explorer functionality from versions of Windows 95 the OEMs are licensed to install on computer systems they sell. In addition, the

DOJ alleges that certain non-disclosure agreements between Microsoft and its customers prohibiting the release of confidential information without prior notice to the other party are impairing the DOJ's ability to enforce the consent decree. The DOJ's petition seeks an order from the Court requiring Microsoft to demonstrate that it has not violated the consent decree. Microsoft does not believe it has violated the consent decree and intends to vigorously contest this lawsuit.

On December 5, 1997, Judge Jackson heard oral argument on the DOJ's contempt petition. On December 11, 1997, the court entered two orders. In the first order, Judge Jackson denied the DOJ's contempt petition, and dismissed the DOJ's request for relief concerning Microsoft's non-disclosure agreements because the DOJ had failed to present evidence that the agreements had interfered with any DOJ investigation. In addition, however, the court ruled that there were disputed issues of fact regarding Microsoft's violation of the consent decree, and concluded that the DOJ was likely to prevail on its claim that a violation had occurred. The court entered a preliminary injunction sua sponte requiring Microsoft not to condition the licensing of Windows 95 or any successor desktop operating system on a computer manufacturer also licensing any Microsoft browser software, including Internet Explorer 3.0 or 4.0. In the second order, the court appointed Harvard Law Professor Lawrence Lessig as a special master, to whom the court delegated the authority to conduct discovery, take evidence, and make proposed findings of fact and conclusions of law on all issues in the case by May 31, 1998.

Microsoft immediately appealed the preliminary injunction to the District of Columbia Circuit Court of Appeals and sought an expedited hearing on the grounds that there are substantial grounds for challenging Judge Jackson's order and that Microsoft will incur irreparable harm if the appeal is not heard quickly. The DOJ opposed expedited treatment. On December 30, 1997, the Court of Appeals entered an order granting Microsoft's motion and set a schedule pursuant to which oral argument was heard on April 21, 1998.

On December 23, 1997, Microsoft filed a motion in the District Court to revoke the reference to a special master on the grounds that improper procedure was used and that the scope of the reference was impermissibly broad. In addition, Microsoft raised concerns about the impartiality of Professor Lessig based upon statements in some of his writings. On January 15, 1998 the District Court denied Microsoft's motion and refused to certify its ruling for appeal. On January 16, 1998 Microsoft filed a petition for mandamus in the District of Columbia Circuit Court of Appeals, seeking

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a stay of all proceedings by the special master until the Court of Appeals could rule, and seeking an order reversing the reference to the special master. On February 2, 1998 the Court of Appeals ordered that the petition for mandamus would be consolidated with the pending appeal and oral argument heard on April 21, 1998. The Court also stayed all proceedings before the special master until it rules on the petition.

The case was heard by a panel of the Court of Appeals on April 21, 1998. The Court has not yet ruled on the matters argued. On May 5, 1998, Microsoft also sought a stay of the District Court's injunction insofar as it applied to Windows 98. On May 12, 1998 the Court of Appeals granted Microsoft's request for a stay.

In other ongoing investigations, the DOJ and sixteen state Attorneys General have requested information from Microsoft concerning various issues. The DOJ and a group of approximately 19 state Attorneys General have threatened to file an antitrust case against Microsoft. The parties are currently exploring whether a negotiated resolution can be reached. If it cannot, management believes it is likely that a lawsuit will be filed, but it is impossible at this time to determine its scope or outcome. We do not believe such an action would include significant claims for damages against Microsoft.

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

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

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

RESULTS OF OPERATIONS

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

REVENUE

Revenue of $3.77 billion in the third quarter of fiscal 1998 increased 18% over the third quarter of fiscal 1997. On a year to date basis, revenue increased 28% from the prior year to $10.49 billion. The growth rate, although slower than that of recent quarters, reflected the continued adoption of Windows(R) 32-bit operating systems and Microsoft Office 97, particularly as Microsoft software is deployed across entire organizations. Software license volume increases have been the principal factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from OEM licenses and organization license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. Microsoft recognizes a portion of Windows operating systems revenue over the products' life cycles. This revenue recognition policy was extended to Office 97 licenses in the third quarter of fiscal 1997. (See notes to financial statements.)

PRODUCT GROUPS

Platforms product revenue grew 17% to $1.97 billion in the third quarter, compared to $1.68 billion in the comparable quarter of the prior year. Year to date Platforms revenue was $5.55 billion in fiscal 1998 and $4.35 billion in fiscal 1997. Platforms product group revenue is primarily licenses of PC operating systems; business systems with client/server, Internet, and intranet architectures; and software development tools.

Windows 95 units licensed through the OEM channel increased strongly over the comparable quarter of the prior year. Revenue from retail versions of Windows 95 decreased as finished goods distributors and resellers reduced channel inventory levels in anticipation of Windows 98. Additionally, revenue from the Microsoft Windows NT(R) Workstation operating system showed healthy growth. The revenue growth rate for Microsoft BackOffice(R) server and server applications products continued to slow from the rapid rates experienced in prior periods.

Applications and Content product revenue increased 18% to $1.81 billion in the March quarter. For the first three quarters of fiscal 1998, revenue was $4.94 billion, compared to $3.83 billion the prior year. Applications and Content product group revenue includes primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. The various Microsoft Office integrated suites, including the Standard, Professional, and Small Business Editions, generate most desktop application revenue. The primary programs in Microsoft Office are Microsoft Word word processor, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows 32-bit, Windows 16-bit, and Macintosh operating systems, also include applications such as Microsoft Access database management program, Microsoft Outlook(TM) desktop manager, Microsoft Schedule+ calendar and scheduling program, and an email client license.

Revenue from integrated suites increased strongly, while stand-alone versions of Microsoft Excel, Microsoft Word, and Microsoft PowerPoint continued to decrease.

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SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, organizational licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers who pre-install Microsoft products, primarily on PCs. Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of organization licenses and packaged products in these channels are primarily to distributors and resellers. The trend has continued toward a higher percentage of organizational licensing versus packaged products.

Revenue from the OEM channel in the March quarter of $1.23 billion was flat with the second quarter, and up 28% over the prior year. Year to date, OEM revenue was $3.43 billion compared to $2.49 billion the prior year. The primary source of OEM revenue is the licensing of desktop operating systems. Greater PC shipments, although at a slowing growth rate, coupled with an increased penetration of higher value 32-bit PC operating systems drove the OEM revenue increase over the prior year.

For the third fiscal quarter, finished goods revenue in the U.S. and Canada increased 18% to $1.11 billion from $938 million the prior year. Year to date revenue of $3.07 billion grew 22% over the prior year. The growth rate in the U.S. and Canada reflected slowing growth of business systems and declining shipments and licensing of retail versions of the Windows 95 operating system. Desktop applications increased over the comparable quarter due to strong licensing of Microsoft Office and Office Professional. Microsoft Office 98 Macintosh Edition was released during the quarter in the U.S.

Third quarter revenue of $849 million in Europe was steady with the immediately prior quarter, but increased only 6% compared to the third quarter of fiscal 1997. Growth rates slowed across most product lines. As discussed below, the strengthening U.S. dollar negatively impacted translated European revenue compared to the third quarter of the prior year. Year to date revenue of $2.33 billion grew 26% over the prior year.

Other International channel revenue in the March quarter was $582 million, an increase of 14% compared to $511 million the prior year. The third quarter growth rate was lower than recent quarters due to declining sales in Japan and Southeast Asia, which partially offset solid growth in Mexico, Brazil, and other South American countries. Year to date revenue was $1.66 billion in fiscal 1998 and $1.33 billion in fiscal 1997. Key drivers of growth were increased organizational licensing of Microsoft Office and sales of BackOffice packaged product.

Translated international revenue is effected by foreign exchange rates. Had the rates from the prior year been in affect in the third quarter, European revenue would have been $80 million higher. Additionally, other international revenue billed in local currencies, principally in Japan, suffered a $46 million drag due to weaknesses in currencies versus the U.S. dollar. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenue as a percent of revenue declined to 8.4% in the third quarter from 9.3% the prior year. For the first three quarters of fiscal 1998, cost of revenue as a percent of revenue was 8.4% compared to 10.3% in fiscal 1997. The decrease was due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks), licenses to OEMs and organizations, and higher-margin Windows NT Server and other BackOffice server products.

Research and development expenses increased 21% in the third quarter to $597 million and increased 27% year to date to $1.79 billion, primarily driven by higher development headcount-related costs and third party development.

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $425 million in stock and cash for WebTV. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV of $296 million.

Sales and marketing expenses were $829 million in the third quarter of fiscal 1998, which represented 22.0% of revenue, compared to 23.4% in the third quarter of the prior year. On a year to date basis, sales and marketing expenses of $2.49 billion represented 23.8% of revenue, compared to 25.8% in fiscal 1997. The total expense as a percent of revenue decreased due to lower relative sales expenses.

General and administrative costs were $104 million in the third quarter compared to $101 million in the comparable quarter of the prior year. In the first three quarters of fiscal 1998, general and administrative expenses were $305 million, compared to costs of $268 million the prior year.

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Interest income increased as a result of a larger investment portfolio generated by cash from operations. Other expenses include primarily the recognition of the Company's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities.

The effective tax rate for the March quarter was 35%, a one-point decrease from the first half of fiscal 1998 due to a legislative clarification of the foreign sales corporation rules as they apply to software. On a year to date basis, the effective income tax rate increased due to the nondeductibility of the write-off of the WebTV in-process technologies and amortization of other WebTV intangible assets.

NET INCOME

Net income for the third quarter of fiscal 1998 was $1.34 billion. On a year to date basis, net income was 29.9% of revenue in fiscal 1998 compared to 29.3% the prior year. Excluding the one-time write-off of WebTV in-process R&D, net income represented 32.7% of revenue in the first three quarters of fiscal 1998. Earnings per share without the write-off were $1.28, a 39% increase compared to the $0.92 earned during the same period the prior year.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $12.32 billion at March 31, 1998. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio includes short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

During 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at March 31, 1998 was $14.68 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $300 million on March 31, 1998.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. Despite recent increases in stock repurchases, the buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 337 million common shares for $7.8 billion while 781 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $42.2 billion as of March 31, 1998. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

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

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

YEAR 2000

The year 2000 poses certain issues for business and consumer computing, particularly the functionality of software for two-digit storage of dates and special meanings for certain dates such as 9/9/99. The year 2000 is also a leap year, which may also lead to incorrect calculations, functions, or system failure. The problem exists for many kinds of software, including software for mainframes, PCs, and embedded systems. Microsoft is in the process of gathering, testing, and producing information about Microsoft technologies impacted by Year 2000 transition. Current information about the Company's products and business and technical concerns is available at the Microsoft

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Year 2000 Resource Center web site (www.microsoft.com/year2000). The web site also contains information about obtaining software patches to resolve various Year 2000 issues in certain Microsoft products. The Company's Year 2000 strategy for its products is as follows:

Definitions. First, Microsoft will classify its products into categories of compliance: compliant, compliant with minor issues, not-compliant, testing yet to be completed, and will not test.

Next steps to compliance. Second, if a product is stated to be non-compliant, Microsoft will provide information as to how an organization could bring that product into compliance.

Provide components for solutions. Third, Microsoft will help organizations find solutions to Year 2000 problems. The technologies and services offered by Microsoft and its partners will be components in overall Year 2000 solutions. Microsoft will assist companies with the task of recognizing how disparate technologies can fit together to create a viable solution set.

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

The Year 2000 issue also affects the Company's internal systems. Microsoft is assessing the readiness of its systems and those of its vendors, distributors, and resellers for handling the year 2000. Although the assessment is still underway, management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

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

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<PAGE>

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See notes to financial statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS
27. Financial Data Schedule

(B) REPORTS ON FORM 8-K
Microsoft filed no reports on Form 8-K during the quarter ended March 31, 1998.

ITEMS 2, 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

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Signature

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

Microsoft Corporation

Date: May 14, 1998 By: /s/ Gregory B. Maffei

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

(Principal Financial and Accounting Officer and Duly Authorized Officer)

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STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
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CITY: REDMOND
STATE: WA
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BUSINESS PHONE: 2068828080

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 1997

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

FOR THE TRANSITION PERIOD FROM _____ TO ____

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON	98052-6399
(Address of principal executive office)	(Zip Code)

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

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

The number of shares outstanding of the registrant's common stock as of January 31, 1998 was 1,217,408,864.

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED DECEMBER 31, 1997

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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Revenue	$2,680	$3,585	$4,975	$6
Operating expenses:				
Cost of revenue	296	313	546	
Research and development	485	627	917	1
Acquired in-process technology	0	0	0	
Sales and marketing	737	876	1,362	1
General and administrative	81	106	167	
Total operating expenses	1,599	1,922	2,992	3
Operating income	1,081	1,663	1,983	2
Interest income	105	157	197	
Other expenses	(46)	(50)	(95)	

Income before income taxes	1,140	1,770	2,085	2
Provision for income taxes	399	637	730	1
Net income	741	1,133	1,355	1
Preferred stock dividends	1	7	1	
Net income available for common shareholders	$ 740	$1,126	$1,354	$1
Earnings per share:				
Basic	$ 0.62	$ 0.93	$ 1.13	$
Diluted	$ 0.57	$ 0.85	$ 1.04	$

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

<TABLE>
<CAPTION>

<S>	June 30 1997 <C>	Dec. 31 1997(1) <C>
ASSETS		
Current assets:		
Cash and short-term investments	$ 8,966	$10,105
Accounts receivable	980	1,081
Other	427	450
Total current assets	10,373	11,636
Property, plant, and equipment	1,465	1,478
Equipment investments	2,346	3,476
Other assets	203	250
Total assets	$14,387	$16,840
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 721	$ 867
Accrued compensation	336	248
Income taxes payable	466	631
Unearned revenue	1,418	2,038
Other	669	712

Total current liabilities	3,610	4,496
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock - shares authorized 100; outstanding 13	980	980
Common stock and paid-in capital - shares authorized 4,000; outstanding 1,204 and 1,211	4,509	6,104
Retained earnings	5,288	5,260
Total stockholders' equity	10,777	12,344
Total liabilities and stockholders' equity	$14,387	$16,840

</TABLE>

(1) Unaudited

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In million)(unaudited)

<TABLE>
<CAPTION>

<S>
CASH FLOWS FROM OPERATIONS

Net income
Depreciation and amortization
Write-off of acquired in-process technologies
Unearned revenue
Recognition of unearned revenue from prior periods
Other current liabilities
Accounts receivable
Other current assets

Net cash from operations

CASH FLOWS USED FOR FINANCING

Common stock issued
Common stock repurchased
Put warrant proceeds
Preferred stock issued

Preferred stock dividends
Stock option income tax benefits
Net cash used for financing
CASH FLOWS USED FOR INVESTMENTS
Additions to property, plant, and equipment
Cash portion of WebTV purchase price
Equity investments and other
Short-term investments
Net cash used for investments
Net change in cash and equivalents
Effect of exchange rates on cash and equivalents
Cash and equivalents, beginning of period
Cash and equivalents, end of period
Short-term investments, end of period
Cash and short-term investments, end of period

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1997 Form 10-K.

STOCK SPLIT

On January 24, 1998, the Company's Board of Directors approved a two-for-one stock split in the form of a 100% stock dividend, effective February 20, 1998 for shareholders of record February 6, 1998. Share and per share amounts have not been restated for the stock split.

EARNINGS PER SHARE

Basic earnings per share is calculated using the average number of common shares outstanding. Diluted earnings per share is computed on the basis of the average number of common shares outstanding plus the effect of outstanding stock options using the "treasury stock" method and preferred shares using the "if-converted" method.

<TABLE>
<CAPTION>

	Three Months Ended Dec. 31 1996	1997
<S>	<C>	<C>
Net income (A)	$ 741	$ 1,133
Preferred stock dividends	(1)	(7)
Net income available for common shareholders (B)	$ 740	$ 1,126
Average outstanding:		
Common stock (C)	1,196	1,212
Preferred stock	1	10
Employee stock options	107	112
Common stock and common stock equivalents (D)	1,304	1,334
Earnings per share:		
Basic (B/C)	$ 0.62	$ 0.93
Diluted (A/D)	$ 0.57	$ 0.85

</TABLE>

UNEARNED REVENUE

Microsoft believes that Internet technologies are integral to its products and has committed to integrating these technologies, such as its browser, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other support commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating systems revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was $860 million at June 30, 1997 and $1.04 billion at December 31, 1997.

Since Office 97 is also tightly integrated with the rapidly evolving Internet, and in the view of subsequent delivery of new Internet technologies, enhancements, and other support, a ratable revenue recognition policy became effective for Office 97 licenses beginning in the third quarter of fiscal 1997. Approximately 20% of Office 97

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revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled $300 million at June 30, 1997 and $570 million at December 31, 1997.

Unearned revenue also includes maintenance and other subscription contracts, including custom enterprise license agreements.

STOCKHOLDERS' EQUITY

Microsoft repurchases its common stock on the open market. This program provides shares for issuance to employees under the Company's stock option and stock purchase plans. During the first half of fiscal 1998, the Company repurchased 3.7 million shares of Microsoft common stock in the open market. In addition, under agreements with an independent third party, the Company purchased 10.6 million shares of stock through forward purchase arrangements. Under these two arrangements, a portion of the purchase price will be paid in the next five or six years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net-share or cash) is at the discretion of the Company. The difference between the cash paid and the price of Microsoft common stock on the date of the agreement is reflected in stockholders' equity.

To enhance its stock repurchase program, Microsoft sells equity put warrants to independent third parties. These put warrants entitle the purchasers to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On December 31, 1997, 23 million warrants were outstanding with strike prices ranging from $125 to $129 per share. The warrants expire at various dates between the fourth quarter of fiscal 1998 and the second quarter of fiscal 2001 and are exercisable only at maturity. These put warrant contracts permit a net-share settlement at the Company's option, and do not result in a put warrant liability on the balance sheet.

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

ACQUISITION OF WEBTV

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $190 million in cash and $235 million of common stock for WebTV. The acquired net working capital of WebTV was not material. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV of $296 million.

CONTINGENCIES

On October 7, 1997, Sun Microsystems, Inc. brought suit against Microsoft in the U.S. District Court for the Northern District of California. On October 14, 1997, Sun filed a First Amended Complaint (Complaint). The Complaint alleges nine claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology. The Complaint alleges: statutory and contractual trademark claims related to Microsoft's alleged improper use of the Java Compatibility logo; a false advertising claim related to statements Microsoft allegedly has made about its Java support and products; a claim that Microsoft has breached the Agreement in several respects; a claim that Microsoft allegedly made Sun's source code generally available to the public; a claim for breach of the covenant of good faith and fair dealing; a claim for unfair competition; a claim for intentional interference with contractual relations between Sun and its customers or prospective customers; and a claim that Microsoft induced software developers to breach their license agreements with Sun. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java Compatibility logo, and against distributing Internet Explorer 4.0 unless certain alleged obligations are met (no motion for preliminary injunction had been filed as of October 29, 1997); an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary and punitive damages, and liquidated damages of $35 million for the alleged source code disclosure.

On October 27, 1997, Microsoft filed its Answer, Affirmative Defenses, and Counterclaims (Answer). In its Answer, Microsoft denies Sun's claims, and denies that Sun is entitled to any relief. Microsoft alleges that Sun agreed to limit its remedies for all claims such as those alleged in the Complaint to compensatory damages capped

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by the total license fees paid (to date, $7 million and $17.5 million over the life of the Agreement). Microsoft specifically denies that Sun is entitled to any injunctive relief. Although the Agreement does provide for liquidated damages of $35 million if Microsoft makes Sun's Source Code generally available to the public under certain conditions, Microsoft denies that there is any basis for such a claim. Microsoft asserts other defenses to each of Sun's claims. In addition, Microsoft alleges counterclaims against Sun, including claims that: Sun has breached the Agreement in many respects; Microsoft is entitled to a court order that Microsoft may terminate Sun's license under the Agreement to certain Microsoft technology and otherwise determining the parties' rights and responsibilities; Sun has breached the covenant of good faith and fair dealing; and Sun has violated California's unfair competition statute. Microsoft also alleges that it has put Sun on notice of other breaches of contract and that Microsoft will seek to amend its counterclaim to state additional claims if those breaches are not timely cured. Microsoft seeks a declaratory judgment consistent with its claims and seeks compensatory damages consistent with the limitations in the Agreement. On November 17, 1997, Sun filed a motion for preliminary injunction seeking to enjoin Microsoft from using the Java compatibility logo on IE 4.0 during the pendency of the litigation on the basis that IE 4.0 does not pass certain Java compatibility tests. A hearing on this motion has been set for February 27, 1998.

On October 20, 1997, the Antitrust Division of the U.S. Department of Justice (DOJ) filed a Petition for An Order To Show Cause in United States District Court for the District of Columbia. The DOJ contends that Microsoft has violated a consent decree that was entered into by the DOJ and Microsoft on July 15, 1994, and approved by the Court on August 18, 1995, to conclude an earlier investigation by the DOJ. In its petition, the DOJ contends that Microsoft has violated the consent decree by including Internet Explorer technology in Windows 95, and by preventing original equipment manufacturers (OEMs) from removing Internet Explorer functionality from versions of Windows 95 the OEMs are licensed to install on computer systems they sell. In addition, the DOJ alleges that certain non-disclosure agreements between Microsoft and its customers prohibiting the release of confidential information without prior notice to the other party are impairing the DOJ's ability to enforce the consent decree. The DOJ's petition seeks an order from the Court requiring Microsoft to demonstrate that it has not violated the consent decree. Microsoft does not believe it has violated the consent decree and intends to vigorously contest this lawsuit.

On December 5, 1997, Judge Jackson heard oral argument on the DOJ's contempt petition. On December 11, 1997, the court entered two orders. In the first order, Judge Jackson denied the DOJ's contempt petition, and dismissed the DOJ's request for relief concerning Microsoft's non-disclosure agreements because the DOJ had failed to present evidence that the agreements had interfered with any DOJ investigation. In addition, however, the court ruled that there were disputed issues of fact regarding Microsoft's violation of the consent decree, and concluded that the DOJ was likely to prevail on its claim that a violation had occurred. The court entered a preliminary injunction sua sponte requiring Microsoft not to condition the licensing of Windows 95 or any successor desktop operating system on a computer manufacturer also licensing any Microsoft browser software, including Internet Explorer 3.0 or 4.0. In the second order, the court appointed Harvard Law Professor Lawrence Lessig as a special master, to whom the court delegated the authority to conduct discovery, take evidence, and make proposed findings of fact and conclusions of law on all issues in the case by May 31, 1998.

Microsoft immediately appealed the preliminary injunction to the District of Columbia Circuit Court of Appeals and sought an expedited hearing on the grounds that there are substantial grounds for challenging Judge Jackson's order and that Microsoft will incur irreparable harm if the appeal is not heard quickly. The DOJ opposed expedited treatment. On December 30, 1997, the Court of Appeals entered an order granting Microsoft's motion and set a schedule pursuant to which oral argument will be heard on April 21, 1998.

On December 23, Microsoft filed a motion in the District Court to revoke the reference to a special master on the grounds that improper procedure was used and that the scope of the reference was impermissibly broad. In addition, Microsoft raised concerns about the impartiality of Professor Lessig based upon statements in some of his writings. On January 15, 1998 the District Court denied Microsoft's motion and refused to certify its ruling for appeal. On January 16, 1998 Microsoft filed a petition for mandamus in the District of Columbia Circuit Court of Appeals, seeking a stay of all proceedings by the special master until the Court of Appeals could rule, and seeking an order reversing the reference to the special master. On February 2, 1998 the Court of Appeals ordered that the petition for mandamus would be consolidated with the pending appeal and oral argument heard on April 21, 1998. The Court also stayed all proceedings before the special master until it rules on the petition.

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In other ongoing investigations, the DOJ and ten state Attorneys General have requested information from Microsoft concerning various issues. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

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

RESULTS OF OPERATIONS

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

REVENUE

Revenue of $3.59 billion in the second quarter of fiscal 1998 increased 34% over the second quarter of fiscal 1997. On a year to date basis, revenue increased 35% from the prior year to $6.72 billion. The strong growth rate reflected the continued adoption of Windows(R) 32-bit operating systems and Microsoft(R) Office 97, particularly as Microsoft software is deployed across entire organizations. Software license volume increases have been the principal factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from OEM licenses and organization license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. Microsoft recognizes a portion of Windows operating systems revenue over the products' life cycles. This revenue recognition policy was extended to Office 97 licenses in the third quarter of fiscal 1997. (See notes to financial statements.)

PRODUCT GROUPS

Platforms product revenue grew 26% to $1.88 billion in the second quarter, compared to $1.49 billion in the comparable quarter of the prior year. Year to date Platforms revenue was $3.58 billion in fiscal 1998 and $2.68 billion in fiscal 1997. Platforms product group revenue is primarily licenses of PC operating systems, business systems with client/server architectures, and software development tools.

Windows 95 unit volume continued to build, as units licensed through the OEM channel increased strongly. Additionally, revenue from the Microsoft Windows NT(R) Workstation operating system showed healthy growth. The revenue growth rate for Microsoft BackOffice(R) server and server applications products slowed from the rapid rates experienced in prior periods.

Applications and Content product revenue increased 43% to $1.71 billion in the December quarter. The comparable quarter of the prior year reflected additional unearned revenue of $200 million to account for versions of Office for Windows 95 shipped during the quarter which carried a "technological guarantee" coupon that entitled customers to a free upgrade to the corresponding Office 97 version of the product. For the first half of fiscal 1998, revenue was $3.14 billion, compared to $2.30 billion the prior year. Applications and Content product group revenue includes primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Integrated suites generate most desktop application revenue. The primary programs in Microsoft Office are Microsoft Word word processor, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows 32-bit, Windows 16-bit, and Macintosh operating systems, also include applications such as Microsoft Access database management program, Microsoft Outlook/TM/ desktop manager, Microsoft Schedule+ calendar and scheduling program, and an email client license.

Revenue from the various Microsoft Office integrated suites, including the Standard, Professional, and Small Business Edition, increased strongly, while stand-alone versions of Microsoft Excel, Microsoft Word, and Microsoft PowerPoint continued to decrease.

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SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, organizational licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of organization licenses and packaged products in these channels are primarily to distributors and resellers. The trend has continued toward a higher percentage of organizational licensing versus packaged products.

Royalties from OEMs reached a record level. Revenue from the OEM channel was $1.21 billion in the second quarter, up 40% over the prior year. Year to date, OEM revenue was $2.20 billion compared to $1.53 billion the prior year. The primary source of OEM revenue is the licensing of desktop operating systems. PC shipment growth coupled with an increased penetration of higher value 32-bit PC operating systems drove the OEM revenue increase.

For the second fiscal quarter, finished goods revenue in the U.S. and Canada increased 31% to $993 million from $759 million the prior year. First half revenue of $1.96 billion grew 25% over the prior year. The growth rate in the U.S. and Canada reflected slowing growth of desktop applications and business systems and flat shipments and licensing of retail versions of 32-bit personal operating systems.

Second quarter revenue of $842 million in Europe grew 33% and second half revenue of $1.48 billion grew 40% due to the increased popularity of organizational licensing of Microsoft Office and Windows products and greater demand for BackOffice family server products.

Other International channel revenue in the December quarter was $538 million, compared to $424 million the prior year. Year to date revenue was $1.08 billion in fiscal 1998 and $817 million in fiscal 1997. Key drivers of growth were increased organizational licensing of Microsoft Office and sales of BackOffice packaged product. The second quarter growth rate was lower than recent quarters due to slowing growth in Japan, Australia, and Southeast Asia, which partially offset strong growth in Mexico, Brazil, and other South American countries.

Microsoft's operating results are affected by foreign exchange rates. Since a portion of local currency denominated revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenue as a percent of revenue declined to 8.7% in the second quarter from 11.0% the prior year. For the first half of fiscal 1998, cost of revenue as a percent of revenue was 8.4% compared to 11.0% in fiscal 1997. The decrease was due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks), licenses to OEMs and organizations, and higher-margin Windows NT Server and other BackOffice server products.

Research and development expenses increased 29% in the second quarter to $627 million and increased 30% in the first half to $1.19 billion, primarily driven by higher development headcount-related costs, third party development, and charges from purchased R&D.

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $425 million in stock and cash for WebTV. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV of $296 million.

Sales and marketing expenses were $876 million in the second quarter of fiscal 1998, which represented 24.4% of revenue, compared to 27.5% in the second quarter of the prior year. On a year to date basis, sales and marketing expenses of $1.66 billion represented 24.8% of revenue, compared to 27.4% in the first half of fiscal 1997. The total expense as a percent of revenue decreased due to lower relative marketing costs in the first quarter and lower relative support costs in the second quarter of fiscal 1998.

General and administrative costs were $106 million in the second quarter compared to $81 million in the comparable quarter of the prior year. In the first half of fiscal 1998, general and administrative expenses were $201 million, compared to costs of $167 million the prior year.

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Interest income increased as a result of a larger investment portfolio generated by cash from operations. Other expenses include primarily the recognition of the Company's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities.

The effective income tax rate increased due to the nondeductibility of the write-off of the WebTV in-process technologies and amortization of other WebTV intangible assets.

NET INCOME

Net income for the second quarter of fiscal 1998 was $1.13 billion. On a year to date basis, net income was 26.7% of revenue in fiscal 1997 compared to 27.2% the prior year. Excluding the one-time write-off of WebTV in-process R&D, net income represented 31.2% of revenue in the first half of fiscal 1998. Earnings per share without the write-off were $1.57, a 51% increase compared to the $1.04 earned during the same period the prior year.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $10.11 billion at December 31, 1997. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

During 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at December 31, 1997 was $12.34 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $200 million on December 31, 1997.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. Despite recent increases in stock repurchases, the buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 168 million common shares for $7.8 billion while 378 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $32.6 billion as of December 31, 1997. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

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

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

NEW ACCOUNTING PRONOUNCEMENT

During October 1997, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants issued Statement of Position (SOP) 97-2, Software Revenue Recognition. The SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Different informal and unauthoritative interpretations of certain provisions of SOP 97-2 have arisen. AcSEC is already deliberating amendments to SOP 97-2, including deferral of the effective date of certain provisions of the SOP so AcSEC can develop and issue an interpretation regarding the applicability and the method of application of those provisions. Because of the uncertainties related to the outcome of these amendments, the impact on the future financial results of the Company is not currently determinable.

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EMPLOYEE STOCK OPTIONS

The Company encourages broad-based employee ownership of Microsoft stock through an employee stock option (ESO) program in which all employees are eligible to participate. At December 31, 1997, 251 million vested and unvested options were outstanding as compared to 1,211 million common shares outstanding.

The Company follows APB Opinion 25 to account for ESO plans in its published financial statements. Accordingly, no compensation cost is recognized because the option exercise price is equal to the market price of the underlying stock on the date of grant. Earnings per share calculations reflect exercised ESOs and the effect of outstanding ESOs under the "treasury stock" method.

In addition, as required by Statement of Financial Accounting Standard 123, the Company discloses the Black-Scholes value of ESO grants and the proforma impact of expensing such value over the vesting period of the ESOs in the footnotes to its annual financial statements.

ESOs are a claim on the increase in the value of the Company and Microsoft does not believe that there is a single income statement presentation that captures the value of that claim. Nonetheless, in an effort to aid understanding of the cost of the Company's ESO plan, we are providing alternative proforma "look-through" income statements as a supplemental presentation of accounting for stock options. This proforma income statement is not required under generally accepted accounting principles. In this presentation, the cost of ESO grants, based on the Black-Scholes value (using similar assumptions to those disclosed in the 1997 Annual Report), is expensed through the income statement operating expense line items in the quarter that the ESOs are granted. In addition, it is assumed that the ESOs granted after fiscal 1995 are "hedged" through the purchase of offsetting call options and therefore "neutralized" and excluded from average shares outstanding used to calculate EPS. Also, interest income is reduced for the proforma use of cash to purchase the hedges.

ESOs are granted upon hire to new employees and annually to current employees. The annual grant, which represents the majority of ESOs granted during any given fiscal year, occurs during the first quarter. Accordingly, the alternative presentation will show the widest variance from reported EPS in that quarter.

ALTERNATIVE PRESENTATION OF ACCOUNTING FOR ESOS
(In millions, except earnings per share)(Unaudited)
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<TABLE>
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	Twelve Months Ended Dec. 31, 1997	Three Dec

	Reported	Proforma	Report
<S>	<C>	<C>	<C>
Revenue	$13,098	$13,098	$3,58
Operating expenses:			
Cost of revenue	1,105	1,152	31
Research and development	2,202	2,891	62
Acquired in-process technology	296	296	
Sales and marketing	3,158	3,628	87
General and administrative	396	539	10
Total operating expenses	7,157	8,506	1,92
Operating income	5,941	4,592	1,66
Interest income	545	480	15
Other expenses	(285)	(285)	(5
Income before income taxes	6,201	4,787	1,77
Provision for income taxes	2,306	1,799	63
Net income	3,895	2,988	1,13
Preferred stock dividends	22	22	
Net income available for common shareholders	$ 3,873	$ 2,966	$1,12
Earnings per share	$ 2.93	$ 2.30	$ 0.8
Weighted average shares outstanding	1,329	1,301	1,33
Options granted	34	34	

</TABLE>

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See notes to financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At the Annual Meeting of Shareholders held on November 14, 1997, the following proposal was adopted by the margins indicated:

To elect a Board of Directors to hold office until the next annual meeting of shareholders and until their successors are elected and qualified.

<TABLE>
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	Number of Shares For	Withheld
<S>	<C>	<C>
William H. Gates	1,089,016,404	6,919,184

Paul G. Allen	1,088,918,842	7,016,746
Jill E. Barad	1,080,362,506	15,573,082
Richard A. Hackborn	1,089,087,674	6,847,914
David F. Marquardt	1,088,942,342	6,993,246
William G. Reed, Jr.	1,089,152,001	6,783,587
Jon A. Shirley	1,089,179,552	6,756,036

</TABLE>

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits
27. Financial Data Schedule

(B) Reports on Form 8-K
Microsoft filed no reports on Form 8-K during the quarter ended December 31, 1997.

ITEMS 2, 3, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

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Signature

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

Microsoft Corporation

Date: February 14, 1998 By: /s/ Gregory B. Maffei

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

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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CONFORMED PERIOD OF REPORT:     19970930
FILED AS OF DATE:               19971029
SROS:                      NASD

FILER:

        COMPANY DATA:
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                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 WA
                FISCAL YEAR END:                        0630

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                SEC ACT:
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                STREET 2:               NORTH OFFICE 2211
                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         2068828080

        MAIL ADDRESS:
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 1997

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

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

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

The number of shares outstanding of the registrant's common stock as of September 30, 1997 was 1,206,691,442.

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MICROSOFT CORPORATION
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 1997
INDEX

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

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

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	Three Months Ende Sept. 30 1996	1997
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Revenue	$2,295	$3,13
Operating expenses:		
Cost of revenue	250	25
Research and development	432	56
Acquired in-process technology	0	29
Sales and marketing	625	78
General and administrative	86	9
Total operating expenses	1,393	1,99
Operating income	902	1,13
Interest income	92	14
Other expenses	(49)	(7

Income before income taxes	945	1,20
Provision for income taxes	331	53
Net income	614	66
Preferred stock dividends	0	
Net income available for common shareholders	$ 614	$ 65
Earnings per share (1)	$ 0.47	$ 0.5
Weighted average shares outstanding (1)	1,294	1,33

</TABLE>

(1) Share and per share amounts for the three months ended September 30, 1996 have been restated to reflect a two-for-one stock split in December 1996.

See accompanying notes.

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MICROSOFT CORPORATION

Balance Sheets
(In millions)

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<S>	June 30 1997 <C>	Sept. 30 1997(1) <C>
ASSETS		
Current assets:		
Cash and short-term investments	$ 8,966	$ 9,634
Accounts receivable	980	788
Other	427	416
Total current assets	10,373	10,838
Property, plant and equipment	1,465	1,484
Equity investments	2,346	2,733
Other assets	203	311
Total assets	$14,387	$15,366
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 721	$ 761
Accrued compensation	336	193
Income taxes payable	466	554
Unearned revenue	1,418	1,671
Other	669	723
Total current liabilities	3,610	3,902
Commitments and contingencies		

Stockholders' equity:		
Convertible preferred stock - shares authorized 100; outstanding 13	980	980
Common stock and paid-in-capital - shares authorized 4,000; outstanding 1,204 and 1,207	4,509	5,630
Retained earnings	5,288	4,854
Total stockholders' equity	10,777	11,464
Total liabilities and stockholders' equity	$14,387	$15,366

</TABLE>
(1) Unaudited

See accompanying notes.

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MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

	Three Months Ended Sept. 30	
	1996	1997
<S>	<C>	<C>
CASH FLOWS FROM OPERATIONS		
Net income	$ 614	$ 663
Depreciation and amortization	162	228
Write-off of acquired in-process technologies	0	296
Unearned revenue	194	533
Recognition of unearned revenue from prior periods	(103)	(280)
Other current liabilities	136	53
Accounts receivable	(205)	180
Other current assets	(15)	7
Net cash from operations	783	1,680
CASH FLOWS USED FOR FINANCING		
Common stock issued	215	207
Common stock repurchased	(729)	(913)
Put warrant proceeds	32	280
Preferred stock dividends	0	(7)
Stock option income tax benefits	106	199
Net cash used for financing	(376)	(234)
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(99)	(117)
Cash portion of WebTV purchase price	0	(190)
Equity investments and other	(156)	(455)
Short-term investments	259	(429)

Net cash used for investments	4	(1,191)
Net change in cash and equivalents	411	255
Effect of exchange rates on cash and equivalents	6	(16)
Cash and equivalents, beginning of period	2,601	3,706
Cash and equivalents, end of period	3,018	3,945
Short-term investments, end of period	4,080	5,689
Cash and short-term investments, end of period	$7,098	$9,634

</TABLE>

See accompanying notes.

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MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1997 Form 10-K.

STOCK SPLIT

In December 1996, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options using the "treasury stock" method and preferred shares using the "if-converted" method. Beginning in the second quarter of fiscal 1998, Microsoft will be required to report earnings per outstanding common share in addition to diluted earnings per share. Earnings per common share computed under the new pronouncement would have been $0.51 and $0.55 in the first quarters of fiscal 1997 and 1998, while reported diluted earnings per share were $0.47 and $0.50.

UNEARNED REVENUE

In fiscal 1996, Microsoft committed to integrating its Internet technologies, such as the Company's Internet browser, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other support commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating systems revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was $860 million at June 30, 1997 and $930 million at September 30, 1997.

Since Office 97 is also tightly integrated with the rapidly evolving Internet, and subsequent delivery of new Internet technologies, enhancements, and other support is likely to be more than minimal, a ratable revenue recognition policy became effective for Office 97 licenses beginning in 1997. Approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled $300 million at June 30, 1997 and $430 million at September 30, 1997.

Unearned revenue also includes maintenance and other subscription contracts, including custom corporate license agreements.

STOCKHOLDERS' EQUITY

Microsoft repurchases common stock on the open market. This program provides shares for issuance to employees under the Company's stock option and stock purchase plans. During the first quarter of fiscal 1998, the Company repurchased 2.1 million shares of Microsoft common stock in the open market. In addition, under an agreement with an independent third party, the Company purchased 5.8 million shares of stock through a forward purchase arrangement. Under this arrangement, a portion of the purchase price will be paid in the next five years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net-share or cash) is at the discretion of the Company. The difference between the cash paid and the price of Microsoft common stock on the date of the agreement is reflected in stockholders' equity.

To enhance its stock repurchase program, Microsoft sells equity put warrants to independent third parties. These put warrants entitle the purchasers to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On September 30, 1997, 23 million warrants were outstanding with strike prices ranging from $123 to $129 per share. The warrants expire at various dates between the third quarter of fiscal 1998 and the first

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quarter of fiscal 2001 and are exercisable only at maturity. These put warrant contracts permit a net-share settlement at the Company's option, and do not result in a put warrant liability on the balance sheet.

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

ACQUISITION OF WEBTV

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $190 million in cash and $235 million of common stock for WebTV. The acquired net working capital of WebTV was not material. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV of $296 million.

CONTINGENCIES

On October 7, 1997, Sun Microsystems, Inc. brought suit against Microsoft in the U.S. District Court for the Northern District of California. On October 14, 1997, Sun filed a First Amended Complaint (Complaint). The Complaint alleges nine claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology. The Complaint alleges: statutory and contractual trademark claims related to Microsoft's alleged improper use of the Java Compatibility logo; a false advertising claim related to statements Microsoft allegedly has made about its Java support and products; a claim that Microsoft has breached the Agreement in several respects; a claim that Microsoft allegedly made Sun's source code generally available to the public; a claim for breach of the covenant of good faith and fair dealing; a claim for unfair competition; a claim for intentional interference with contractual relations between Sun and its customers or prospective customers; and a claim that Microsoft induced software developers to breach their license agreements with Sun. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java Compatibility logo, and against distributing Internet Explorer 4.0 unless certain alleged obligations are met (no motion for preliminary injunction had been filed as of October 29, 1997); an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary and punitive damages, and liquidated damages of $35 million for the alleged source code disclosure.

On October 27, 1997, Microsoft filed its Answer, Affirmative Defenses and Counterclaims (Answer). In its Answer, Microsoft denies Sun's claims, and denies that Sun is entitled to any relief. Microsoft alleges that Sun agreed to limit its remedies for all claims such as those alleged in the Complaint to compensatory damages capped by the total license fees paid (to date, $7 million). Microsoft specifically denies that Sun is entitled to any injunctive relief. Although the Agreement does provide for liquidated damages of $35 million if Microsoft makes Sun's Source Code generally available to the public under certain conditions, Microsoft denies that there is any basis for such a claim. Microsoft asserts other defenses to each of Sun's claims. In addition, Microsoft alleges counterclaims against Sun, including claims that: Sun has breached the Agreement in many respects; Microsoft is entitled to a court order that Microsoft may terminate Sun's license under the Agreement to certain Microsoft technology and otherwise determining the parties' rights and responsibilities; Sun has breached the covenant of good faith and fair dealing; and Sun has violated California's unfair competition statute. Microsoft also alleges that it has put Sun on notice of other breaches of contract and that Microsoft will seek to amend its counterclaim to state additional claims if those breaches are not timely cured. Microsoft seeks a declaratory judgment consistent with its claims and seeks compensatory damages consistent with the limitations in the Agreement.

On October 20, 1997, the Antitrust Division of the U.S. Department of Justice (DOJ) filed a Petition for An Order To Show Cause in United States District Court for the District of Columbia. The DOJ contends that Microsoft has violated a consent decree that was entered into by the DOJ and Microsoft on July 15, 1994, and approved by the Court on August 18, 1995, to conclude an earlier investigation by the DOJ. In its petition, the DOJ contends that Microsoft has violated the consent decree by including Internet Explorer technology in Windows 95, and by preventing original equipment manufacturers (OEMs) from removing Internet Explorer functionality from versions of Windows 95 the OEMs are licensed to install on computer systems they sell. In addition, the DOJ alleges that

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certain non-disclosure agreements between Microsoft and its customers prohibiting the release of confidential information without prior notice to the other party are impairing the DOJ's ability to enforce the consent decree. The DOJ's petition seeks an order from the Court requiring Microsoft to demonstrate that it has not violated the consent decree. If such proceedings are ordered, and if the Court thereafter finds Microsoft to have violated the consent decree, the DOJ petition seeks a further order directing Microsoft to: permit OEMs to license and install Windows 95 independent of Internet Explorer; advise certain end users that they are not required to use Internet Explorer and provide those end users with instructions for removing Internet Explorer from the Windows 95 desktop; modify all existing and future non-disclosure provisions in any agreement; and other relief. Microsoft does not believe it has violated the consent decree and intends to vigorously contest this lawsuit.

On October 27, 1997, the Court held a scheduling conference. The Court ruled that it will enter a scheduling order, pursuant to which Microsoft is to respond to the Petition within ten days after the order is entered, and the DOJ is to reply ten days thereafter. Following those submissions, the Court will hold an additional scheduling conference to set the schedule for any additional proceedings it may deem necessary.

In other ongoing investigations, the DOJ has requested information from Microsoft concerning various issues. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

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

RESULTS OF OPERATIONS

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

REVENUE

Revenue of $3.13 billion in the first quarter of fiscal 1998 increased 36% over the first quarter of fiscal 1997. The strong growth rate reflected the continued adoption of Windows(R) 32-bit operating systems and Microsoft(R) Office 97. Software license volume increases have been the principal factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from OEM licenses and corporate and organization license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. Microsoft recognizes a portion of Windows operating systems revenue over the products' life cycles. This revenue recognition policy was extended to Office 97 licenses in the third quarter of fiscal 1997. (See notes to financial statements.)

PRODUCT GROUPS

Platforms product revenue grew 43% to $1.70 billion in the first quarter, compared to $1.19 billion in the comparable quarter of the prior year. Platforms product group revenue is primarily licenses of PC operating systems, business systems with client/server architectures, and software development tools.

Windows 95 unit volume continued to build, as units licensed through the OEM channel increased strongly. Additionally, revenue from the Microsoft Windows NT(R) Workstation operating system showed healthy growth. The revenue growth rate for Microsoft BackOffice(R) server and server applications products slowed from the rapid rates experienced in prior quarters.

Applications and Content product revenue increased 29% to $1.43 billion in the September quarter. Applications and Content product group revenue include primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Integrated suites generate most desktop application revenue. The primary programs in Microsoft Office are Microsoft Word word processor, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows 32-bit, Windows 16-bit, and Macintosh operating systems, also include applications such as Microsoft Access database management program, Microsoft Outlook(TM) desktop manager, Microsoft Schedule+ calendar and scheduling program, and an email client license.

Revenue from the various Microsoft Office integrated suites, including the Standard, Professional, and Small Business Editions, increased strongly, while stand-alone versions of Microsoft Excel, Microsoft Word, and Microsoft PowerPoint continued to decrease.

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SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate and organizational licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate and organization licenses and packaged products in these channels are primarily to distributors and resellers. The trend has continued toward a higher percentage of corporate licensing versus packaged products.

Royalties from OEMs reached a record level. Revenue from the OEM channel was $983 million in the first quarter, up 48% over the prior year. The primary source of OEM revenue is the licensing of desktop operating systems. PC shipment growth coupled with an increased penetration of higher value 32-bit PC operating systems drove the OEM revenue increase.

For the first fiscal quarter, finished goods revenue in the U.S. and Canada increased 19% to $968 million from $812 million the prior year. The growth rate in the U.S. and Canada reflected slowing growth of desktop applications and business systems and flat shipments and licensing of retail versions of 32-bit personal operating systems.

First quarter revenue of $641 million in Europe grew 50% from $427 million due to the increased popularity of corporate licensing of Microsoft Office and Windows products and greater demand for BackOffice family server products.

Other International channel revenue in the first quarter was $538 million, an increase of 37% from $393 million the prior year. Key drivers of growth were increased corporate licensing of Microsoft Office, BackOffice packaged product, and expansion in emerging markets.

Microsoft's operating results are affected by foreign exchange rates. Since a portion of local currency denominated revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenue as a percent of revenue declined to 8.1% in the first quarter from 10.9% the prior year. The decrease was due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks), licenses to OEMs and corporations, and higher-margin Windows NT Server and other BackOffice server products.

Research and development expenses increased 31% in the first quarter to $567 million, primarily driven by higher development headcount-related costs, third party development, and charges from purchased R&D.

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $425 million in stock and cash for WebTV. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV of $296 million.

Sales and marketing expenses were $788 million in the first quarter of fiscal 1998, which represented 25.2% of revenue, compared to 27.3% in the first quarter of the prior year. The total expense as a percent of revenue decreased due to lower relative marketing costs.

General and administrative costs were $95 million in the first quarter compared to $86 million in the comparable quarter of the prior year.

Interest income increased as a result of a larger investment portfolio generated by cash from operations. Other expenses include primarily the recognition of the Company's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities.

The effective income tax rate increased due to the nondeductibility of the write-off of the WebTV in-process technologies and amortization of other WebTV intangible assets.

NET INCOME

Net income for the first quarter of fiscal 1998 was $663 million. Excluding the one-time write-off of WebTV in-process R&D, net income represented 30.6% of revenue compared with 26.8% in the first quarter of 1997. Earnings per share without the write-off were $0.72, representing a 53% increase compared to the $0.47 earned during the same quarter the prior year.

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EMPLOYEE STOCK OPTIONS

As disclosed in the Microsoft Annual Report and elsewhere, the Company encourages broad-based employee ownership of Microsoft stock through a stock option program in which all employees are eligible to participate. At September 30, 1997, 258 million options were outstanding.

The Company follows APB Opinion 25 to account for stock option plans in its published financial statements. Accordingly, no compensation cost is recognized because the option exercise price is equal to the market price of the underlying stock on the date of grant. Earnings per share calculations reflect exercised options and the effect of outstanding stock options under the "treasury stock" method.

In addition, as required by Statement of Financial Accounting Standard 123, the Company discloses the Black-Scholes value of option grants and the proforma impact of expensing such value over the vesting period of the options in the footnotes to its annual financial statements.

Options are granted upon hire to new employees and annually to current employees. The annual grant occurs during the first quarter and represents the majority of options granted during any given fiscal year.

In an effort to aid understanding of the impact of the Company's stock option plan, proforma "look-through" income statements are provided below as an alternative presentation of accounting for stock options. This proforma income statement is not required under generally accepted accounting principles, but offers an additional method of considering stock options. In this presentation, the expense of option grants, based on the Black-Scholes value of the options (using similar assumptions to those disclosed in the 1997 Annual Report), is reflected in the income statement operating expense line items in the quarter that the options are granted. In addition, it is assumed that the options are "hedged" through the purchase of offsetting call options and therefore excluded from average shares outstanding used to calculate earnings per share.

Alternative Presentation of Accounting for Stock Options
(In millions, except earnings per share) (Unaudited)

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	Twelve Months Ended Sept. 30, 1997		Three Mont Sept. 30
	Reported	Proforma	Reported
<S>	<C>	<C>	<C>
Revenue	$12,193	$12,193	$3,130
Operating expenses:			
Cost of revenue	1,088	1,132	253
Research and development	2,060	2,729	567
Acquired in-process technology	296	296	296
Sales and marketing	3,019	3,472	788
General and administrative	371	523	95
Total operating expenses	6,834	8,152	1,999
Operating income	5,359	4,041	1,131
Interest income	493	493	142
Other expenses	(281)	(281)	(71)
Income before income taxes	5,571	4,253	1,202
Provision for income taxes	2,068	1,596	539
Net income	3,503	2,657	663
Preferred stock dividends	22	22	7
Net income available for common shareholders	$ 3,481	$ 2,635	$ 656
Earnings per share	$ 2.65	$ 2.05	$ 0.50
Weighted average shares outstanding	1,322	1,298	1,333
Options granted	34	34	28

</TABLE>

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FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $9.63 billion at September 30, 1997. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

During 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at September 30, 1997 was $11.46 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $300 million on September 30, 1997.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. Despite recent increases in stock repurchases, the buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 162 million common shares for $7.1 billion while 371 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $34.2 billion as of September 30, 1997. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

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

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

- --

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See notes to financial statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

11. Computation of Earnings Per Share is on page 13.
27. Financial Data Schedule

(B) Reports on Form 8-K

Microsoft filed no reports on Form 8-K during the quarter ended September 30, 1997.

ITEMS 2, 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

- --

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<PAGE>

Signature

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

Microsoft Corporation

Date: October 29, 1997 By: /s/ Gregory B. Maffei

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

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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EXHIBIT 11.

MICROSOFT CORPORATION

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

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	Three Months Ende Sept. 30	
	1996	1997
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Weighted average number of common shares outstanding (3)	1,194	1,20
Earnings per common share (3)	$0.51	$0.5
Common stock equivalents:		
Preferred stock (1)	0	1
Employee stock options (2)	100	11
Average common and common stock equivalents outstanding (3)	1,294	1,33
Diluted earnings per share (3)	$0.47	$0.5

</TABLE>

(1) Calculated under the "if-converted" method.
(2) Calculated under the "treasury stock" method.
(3) Share and per share amounts for the three months ended September 30, 1996 have been restated to reflect a two-for-one stock split in December 1996.

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards 128, Earnings Per Share. The new rule will require specific disclosure of both diluted earnings per share and earnings per common share calculated without the dilutive impacts of outstanding stock options or convertible securities such as preferred stock. There was no material difference between reported earnings per share and diluted earnings per share for any period presented.

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PUBLIC DOCUMENT COUNT: 3
CONFORMED PERIOD OF REPORT: 19970331
FILED AS OF DATE: 19970515
SROS: NASD

FILER:

COMPANY DATA:
COMPANY CONFORMED NAME: MICROSOFT CORP
CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT: 1934 Act
SEC FILE NUMBER: 000-14278
FILM NUMBER: 97608312

BUSINESS ADDRESS:
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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 1997

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

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

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

The number of shares outstanding of the registrant's common stock as of April 30, 1997 was 1,198,327,269.

==

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 1997

INDEX

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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	Three Months Ended March 31		Nine Months Ende March 31	
	1996	1997	1996	1997
<S>	<C>	<C>	<C>	<C>
Net revenues	$2,205	$3,208	$6,416	$8,18
Operating expenses:				
Cost of revenues	295	297	947	84
Research and development	364	492	979	1,40
Sales and marketing	685	750	1,996	2,11
General and administrative	87	101	226	26
Total operating expenses	1,431	1,640	4,148	4,63
Operating income	774	1,568	2,268	3,55
Interest income	86	119	228	31

Other income (expense)	4	(84)	23	(17
Income before income taxes	864	1,603	2,519	3,68
Provision for income taxes	302	561	883	1,29
Net income	562	1,042	1,636	2,39
Preferred stock dividends		7		
Net income available for common shareholders	$ 562	$1,035	$1,636	$2,38
Earnings per share (1)	$ 0.44	$ 0.79	$ 1.28	$ 1.8
Weighted average shares outstanding(1)	1,278	1,322	1,278	1,30

</TABLE>

(1) Share and per share amounts for the three and nine months ended March 31, 1996 have been restated to reflect a two-for-one stock split in December 1996.

See accompanying notes.

1

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MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

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ASSETS

Current assets:
  Cash and short-term investments
  Accounts receivable
  Other

    Total current assets
Property, plant, and equipment
Equity investments
Other assets

      Total assets

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:
  Accounts payable
  Accrued compensation
  Income taxes payable
  Unearned revenues
  Other

    Total current liabilities

Minority interest

Put warrants

Commitments and contingencies
Stockholders' equity:
  Convertible preferred stock -
    shares authorized 100; outstanding 13
  Common stock and paid-in capital -
    shares authorized 4,000; outstanding 1,194 and 1,191
  Retained earnings

    Total stockholders' equity

        Total liabilities and stockholders' equity

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(1) Unaudited

See accompanying notes.

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MICROSOFT CORPORATION

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CASH FLOWS STATEMENTS
(In millions)(Unaudited)

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CASH FLOWS FROM OPERATIONS
  Net income
  Depreciation and amortization
  Current liabilities
  Accounts receivable
  Other current assets

    Net cash from operations

CASH FLOWS USED FOR FINANCING
  Common stock issued
  Common stock repurchased
  Preferred stock issued
  Preferred stock dividends
  Stock option income tax benefits

    Net cash used for financing

CASH FLOWS USED FOR INVESTMENTS
  Additions to property, plant, and equipment
  Equity investments and other
  Short-term investments

- --

Net cash used for investments

- --

Net change in cash and equivalents
Effect of exchange rates on cash and equivalents
Cash and equivalents, beginning of period

- --

Cash and equivalents, end of period
Short-term investments, end of period

- --

Cash and short-term investments, end of period

==

</TABLE>

See accompanying notes.

<PAGE> 6
MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

- --

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1996 Form 10-K.

STOCK SPLIT

In December 1996, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effects of outstanding stock options using the "treasury stock" method and preferred shares using the "if-converted" method.

STOCKHOLDERS' EQUITY

Microsoft repurchases common stock on the open market. This program provides shares for issuance to employees under the Company's stock option and stock purchase plans. During the first three quarters of fiscal 1997, the Company repurchased 37 million shares for $3.10 billion.

To enhance its stock repurchase program, Microsoft sells equity put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On March 31, 1997, 30 million warrants were outstanding with strike prices ranging between $69 and $78 per share. The warrants expire at various dates between the first quarter of fiscal 1998 and the first quarter of fiscal 1999 and are exercisable only at maturity. These put warrant contracts permit a net-share settlement method in addition to cash settlement or physical delivery at the Company's option, thus Microsoft is no longer required to reflect a put warrant liability on the accompanying balance sheet.

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

MICROSOFT NETWORK PARTNERSHIP

During October 1996, Microsoft and a subsidiary of Tele-Communications, Inc. (TCI) terminated a partnership under which TCI owned a 20% minority interest in The Microsoft Network, LLC, owner of the business assets of MSN(TM), The Microsoft Network, an online service. Due to the evolving nature of the online industry and MSN's move to a Web-based offering, the original direction of the partnership changed and both Microsoft and TCI agreed to terminate this partnership focused exclusively on MSN. In return for approximately $125 million of TCI securities, Microsoft became the sole owner of MSN and the minority interest on the accompanying balance sheet was eliminated. There was no other material financial impact of the dissolution.

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ACQUISITION AGREEMENT

In April 1997, Microsoft announced its agreement to acquire WebTV Networks, Inc. (WebTV), an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. Microsoft will pay $425 million in stock and cash for WebTV. Microsoft expects an in process R&D write-off of $300 million will be required in the quarter of acquisition. The agreement has been approved by the Boards of Directors of Microsoft and WebTV and is subject to approval by the shareholders of WebTV and to satisfaction of regulatory requirements.

CONTINGENCIES

In an ongoing investigation, the Antitrust Division of the U.S. Department of Justice requested information from Microsoft concerning various issues. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business. Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

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

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs) and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company has recently expanded its interactive content efforts, including MSN, the Microsoft Network online service, various Internet-based services, and entertainment and information software programs. Microsoft also sells personal computer books and input devices, and researches and develops advanced technologies for future software products.

REVENUES

Revenues were $3.21 billion in the third quarter of fiscal 1997, an increase of 45% over the comparable quarter of fiscal 1996. Growth was enhanced due to the introduction of Microsoft Office 97 during the March quarter. On a year-to-date basis, revenues were $8.18 billion, 28% greater than the first three quarters of the prior fiscal year. Revenue growth was particularly strong in the first two quarters of the prior year due to the retail introduction of the Microsoft(R) Windows(R) 95 operating system and Microsoft Office for Windows 95.

Software license volume increases have been the principal factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately.

Microsoft is committed to integrating Internet technology into existing products at no additional cost to its customers. Given this strategy, combined with commitments such as Internet-based technical support, telephone support, and unspecified enhancements, Microsoft recognizes a portion of Windows operating systems revenue over the products' life cycles, currently estimated at two years. Since Office 97 is also tightly integrated with the rapidly evolving Internet, and subsequent delivery of new Internet technologies, enhancements, and other support is likely to be more than minimal, this revenue recognition policy was extended to Office 97 licenses in the March quarter. Associated revenues will be recognized ratably over the estimated 18-month product life cycle.

The portion of the Company's revenues that are earned later than billed is reflected in unearned revenues on the accompanying balance sheet. Of the March 31, 1997 balance of $1.29 billion, approximately $765 million represented the unearned portion of Windows desktop operating systems revenues and $150 million represented the unearned portion of Office 97 revenues. As discussed below, unearned revenues associated with upgrade rights for Microsoft Office 97 were $190 million. The balance of unearned revenues was primarily attributable to maintenance and other subscription contracts.

PRODUCT GROUPS

Platforms product group revenues were $1.68 billion in the third quarter of fiscal 1997, compared to $970 million for the same period of 1996, an increase of 73%. On a year-to-date basis, platforms product group revenues increased to

$4.35 billion from $3.14 billion. Platforms product group revenues are primarily from licenses of PC operating systems, business systems with client/server architectures, and software development tools.

Windows 95 unit volume continued to build, as units licensed through the OEM channel increased strongly. Additionally, revenues from Windows NT Workstation operating system grew, particularly through retail channels. Business systems, which include servers and server applications, exhibited strong revenues, with the greatest growth in Windows NT Server revenues.

Applications and content product group revenues were $1.53 billion in the March quarter of fiscal 1997, increasing 24% from $1.24 billion in the March quarter of fiscal 1996. For the first three quarters of fiscal 1997, applications and content product revenues were $3.83 billion, compared to $3.28 billion in the corresponding period of 1996. Applications and content product group revenues include primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Integrated suites generate most desktop application revenues. The primary programs in Microsoft Office are Microsoft Word word processor, Microsoft Excel

spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows 32-bit, Windows 16-bit, and Macintosh operating systems, also include applications such as Microsoft Access(R) database management program, Microsoft Outlook(TM) desktop manager, Microsoft Schedule+ calendar and scheduling program, and an email client license.

During the third quarter, Microsoft Office 97 was released in most geographical regions, propelling excellent results. Most versions of Microsoft Office for Windows 95 shipped during the second and third quarters carried a "technological guarantee" that entitled customers to a free upgrade to the corresponding Microsoft Office 97 version of the product. Associated revenues will be recognized when the upgrade delivery obligation is fulfilled.

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM earned revenues were $960 million in the third quarter compared to the $633 million recorded in the comparable quarter of the prior year. On a year-to-date basis, OEM revenues were $2.49 billion, compared to $1.85 billion in fiscal 1996. The primary source of OEM revenues is the licensing of desktop operating systems. The percentage of new PCs with Windows 95 preinstalled increased to more than 75% of reported shipments during the third quarter of fiscal 1997, while MS-DOS and Windows 3.x or Windows NT Workstation were preinstalled on many of the remainder of PCs sold by OEMs. The above-mentioned ratable revenue recognition policy was extended to Windows operating systems licensed through the OEM channel in the third quarter of the prior fiscal year.

Revenues in the U.S. and Canada were $938 million in the third quarter of fiscal 1997 compared to $620 million in the third quarter of 1996. Revenues in the first three quarters of fiscal 1997 were $2.51 billion, compared to $2.00

billion recorded last year. Revenues in Europe were $799 million in the second quarter of fiscal 1997 compared to $555 million in the prior year. European revenues were $1.86 billion in the first three quarters of 1997 compared to $1.55 billion the prior year. Other International channel revenues increased to $511 million in the third quarter of fiscal 1997 from $397 million in the third quarter of fiscal 1996. On a year-to-date basis, Other International revenues were $1.33 billion in fiscal 1997 compared to $1.02 billion the prior year.

Excluding the impact of the shipment of retail upgrade versions of Windows 95 in the first half of fiscal 1996, the trend has continued toward a higher percentage of corporate licensing versus packaged products.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the third quarter of the prior year been in effect during the third quarter of 1997, translated revenues in Europe would have been $36 million higher and translated Other International revenues would have been $46 million higher. The relative translation impact of exchange rates on net income is less than these amounts because a portion of local currency denominated revenues is hedged with purchased options and much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 9.3% in the third quarter of fiscal 1997 compared to 13.4% in the third quarter of 1996, and 10.3% in the first three quarters of fiscal 1997 versus 14.8% in the same period of 1996. The decrease was due to high shipments of retail upgrade versions of Windows 95 in the first half of the prior year and general trends toward more corporate licensing and more shipments of products on CD-ROM, which carry lower cost of goods than floppy disks.

Research and development expenses increased 35% to $492 million (15.3% of revenues) in the March quarter of fiscal 1997 from $364 million (16.5% of revenues) in the corresponding quarter of 1996. The continued increase in research and development expenses in fiscal 1997 resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses were $750 million in the third quarter of fiscal 1997 compared with $685 million in 1996. As a percentage of revenues, sales and marketing expenses were 23.4% and 31.1% in the respective third quarters of fiscal 1997 and 1996. Sales and marketing expense as a percentage of revenues decreased due to lower relative sales and support expenses in fiscal 1997 offset somewhat by the marketing of Office 97.

General and administrative expenses were $101 million (3.1% of revenues) in the third quarter of fiscal 1997 and $87 million (3.9% of revenues) in the third quarter of 1996. Fiscal 1997 increases were due to growth in the systems and number of people necessary to support overall increases in the scope of the Company's operations.

Interest income increased as a result of a larger investment portfolio generated by cash from operations. Other expenses increased in fiscal 1997 due to recognition of the Company's share of operational expenses of joint ventures, including DreamWorks Interactive and the MSNBC entities.

The effective income tax rate was 35% in all periods.

NET INCOME

Net income for the third quarter of fiscal 1997 was $1.04 billion, representing 32.5% of revenues compared with 25.5% in the third quarter of 1996. On a year to date basis, net income was 29.3% of revenues in fiscal 1997 compared to 25.5% the prior year. The increase in net income as a percentage of revenues in fiscal 1997 was primarily the result of substantial reductions in relative cost of revenues and sales and marketing expenses, partially offset by the funding of joint ventures.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $9.09 billion at March 31, 1997. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at March 31, 1997 was $9.13 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. Research and development investments will continue in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff. Commitments for constructing new buildings were $380 million on March 31, 1997.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million 2.75% preferred shares. Net proceeds of $980 million were used to repurchase common shares.

During fiscal 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale cash needs that may arise, and to fund an increased stock buyback program over historical levels to reduce the dilutive impact of the Company's employee stock option and purchase programs. Despite recent increases in stock repurchases, the buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 154 million common shares for $6.2 billion while 350 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $23.0 billion as of March 31, 1997.

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

NEW ACCOUNTING PRONOUNCEMENT

Beginning in the second quarter of fiscal 1998, Microsoft will be required to report earnings per outstanding common share in addition to diluted earnings per share. Earnings per common share was $0.87 in the third quarter of fiscal 1997, compared to $0.47 in the third quarter of fiscal 1996. See Exhibit 11.

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See notes to financial statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS
   11. Computation of Earnings Per Share is on page 11.
   27. Financial Data Schedule

(B) REPORTS ON FORM 8-K
   Microsoft filed no reports on Form 8-K during the quarter ended March 31, 1997.

ITEMS 2, 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

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<PAGE> 12

Signature

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

Microsoft Corporation

Date: May 13, 1997   By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting Officer and Duly Authorized Officer)

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EXHIBIT INDEX

Exhibits
- --------
11. Computation of Earnings Per Share
27. Financial Data Schedule

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EXHIBIT 11.

MICROSOFT CORPORATION

COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share) (Unaudited)
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	Three Months Ended March 31		Nine Months Ended March 31	
	1996	1997	1996	1997
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Weighted average number of common shares outstanding (3)	1,186	1,194	1,180	1,196
Earnings per common share (3)	$0.47	$0.87	$1.39	$2.00
Common stock equivalents:				
Preferred stock (1)		13		4
Employee stock options (2)	92	115	98	107
Average common and common stock equivalents outstanding (3)	1,278	1,322	1,278	1,307
Diluted earnings per share (3)	$0.44	$0.79	$1.28	$1.83

</TABLE>

(1) Calculated under the "if-converted" method.
(2) Calculated under the "treasury stock" method.
(3) Share and per share amounts for the three and nine months ended March 31, 1996 have been restated to reflect a two-for-one stock split in December 1996.

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, Earnings Per Share. The new rule will require specific disclosure of both diluted earnings per share and earnings per common share calculated without the dilutive impacts of outstanding stock options or convertible securities such as preferred stock. There was no material difference between reported earnings per share and diluted earnings per share for any period presented.

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PUBLIC DOCUMENT COUNT: 3
CONFORMED PERIOD OF REPORT: 19961231
FILED AS OF DATE: 19970214
SROS: NASD

FILER:

COMPANY DATA:
COMPANY CONFORMED NAME: MICROSOFT CORP
CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT: 1934 Act
SEC FILE NUMBER: 000-14278
FILM NUMBER: 97534239

BUSINESS ADDRESS:
STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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STREET 2: NORTH OFFICE 2211
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 1996

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of January 31, 1997 was 1,203,155,525.

<PAGE> 2

MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED DECEMBER 31, 1996

INDEX

PART I. FINANCIAL INFORMATION

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

- --

<TABLE>
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	Three Months Ended December 31 1995	1996
<S>	<C>	<C>
Net revenues	$ 2,195	$ 2,680
Operating expenses:		
Cost of revenues	330	296
Research and development	313	485

Sales and marketing	690	737
General and administrative	76	81
Total operating expenses	1,409	1,599
Operating income	786	1,081
Interest income	76	105
Other income (expense)	23	(46)
Income before income taxes	885	1,140
Provision for income taxes	310	399
Net income	575	741
Preferred stock dividends		1
Net income available for common shareholders	$ 575	$ 740
Earnings per share (1)	$ 0.45	$ 0.57
Weighted average shares outstanding (1)	1,276	1,304

</TABLE>

(1) Share and per share amounts for the three and six months ended December 31, 1995 have been restated to reflect a two-for-one stock split in December 1996.

See accompanying notes.

<PAGE> 4

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

<TABLE>
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	June 30 1996
<S>	<C>
ASSETS	
Current assets:	
Cash and short-term investments	$ 6,940
Accounts receivable	639
Other	260
Total current assets	7,839
Property, plant, and equipment	1,326

Equity investments	675
Other assets	253
Total assets	$10,093
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$ 808
Accrued compensation	202
Income taxes payable	484
Unearned revenues	560
Other	371
Total current liabilities	2,425
Minority interest	125
Put warrants	635
Commitments and contingencies	
Stockholders' equity:	
Preferred stock - shares authorized 100; outstanding 12.5	
Common stock and paid-in capital - shares authorized 4,000; outstanding 1,194 and 1,198	2,924
Retained earnings	3,984
Total stockholders' equity	6,908
Total liabilities and stockholders' equity	$10,093

</TABLE>

(1) Unaudited

See accompanying notes.

<PAGE> 5

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

<TABLE>
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	Six Months Ended December 31	
	1995	1996
<S>	<C>	<C>
CASH FLOWS FROM OPERATIONS		
Net income	$ 1,074	$ 1,355
Depreciation and amortization	147	306

Current liabilities	892	709
Accounts receivable	(187)	(326)
Other current assets	(25)	(43)
Net cash from operations	1,901	2,001
CASH FLOWS FROM FINANCING		
Common stock issued	173	314
Common stock repurchased	(472)	(1,024)
Preferred stock issued		980
Stock option income tax benefits	71	226
Net cash from (used for) financing	(228)	496
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(204)	(216)
Equity investments and other	(203)	(66)
Short-term investments	(906)	(1,725)
Net cash used for investments	(1,313)	(2,007)
Net change in cash and equivalents	360	490
Effect of exchange rates on cash	1	5
Cash and equivalents, beginning of period	1,962	2,601
Cash and equivalents, end of period	2,323	3,096
Short-term investments, end of period	3,694	6,064
Cash and short-term investments, end of period	$ 6,017	$ 9,160

</TABLE>

See accompanying notes.

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<PAGE> 6

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

BASIS OF PRESENTATION

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

Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1996 Form 10-K.

STOCK SPLIT

Effective December 9, 1996, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effects of outstanding stock options using the treasury stock method and preferred shares using the if-converted method.

STOCKHOLDERS' EQUITY

Microsoft repurchases common stock on the open market. This program provides shares for issuance to employees under the Company's stock option and stock purchase plans. During the first two quarters of fiscal 1997, the Company repurchased 16.7 million shares for $1.10 billion.

To enhance its stock repurchase program, Microsoft sells equity put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On December 31, 1996, 28 million warrants were outstanding with strike prices ranging between $60 and $67 per share. The warrants expire at various dates between the fourth quarter of fiscal 1997 and the fourth quarter of fiscal 1998 and are exercisable only at maturity. These put warrant contracts permit a net-share settlement method in addition to cash settlement or physical delivery at the Company's option, thus Microsoft is no longer required to reflect a put warrant liability on the accompanying balance sheet.

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

MICROSOFT NETWORK PARTNERSHIP

During October 1996, Microsoft and a subsidiary of Tele-Communications, Inc. (TCI) terminated a partnership under which TCI owned a 20% minority interest in The Microsoft Network, LLC, owner of the business assets of MSN(TM), The Microsoft Network, an online service. Due to the evolving nature of the online industry and MSN's move to a Web-based offering, the original direction of the partnership changed and both Microsoft and TCI agreed to terminate this partnership focused exclusively on MSN. In return for approximately $125 million of TCI securities, Microsoft became the sole owner of MSN and the minority interest on the accompanying balance sheet was eliminated. There was no other material financial impact of the dissolution.

CONTINGENCIES

In an ongoing investigation, the Antitrust Division of the U.S. Department of Justice requested information from Microsoft in September 1996 concerning Web browsers. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business. Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

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

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs) and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company has recently expanded its interactive content efforts, including MSN, the Microsoft Network online service, various Internet-based services, and entertainment and information software programs. Microsoft also sells personal computer books and input devices, and researches and develops advanced technologies for future software products.

REVENUES

Revenues were $2.68 billion in the second quarter of fiscal 1997, an increase of 22% over the comparable quarter of fiscal 1996. On a year-to-date basis, revenues were $4.98 billion, 18% greater than the comparable period of the prior fiscal year. Revenue growth rates were higher in the first two quarters of the prior year due to the introduction of the Microsoft(R) Windows(R) 95 operating system and Microsoft Office for Windows 95.

Software license volume increases have been the principal factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately.

A portion of the Company's revenues will be earned later than billed. Unearned revenues as of December 31, 1996 on the accompanying balance sheet were $1.01 billion. Approximately $665 million of this amount represented the unearned portion of Windows desktop operating systems revenues attributable to future support commitments, Internet browser updates, and other unspecified enhancements that will be recognized ratably over the products' life cycles, currently estimated to be two years. As discussed below, unearned revenues associated with upgrade rights for Microsoft Office 97 were $200 million. The balance of unearned revenues was primarily attributable to maintenance and other subscription contracts.

PRODUCT GROUPS

Platforms product group revenues were $1.49 billion in the second quarter of fiscal 1997, compared to $1.13 billion for the same period of 1996, an increase of 32%. On a year-to-date basis, platforms product group revenues increased to $2.68 billion from $2.17 billion. Platforms product group revenues are primarily from licenses of PC operating systems, business systems with client/server architectures, and software development tools.

As expected, revenues from retail upgrade versions of Windows 95 decreased compared to the comparable quarters of the prior year, the period during which Windows 95 was released. Total Windows 95 unit volume continued to build, as units licensed through the OEM channel increased strongly.

English and certain European language versions of Windows NT(R) 4.0 were released during the first quarter of fiscal 1997, while a Japanese version was released during the second quarter. These product introductions fueled revenue increases for both Windows NT Workstation and Windows NT Server during both quarters.

Applications and content product group revenues were $1.19 billion in the second quarter of fiscal 1997, increasing 12% from $1.07 billion in the second quarter of fiscal 1996. For the first two quarters of fiscal 1997, applications and content product revenues were $2.30 billion, compared to $2.05 billion in the corresponding period of 1996. Applications and content product group revenues include primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Integrated suites generate most desktop application revenues. The primary programs in Microsoft Office are the Microsoft Word word processor, the Microsoft Excel spreadsheet, and the Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows 32-bit, Windows 16-bit, and Macintosh operating systems, also include applications such as the Microsoft Access(R) database management program, the Microsoft Schedule+ calendar and scheduling program, and an email client license. The sales mix of 32-bit versions of Microsoft Office continued to increase. Applications and Content revenues grew at a rate lower than recent levels due to the gradual reduction of the

- --

amount of product in the channel in anticipation of the launch of the newest version of the Company's primary desktop application product (Microsoft Office 97). Also, unearned revenues of $200 million attributed to upgrade rights impacted the growth rate. Most versions of Microsoft Office for Windows 95 shipped during the second quarter carried a "technological guarantee" that entitled customers to a free upgrade to the corresponding Microsoft Office 97 version of the product. Associated revenues will be recognized when the upgrade delivery obligation is fulfilled.

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM earned revenues were $866 million in the second quarter compared to the $672 million recorded in the comparable quarter of the prior year. On a year-to-date basis, OEM revenues were $1.53 billion, compared to $1.22 billion in fiscal 1996. The primary source of OEM revenues is the licensing of desktop operating systems. The percentage of new PCs with Windows 95 preinstalled increased to more than 75% of reported shipments during the second quarter of fiscal 1997, while MS-DOS and Windows 3.x continued to be preinstalled on many of the remainder of PCs sold by OEMs. The above-mentioned ratable revenue recognition policy was extended to Windows operating systems licensed through the OEM channel in the third quarter of the prior fiscal year.

Revenues in the U.S. and Canada were $759 million in the second quarter of fiscal 1997 compared to $632 million in the second quarter of 1996. Revenues in the first half of fiscal 1997 were $1.57 billion, compared to $1.38 billion recorded last year. Revenues in Europe were $631 million in the second quarter of fiscal 1997 compared to $569 million in the prior year. European revenues were $1.06 billion in the first half of 1997 compared to $995 million the prior year. Growth rates slowed in the U.S. and Canadian and European channels due to the strong sales of Windows 95 and Microsoft Office for Windows 95 the prior year, reflecting typical retail upgrade sales patterns of new versions of PC operating systems and desktop applications. Other International channel revenues increased 32% to $424 million in the second quarter of fiscal 1997 from $322 million in the second quarter of fiscal 1996, reflecting strong sales in Japan. On a year-to-date basis, Other International revenues were $817 million in fiscal 1997 compared to $619 million the prior year.

Excluding the impact of the shipment of retail upgrade versions of Windows 95 and Microsoft Office for Windows 95 in the first half of fiscal 1996, the trend has continued toward a higher percentage of corporate licensing versus packaged products.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the second quarter of the prior year been in effect during the second quarter of 1997, translated revenues in Europe would have been $15 million higher and translated Other International revenues would have been $20 million higher. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues. Also, a portion of planned translated international finished goods revenues in fiscal 1997 is hedged with purchased options.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 11.0% in the second quarter of fiscal 1997 compared to 15.0% in the second quarter of 1996, and 11.0% in the first half of fiscal 1997 versus 15.5% in the first half of 1996. The decrease was primarily due to high shipments of retail upgrade versions of Windows 95 and Microsoft Office for Windows 95 in the comparable periods of the prior year. Cost of revenues also decreased because of general trends toward more corporate licensing and more shipments of products on CD-ROM, which carry lower cost of goods than floppy disks.

Research and development expenses increased 55% to $485 million (18.1% of revenues) in the second quarter of fiscal 1997 from $313 million (14.3% of revenues) in the corresponding quarter of 1996. The continued increase in research and development expenses in fiscal 1997 resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

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Sales and marketing expenses were $737 million in the second quarter of fiscal

1997 compared with $690 million in 1996. As a percentage of revenues, sales and marketing expenses were 27.5% and 31.4% in the respective second quarters of fiscal 1997 and 1996. Sales and marketing expenses as a percent of revenues in fiscal 1997 decreased due to the high level of marketing and support associated with the launch of Windows 95 in 1996.

General and administrative expenses were $81 million (3.0% of revenues) in the second quarter of fiscal 1997 and $76 million (3.5% of revenues) in the second quarter of 1996. Fiscal 1997 increases were due to growth in the systems and number of people necessary to support overall increases in the scope of the Company's operations.

Interest income increased as a result of a larger investment portfolio generated by cash from operations.

Other expenses increased in both the first and second quarters of 1997 due to recognition of the Company's share of operational expenses of joint ventures, including DreamWorks Interactive and the MSNBC entities.

The effective income tax rate was 35% in all periods.

NET INCOME

Net income for the second quarter of fiscal 1997 was $741 million. Net income as a percentage of revenues was 27.6% in the second quarter of fiscal 1997 compared with 26.2% in the second quarter of 1996. The increase in net income as a percentage of revenues in fiscal 1997 was primarily the result of substantial reductions in relative cost of revenues and sales and marketing expenses, partially offset by increases in research and development and funding of joint ventures.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $9.16 billion at December 31, 1996. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management.

Stockholders' equity at December 31, 1996 was $9.64 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. Research and development investments will continue in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff. Commitments for constructing new buildings were $450 million on December 31, 1996.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. Microsoft enhances its repurchase program by selling put warrants. See notes to financial statements.

During December 1996, Microsoft issued 12.5 million 2.75% preferred shares. See notes to financial statements.

During fiscal 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale cash needs that may arise, and to fund an increased stock buyback program over historical levels to reduce the dilutive impact of the Company's employee stock option and purchase programs. Despite recent increases in stock repurchases, the buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 134 million common shares for $4.2 billion while 336 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $21.8 billion as of December 31, 1996.

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

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See notes to financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At the Annual Meeting of Shareholders held on November 12, 1996, the following proposals were adopted by the margins indicated:

1. To elect a Board of Directors to hold office until the next annual meeting of shareholders and until their successors are elected and qualified.

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	NUMBER OF SHARES	
	FOR	WITHHELD
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William H. Gates	536,874,375	2,152,263
Paul G. Allen	536,871,320	2,155,318
Jill E. Barad	534,523,936	4,502,702
Richard A. Hackborn	536,917,381	2,109,257
David F. Marquardt	536,933,188	2,093,450
Robert D. O'Brien	536,719,379	2,307,259

William G. Reed, Jr.	536,971,762	2,054,876
Jon A. Shirley	536,964,036	2,062,602

</TABLE>

2. To approve an amendment to the Company's 1991 Stock Option Plan to reserve an additional 200,000,000 shares (restated to reflect the two-for-one stock split) of common stock for issuance thereunder.

For	307,280,849
Against	129,627,668
Abstain	2,290,050

3. To approve the adoption of the 1997 Employee Stock Purchase Plan, including the reservation of 200,000,000 shares (restated to reflect the two-for-one stock split) of common stock thereunder.

For	422,180,091
Against	14,998,735
Abstain	2,019,762

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS
11. Computation of Earnings Per Share is on page 10.
27. Financial Data Schedule

(B) REPORTS ON FORM 8-K
Microsoft filed no reports on Form 8-K during the quarter ended December 31, 1996.

ITEMS 2, 3, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

- --

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Signature

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

Microsoft Corporation

Date: February 13, 1997

By:/s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

\- ---

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EXHIBIT INDEX

EXHIBITS

11. Computation of Earnings Per Share

27. Financial Data Schedule

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EXHIBIT 11.

MICROSOFT CORPORATION

COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share) (Unaudited)
\- ---

<TABLE>
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	THREE MONTHS DECEMBER 1995	
<S>	<C>	<
Weighted average number of common shares outstanding	1,180	1
Common stock equivalents - stock options	96	
Common stock equivalents - preferred stock		
Average common and common stock equivalents outstanding (1)	1,276	1
Net income	$ 575	$
Earnings per share (1) (2)	$ 0.45	$

</TABLE>

(1) Share and per share amounts for the three and six months ended December

31, 1995 have been restated to reflect a two-for-one stock split in December 1996.

(2) Fully diluted earnings per share have not been presented because the effects are not material.

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                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 WA
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 1996

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON	98052-6399
(Address of principal executive office)	(Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes |X| No |_|

The number of shares outstanding of the registrant's common stock as of October 31, 1996 was 597,593,969.

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 1996

INDEX

PART I. FINANCIAL INFORMATION

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

<TABLE>
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INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

	Three Months End September 30 1995	 199
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Net revenues	$2,016	$2,29
Operating expenses:		
Cost of revenues	322	25
Research and development	302	43
Sales and marketing	621	62
General and administrative	63	8

Total operating expenses	1,308	1,39
Operating income	708	90
Interest income	66	9
Other expenses	(4)	(4
Income before income taxes	770	94
Provision for income taxes	271	33
Net income	$ 499	$ 61
Earnings per share	$ 0.78	$ 0.9
Weighted average shares outstanding	640	64

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See accompanying notes.

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MICROSOFT CORPORATION

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(In millions)

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Current assets:
  Cash and short-term investments
  Accounts receivable
  Other

    Total current assets
Property, plant, and equipment
Equity investments
Other assets

      Total assets

LIABILITIES AND STOCKHOLDERS' EQUITY
Current liabilities:
  Accounts payable
  Accrued compensation
  Income taxes payable
  Unearned revenues
  Other

    Total current liabilities

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- ---------------------------------------------------------------------------------
Minority interest
- ---------------------------------------------------------------------------------
Put warrants
- ---------------------------------------------------------------------------------
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  Common stock and paid-in capital --
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      Total liabilities and stockholders' equity
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(1)  Unaudited


                             See accompanying notes.

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MICROSOFT CORPORATION

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(In millions)(Unaudited)
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  Net income
  Depreciation and amortization
  Current liabilities
  Accounts receivable
  Other current assets
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    Net cash from operations
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CASH FLOWS USED FOR FINANCING
  Common stock issued
  Common stock repurchased
  Stock option income tax benefits
- ---------------------------------------------------------------------------------
    Net cash used for financing
- ---------------------------------------------------------------------------------
CASH FLOWS USED FOR INVESTMENTS
  Additions to property, plant, and equipment
  Equity investments and other
  Short-term investments
- ---------------------------------------------------------------------------------
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Net cash used for investments

- --

Net change in cash and equivalents
Effect of exchange rates on cash
Cash and equivalents, beginning of period

- --

Cash and equivalents, end of period
Short-term investments, end of period

- --

Cash and short-term investments, end of period

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See accompanying notes.

- --

3

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

- --

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1996 Annual Report on Form 10-K.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

CONTINGENCIES

In connection with an ongoing investigation, the Antitrust Division of the U.S. Department of Justice requested information from Microsoft in September 1996 concerning Web browsers. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business. Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

SUBSEQUENT EVENTS

During October 1996, Microsoft and a subsidiary of Tele-Communications, Inc.

(TCI) terminated a partnership under which TCI owned a 20% minority interest in The Microsoft Network, LLC, owner of the business assets of MSN, The Microsoft Network, an online service. Due to the evolving nature of the online industry and MSN's move to a Web-based offering, the original direction of the partnership changed and both Microsoft and TCI agreed to terminate this partnership focused exclusively on MSN. In return for approximately $125 million of TCI securities, Microsoft became the sole owner of MSN. There was no other material financial impact of the dissolution.

On November 12, 1996, the Company's Board of Directors approved a two-for-one stock split, effective November 22, 1996. Share and per share amounts have not been restated for the upcoming stock split.

- --

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

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs) and servers, server applications for client/server environments, business and consumer productivity applications, interactive media programs, and Internet platform and development tools. Microsoft also offers online services, sells personal computer books and input devices, and researches and develops advanced technology software products.

REVENUES

Revenues for the first quarter of fiscal 1997 increased 14% over revenues for the first quarter of fiscal 1996. Revenues experienced large growth in the first quarter of the prior year due to the introduction of the Microsoft(R) Windows 95(R) operating system.

Software license volume increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately.

A portion of the Company's revenues will be earned later than billed. Unearned revenues as of September 30, 1996 on the accompanying balance sheet were $651 million. Approximately $525 million of this amount represented the unearned portion of Windows-based desktop operating systems revenues attributable to future support commitments, Internet browser updates, and other unspecified enhancements that will be recognized ratably over the products' life cycles. The balance of unearned revenues was primarily attributable to maintenance and other subscription contracts.

PRODUCT GROUPS

Platforms product group revenues were $1.19 billion in the first quarter of 1997, compared to $1.04 billion for the same period of 1996, an increase of 15%. Platforms product group revenues are primarily from licenses of PC operating systems, business systems with client/server architectures, and software development tools.

As expected, revenues from retail upgrade versions of Microsoft Windows 95 decreased compared to the comparable quarter of the prior year, the quarter during which Windows 95 was released. Total Windows 95 unit volume continued to build, as units licensed through the OEM channel increased strongly.

Windows NT(R) 4.0 was released during the first quarter of 1997, fueling revenue increases for both Windows NT Workstation and Windows NT Server. Additionally, revenues from server applications in the BackOffice(TM) family of business systems were strong.

Applications and content product group revenues were $1.11 billion in the first quarter of 1997, increasing 13% from $977 million in the first quarter of 1996. Applications and content product group revenues include primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Most desktop application revenues are generated by integrated suites. The primary programs in Microsoft Office are the Microsoft Word word processor, the Microsoft Excel spreadsheet, and the Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows 32-bit, Windows 16-bit, and Macintosh operating systems, also include applications such as the Microsoft Access(R) database management program, the Microsoft Schedule+ calendar and scheduling program, and an email client license. Increases in applications and content revenues were led by strong sales of 32-bit Windows versions of Microsoft Office.

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

- ---

OEM earned revenues were $663 million in the first quarter compared to the $548 million recorded in the comparable quarter of the prior year. The primary source of OEM revenues is the licensing of desktop operating systems. Higher levels of PC shipments was the principal driver of increased revenues through the OEM channel. The percentage of new PCs with Windows 95 preinstalled increased to more than 70% of reported shipments during the first quarter of 1997, while MS-DOS and Windows 3.x continued to be preinstalled on many of the remainder of PCs sold by OEMs. The above-mentioned ratable revenue recognition policy was extended to operating systems licensed through the OEM channel in the third quarter of the prior fiscal year.

Revenues in the U.S. and Canada were $812 million in the first quarter of 1997 compared to $745 million in the first quarter of 1996. Revenues in Europe were $427 million in the first quarter of 1997 compared to $426 million in the prior year. Growth rates slowed in the U.S. and Canada and European channels due to the strong sales of Windows 95 the prior year, reflecting typical retail upgrade sales patterns of new versions of PC operating systems. Other International channel revenues increased 32% to $393 million in the first quarter of 1997 from $297 million in the first quarter of 1996, reflecting strong sales in Japan. The Japanese version of Windows 95 was released in Japan during the second quarter of fiscal 1996.

Excluding the impact of the shipment of Windows 95 retail upgrades and 32-bit versions of desktop applications in the first quarter of fiscal 1996, the trend has continued toward a higher percentage of corporate licensing (versus packaged products).

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the first quarter of the prior year been in effect during the first quarter of 1997, translated revenues in Europe would have been $23 million higher and translated Other International revenues would have been $28 million higher. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues. Also, a portion of planned translated international finished goods revenues in fiscal 1997 is hedged with purchased options.

OPERATING EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 10.9% in the first quarter of 1997 compared to 16.0% in the first quarter of 1996. The decrease was primarily due to high shipments of retail upgrade versions of Windows 95 and Microsoft Office for Windows 95 in the comparable quarter. Cost of revenues also decreased because of general trends toward more corporate licensing and more shipments of products on CD-ROM, which carry lower cost of goods than floppy disks.

Research and development expenses increased 43% to $432 million (18.8% of revenues) in the first quarter of 1997 from $302 million (15.0% of revenues) in the corresponding quarter of 1996. The increase in research and development expenses resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses were $625 million in the first quarter of 1997, flat with the comparable quarter's $621 million. As a percentage of revenues, sales and marketing expenses were 27.2% and 30.8% in the respective first quarters of 1997 and 1996. Sales and marketing expenses as a percent of revenues decreased due to the high level of marketing and support associated with the launch of Windows 95 in the prior year.

General and administrative expenses were $86 million (3.8% of revenues) in the first quarter of 1997 and $63 million (3.1% of revenues) in the first quarter of 1996. The increase was due to growth in the systems and number of people necessary to support overall increases in the scope of the Company's operations.

Interest income increased as a result of a larger investment portfolio generated by cash from operations.

Other expenses increased in the first quarter of 1997 due to recognition of the Company's share of operational expenses of joint ventures, including DreamWorks Interactive and the MSNBC entities.

The effective income tax rate was 35% in both periods.

NET INCOME

Net income for the first quarter of 1997 was $614 million. Net income as a percentage of revenues was 26.8% in the first quarter of 1997 compared with

24.8% in the first quarter of 1996. The increase in net income as a percentage of revenues was primarily the result of substantial reductions in relative cost of revenues and sales and marketing expenses, partially offset by increases in research and development and funding of joint ventures.

- --

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $7.10 billion at September 30, 1996. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management.

Stockholders' equity at September 30, 1996 was $7.28 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, research and development investments will continue in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff. On September 30, 1996, commitments for constructing new buildings approximated $360 million.

Employees exercising stock options provide additional cash. These proceeds have funded Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1997.

To enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On September 30, 1996, 14 million warrants were outstanding with strike prices ranging between $100 and $110 per share. The warrants expire at various dates between the second quarter of fiscal 1997 and the second quarter of fiscal 1998, are exercisable only at maturity, and are settleable in cash at Microsoft's option. The maximum potential repurchase obligation as of September 30, 1996, $675 million, has been reclassified from stockholders' equity to put warrants.

During 1996, Microsoft and National Broadcasting Company (NBC) established two joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuit of Microsoft's long-term strategies. Additionally, Microsoft shareholders have authorized the issuance of up to 100 million shares of preferred stock, which may be used by Microsoft for any proper corporate purpose.

Microsoft has not paid cash dividends on its common stock.

- --

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See Notes to Financial Statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS
11. Computation of Earnings Per Share is on page 10.
(B) REPORTS ON FORM 8-K
No reports on Form 8-K were filed by Microsoft during the quarter ended September 30, 1996.

ITEMS 2, 3, 4 AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

- --

Signature

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

Microsoft Corporation

Date: November 13, 1996 By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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MICROSOFT CORPORATION
COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share) (Unaudited)

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Weighted average number of common shares outstanding	589	
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Average common and common stock equivalents outstanding	640	
Net income	$ 499	$
Earnings per share (1)	$0.78	$

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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

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SEC FILE NUMBER: 000-14278
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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 1996

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

FOR THE TRANSITION PERIOD FROM TO

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of April 30, 1996 was 598,249,261.

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 1996

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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	Three Months Ended March 31 1995	Three Months Ended March 31 1996	Nine Months Ende March 31 1995	199
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Net revenues	$1,587	$2,205	$4,316	$6,41
Costs and expenses:				
Cost of revenues	235	295	643	94
Research and development	219	364	596	97
Sales and marketing	516	685	1,390	1,99
General and administrative	68	87	181	22
Total costs and expenses	1,038	1,431	2,810	4,14
Operating income	549	774	1,506	2,26
Interest income - net	48	86	126	22
Other income (expense)	(5)	4	(12)	2
Income before income taxes	592	864	1,620	2,51
Provision for income taxes	196	302	535	83
Net income	$ 396	$ 562	$1,085	$1,63
Earnings per share	$ 0.63	$ 0.88	$ 1.74	$ 2.5

Weighted average shares outstanding	626	639	624	63

</TABLE>

See accompanying notes.

<PAGE> 4

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

<TABLE>
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	June 30 1995	March 31 1996 (1)
<S>	<C>	<C>
ASSETS		
Current assets:		
Cash and short-term investments	$4,750	$6,770
Accounts receivable - net	581	681
Inventories	88	33
Other	201	212
Total current assets	5,620	7,696
Property, plant, and equipment - net	1,192	1,281
Other assets	398	613
Total assets	$7,210	$9,590
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 563	$ 652
Accrued compensation	130	142
Income taxes payable	410	616
Unearned revenues	54	545
Other	190	309
Total current liabilities	1,347	2,264
Minority interest	125	125
Put warrants	405	606
Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 2,000; shares outstanding 588 and 595	2,005	2,678
Retained earnings	3,328	3,917

Total stockholders' equity	5,333	6,595
Total liabilities and stockholders' equity	$7,210	$9,590

</TABLE>

(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

<TABLE>
<CAPTION>

	Nine Months Ended March 31	
	1995	1996
CASH FLOWS FROM OPERATIONS		
<S>	<C>	<C>
Net income	$ 1,085	$ 1,636
Depreciation and amortization	203	336
Current liabilities	237	959
Accounts receivable	(40)	(154)
Inventories	17	53
Other current assets	(24)	(24)
Net cash from operations	1,478	2,806
CASH FLOWS USED FOR FINANCING		
Common stock issued	259	384
Common stock repurchased	(664)	(800)
Stock option income tax benefits	123	243
Net cash used for financing	(282)	(173)
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(272)	(336)
Other assets	(91)	(257)
Short-term investments	(1,123)	(1,045)
Net cash used for investments	(1,486)	(1,638)
Net change in cash and equivalents	(290)	995
Effect of exchange rates on cash and equivalents	18	(20)
Cash and equivalents, beginning of period	1,477	1,962
Cash and equivalents, end of period	1,205	2,937
Short-term investments, end of period	3,260	3,833
Cash and short-term investments, end of period	$ 4,465	$ 6,770

</TABLE>

See accompanying notes.

- --

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

- --

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1995 Annual Report on Form 10-K.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

CONTINGENCIES

Microsoft is subject to various legal proceedings and claims which arise in the ordinary course of business. Management currently believes that resolution of these matters will not have a material adverse impact on the Company's financial position or results of operations.

- --

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

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs) and servers; server applications for client-server environments; business and consumer productivity programs; interactive media programs; and Internet platform and development tools. Microsoft also offers an online service, sells personal computer books and input devices, and is engaged in the research and potential development of advanced technology software products.

REVENUES

Revenues for the third quarter of fiscal 1996 increased 39% over revenues for the third quarter of fiscal 1995. For the first three quarters of the year, revenues increased 49% over the comparable period of the prior year.

Software license volume (as opposed to price) increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft(R) Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, e.g., Microsoft Office, are less than the sum of the prices for the individual programs included in these products when such programs are licensed separately.

PRODUCT GROUPS

Platforms product group revenues were $970 million in the third quarter of 1996, compared to $617 million recorded in the same period of 1995, an increase of 57%. On a year-to-date basis, platforms product group revenues increased to $3.14 billion from $1.72 billion. Platforms product group revenues are primarily from licenses of PC operating systems and business systems with client-server architectures.

Desktop operating system revenues increased strongly in the third quarter of 1996 compared to the third quarter of 1995, and also on a year-to-date basis compared to the comparable period of the prior year. During the first quarter of fiscal 1996, the Company released Microsoft Windows(R) 95, its new personal computer operating system, which experienced strong demand by users of existing PCs. Demand for Windows 95 through the retail channels decreased in the second and third quarters, reflecting the typical sales pattern for upgrades of operating systems. During the third quarter of fiscal 1996, demand for Windows 95 operating systems licensed through the OEM channel increased from the first two quarters of fiscal 1996 while revenues declined from OEM licensing of Microsoft MS-DOS(R), Microsoft Windows 3.1, and Microsoft Windows for Workgroups 3.11. (Windows 3.1 and Windows for Workgroups 3.11 are hereafter referred to collectively as "Windows 3.x.")

During the quarter Microsoft implemented its policy of offering customers the latest Internet technology at no additional cost. Given this strategy and because Internet browsers are a fundamental and integral part of its Windows-based operating systems, ratable revenue recognition is appropriate for a portion of all Windows-based operating system license fees, including those licensed through its retail and OEM channels. Unearned revenues as of March 31, 1996 on the accompanying balance sheet include $300 million for future support commitments, Internet browser updates, and other unspecified enhancements to Windows-based operating systems which will be recognized ratably over the products' life cycles as earned.

Revenues from business systems products (principally the Windows NT(R) operating system and server applications in Microsoft's BackOffice(TM) family of products) increased strongly, due to greater corporate demand for Windows NT Workstation and Windows NT Server.

Applications and content product group revenues were $1.24 billion in the third quarter of 1996, increasing 27% from $970 million in the third quarter of 1995. For the first three quarters of 1996, applications and content product group revenues were $3.28 billion, compared to $2.60 billion in the corresponding period of 1995. Applications and content product group revenues include primarily licenses of desktop and consumer productivity programs, interactive media programs, and PC input devices.

- --

Increases in applications and content revenues were led by strong sales of 16-bit and 32-bit versions of Microsoft Office. Microsoft Office Standard includes the Microsoft Word word processor, the Microsoft Excel spreadsheet, and the Microsoft PowerPoint(R) presentation graphics program. The Microsoft Office for Windows 95 (32-bit) version also includes the Microsoft Schedule+ calendar and scheduling program. Microsoft Office Professional includes all of the above plus the Microsoft Access(R) database management program. Revenues from desktop applications exceeded $1.0 billion in the third quarter of fiscal 1996. The accompanying balance sheet also includes $110 million of unearned revenues as of March 31, 1996 in connection with the sale of 16-bit versions of desktop productivity programs that will not be earned and recognized as revenues until related coupons for 32-bit version upgrades have been fulfilled.

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packages. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

Royalties from OEMs (primarily for PC operating systems) reached a record level. Earned revenues were $633 million in the third quarter compared to the $451 million recorded in the comparable quarter of the prior year, and reflected the extension of the above-mentioned ratable revenue recognition policy to operating systems licensed through the OEM channel. On a year-to-date basis, OEM revenues were $1.85 billion in 1996, compared to $1.18 billion in 1995. The percentage of new PCs with Windows 95 preinstalled increased to more than 70% of reported shipments during the third quarter of 1996, while MS-DOS and Windows 3.x continued to be preinstalled on many of the remainder of PCs sold by OEMs. Higher levels of PC shipments was the principal driver of increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $620 million in the third quarter of 1996 compared to $481 million in the third quarter of 1995. Revenues in the first three quarters of 1996 were $2.00 billion, compared to $1.40 billion recorded last year. Revenues in Europe were $555 million in the third quarter of 1996 compared to $419 million in the prior year. European revenues were $1.55 billion in the first three quarters of 1996 compared to $1.11 billion in the prior year. Excluding the impact of shipment of retail upgrade packaged product of Windows 95 and 32-bit versions of desktop applications in the first two quarters of fiscal 1996, the trend has continued toward a higher percentage of corporate licensing (versus packaged products), particularly in Europe and the U.S. and Canada channels.

Other International channel revenues increased 68% to $397 million in the third quarter of 1996 from $236 million in the third quarter of 1995, reflecting strong sales in Japan. Year-to-date revenues were $1.02 billion in 1996 compared to $630 million in 1995.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the third quarter of the prior year been in effect during the third quarter of 1996, translated revenues in Europe would have been $14 million lower and translated Other International revenues would have been $25 million higher. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues.

COSTS AND EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 13.4% in the third quarter of 1996 and 14.8% in the third quarter of 1995. The decrease was due to channel mix, more corporate licensing, and more shipments of products on CD-ROM, which carry lower cost of goods than floppy disks. For the first three quarters of 1996, cost of revenues was 14.8% of revenues, compared to 14.9% the prior year. This slight decrease is attributable to the above-mentioned mix shifts offset somewhat by high shipments of retail upgrade versions of Windows 95 and Microsoft Office for Windows 95, particularly in the first two quarters of fiscal 1996.

Research and development expenses increased 66% to $364 million, or 16.5% of revenues in the third quarter of 1996 from $219 million, or 13.8% of revenues in the corresponding quarter of 1995. On a year-to-date basis, R&D expenses were $979 million in 1996 and $596 million in 1995. The increase in research and development expenses in 1996 resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 33% to $685 million from $516 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 31.1% and 32.5% in the respective third quarters of 1996 and 1995. For the first three quarters, sales and marketing expenses were $2.00 billion in 1996 and $1.39 billion in 1995. The increase in sales and marketing expenses in 1996 was impacted by greater sales expense, increased product support costs, and higher product-specific marketing costs, particularly for Windows 95 and Microsoft Office for Windows 95.

General and administrative expenses were $87 million (3.9% of revenues) in the third quarter of 1996 and $68 million (4.3% of revenues) in the third quarter of 1995. For the first three quarters of 1996, general and administrative expenses were $226 million compared to $181 million in 1995. The increases in absolute dollars incurred in 1996 were due to growth in the systems and number of people necessary to support overall increases in the scope of the Company's operations.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with higher interest rates. Other income in the second quarter of 1996 included a net gain of $30 million from the disposal of long-term assets.

The effective income tax rate was 35% in 1996 and 33% in 1995, with the increase due primarily to changes in U.S. tax law.

NET INCOME

Net income for the third quarter of 1996 was $562 million. Net income as a percentage of revenues was 25.5% in the third quarter of 1996, compared with 25.0% in the third quarter of 1995. On a year-to-date basis, net income as a percentage of revenues was 25.5% in 1996 compared to 25.1% the prior year. The increase in net income as a percentage of revenues was primarily the result of revenues growing faster than operating expenses other than those for research and development and higher nonoperating income such as interest income and the disposal net gain.

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FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $6.77 billion at March 31, 1996. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management. Stockholders' equity at March 31, 1996 was $6.60 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, investments will continue in research and development in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff.

The exercise of stock options by employees provides additional cash. These proceeds have been used in Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1996.

To enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties during 1995 and 1996. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On March 31, 1996, 13 million warrants were outstanding with strike prices ranging between $87 and $95 per share. The warrants expire at various dates between the first quarter of fiscal 1997 and the first quarter of fiscal 1998, are exercisable only at maturity, and are settleable in cash at Microsoft's option. The maximum potential repurchase obligation as of March 31, 1996, $606 million, has been reclassified from stockholders' equity to put warrants.

A subsidiary of Tele-Communications, Inc. (TCI) owns a 20% minority interest in The Microsoft Network, LLC. TCI contributed $125 million of TCI common stock, and Microsoft contributed the business assets of its online service, The Microsoft Network, which began operation in August 1995.

During the third quarter of 1996, Microsoft and NBC established two joint ventures: a 24-hour cable news and information channel and an interactive online news service to be distributed on The Microsoft Network. Both of these services will be offered worldwide and integrated with the NBC Television Network. Microsoft has agreed to pay $220 million over five years for its interest in the cable venture.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuit of Microsoft's long-term strategies. Additionally, Microsoft shareholders have authorized the issuance of up to 100 million shares of preferred stock, which may be used by Microsoft for any proper corporate purpose.

Microsoft has not paid cash dividends on its common stock.

- --

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See Notes to Financial Statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS

11. Computation of Earnings Per Share is on page 11.

(B) REPORTS ON FORM 8-K

No reports on Form 8-K were filed by Microsoft during the quarter ended March 31, 1996.

ITEMS 2, 3, 4 AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

Signature

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

Microsoft Corporation

Date: May 15, 1996 By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting Officer and Duly Authorized Officer)

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<DOCUMENT>
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<SEQUENCE>2
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EXHIBIT 11.

MICROSOFT CORPORATION

COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share) (Unaudited)

<TABLE>
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	Three Months Ended March 31 1995	1996
<S>	<C>	<C>
Weighted average number of common shares outstanding	582	593
Common stock equivalents from outstanding stock options	44	46
Average common and common stock equivalents outstanding	626	639
Net income	$ 396	$ 562
Earnings per share (1)	$0.63	$0.88

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(1) Fully diluted earnings per share have not been presented because the effects are not material.

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PUBLIC DOCUMENT COUNT: 3
CONFORMED PERIOD OF REPORT: 19951231
FILED AS OF DATE: 19960213
SROS: NASD

FILER:

COMPANY DATA:
COMPANY CONFORMED NAME: MICROSOFT CORP
CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWAR
IRS NUMBER: 911144442
STATE OF INCORPORATION: DE
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT: 1934 Act
SEC FILE NUMBER: 000-14278
FILM NUMBER: 96517045

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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended December 31, 1995

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

For the Transition Period From _____ to _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes /X/ No / /

The number of shares outstanding of the registrant's common stock as of January 31, 1996 was 594,003,653.

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 1995

INDEX

<TABLE>

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PART I. FINANCIAL INFORMATION
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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

<TABLE>
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	Three Months Ended December 31	
	1994	1995
<S>	<C>	<C>
Net revenues	$1,482	$2,195
Costs and expenses:		
Cost of revenues	222	330
Research and development	199	313
Sales and marketing	479	690
General and administrative	62	76

Total costs and expenses	962	1,409
Operating income	520	786
Interest income - net	42	76
Other income (expense)	(5)	23
Income before income taxes	557	885
Provision for income taxes	184	310
Net income	$ 373	$ 575
Earnings per share	$ 0.60	$ 0.90
Weighted average shares outstanding	625	638

</TABLE>

See accompanying notes.

1

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MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

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ASSETS

Current assets:

Cash and short-term investments

Accounts receivable - net

Inventories

Other

Total current assets

Property, plant, and equipment - net

Other assets

Total assets

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:	
Accounts payable	
Accrued compensation	
Income taxes payable	
Unearned revenues	
Other	
Total current liabilities	
Minority interest	
Put warrants	
Stockholders' equity:	
Common stock and paid-in capital -- shares authorized 2,000; shares outstanding 588 and 590	
Retained earnings	
Total stockholders' equity	
Total liabilities and stockholders' equity	

</TABLE>

(1) Unaudited

See accompanying notes.

<PAGE> 5

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)
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<S>	<C>
CASH FLOWS FROM OPERATIONS	
Net income	$
Depreciation and amortization	
Current liabilities	

Accounts receivable	(
Inventories	
Other current assets	
Net cash from operations	
CASH FLOWS USED FOR FINANCING	
Common stock issued	
Common stock repurchased	(
Stock option income tax benefits	
Net cash used for financing	(
CASH FLOWS USED FOR INVESTMENTS	
Additions to property, plant, and equipment	(
Other assets	
Short-term investments	(
Net cash used for investments	(1,
Net change in cash and equivalents	(
Effect of exchange rates on cash and equivalents	
Cash and equivalents, beginning of period	1,
Cash and equivalents, end of period	
Short-term investments, end of period	2,
Cash and short-term investments, end of period	$ 3,

</TABLE>

See accompanying notes.

<PAGE> 6

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1995 Annual Report on Form 10-K.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

MERGER

During January 1996, Microsoft merged with Vermeer Technologies, Inc., a developer of Web authoring software. The transaction will be accounted for as a pooling of interests. Management does not expect the transaction to have a material financial effect on the Company's financial results.

CONTINGENCIES

The Antitrust Division of the U.S. Department of Justice has stated that it is conducting an investigation concerning Microsoft's inclusion of client-access software for The Microsoft Network in Microsoft Windows(R) 95. Although there is no assurance that this matter will be resolved favorably and that Microsoft's future financial statements will not be adversely affected, Microsoft currently believes that resolution of this matter will not have a material adverse effect on its financial condition or results of operations.

- --

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

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and development tools. Microsoft also offers an online service, sells personal computer books and input devices, and is engaged in the research and potential development of advanced technology software products.

REVENUES

Revenues for the second quarter of fiscal 1996 increased 48% over revenues for the second quarter of fiscal 1995. For the first half of the year, revenues increased 54% over the comparable period of the prior year.

Software license volume (as opposed to price) increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, e.g., Microsoft Office, are less than the sum of the prices for the individual programs included in these products when such programs are licensed separately.

PRODUCT GROUPS

Platforms product group revenues were $1.13 billion in the second quarter of 1996, compared to $592 million recorded in the same period of 1995, an increase of 90%. On a year-to-date basis, platforms product group revenues increased to $2.17 billion from $1.10 billion. Platforms product group revenues are primarily from licenses of personal computer operating systems and business systems with client-server architectures.

During the first quarter of fiscal 1996, the Company released Microsoft Windows 95, its new personal computer operating system, which experienced strong demand by users of existing PCs. To prevent stock outs in the retail channel, certain distributors and resellers over-ordered Windows 95 product prior to its formal launch on August 24, 1995 and began returning excess inventory in the first two quarters of 1996. The Company provided for management's estimate of additional product that will be returned to Microsoft. The Company's earned retail revenues of Windows 95 were $260 million in the first quarter and $180 million in the second quarter. Additionally, unearned revenues as of December 31, 1995 on the accompanying balance sheet include $200 million attributable to future telephone support and unspecified enhancements to Windows 95 which will be recognized ratably over the product's life cycle as it is earned. The Company also experienced continued revenue growth in Microsoft MS-DOS(R), Microsoft Windows 3.1, Microsoft Windows for Workgroups 3.11, and Windows 95 operating systems licensed through the OEM channel. (Windows 3.1 and Windows for Workgroups 3.11 are hereafter referred to collectively as "Windows 3.x."). Revenues from business systems products (principally the Windows NT(TM) operating system and server applications in the Microsoft's BackOffice(TM) family of products) increased strongly, due to greater corporate demand for Windows NT Workstation and Windows NT Server.

Applications and content product group revenues were $1.07 billion in the second quarter of 1996, increasing 20% from $890 million in the second quarter of 1995. For the first two quarters of 1996, applications and content product revenues were $2.05 billion, compared to $1.63 billion in the corresponding period of 1995. Applications product group revenues include primarily licenses of desktop productivity, consumer, and developer programs.

Increases in applications and content revenues were led by strong sales of 16-bit and 32-bit versions of Microsoft Office. Microsoft Office Standard includes the Microsoft Word word processor, the Microsoft Excel spreadsheet, and the Microsoft PowerPoint(R) presentation graphics program. The Microsoft Office for Windows 95 (32-bit) version also includes the Microsoft Schedule+ calendar and scheduling program. Microsoft Office Professional includes all of the above plus the Microsoft Access(R) database management program. The accompanying balance sheet also includes $230 million of unearned revenues as of December 31, 1995 in connection with the sale of 16-bit versions of desktop productivity programs that will not be earned and recognized as revenues until related coupons for Windows 95 version upgrades have been fulfilled.

- ---

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Revenues from consumer products grew 23% in the second quarter of 1996. New titles and new versions of existing titles both contributed to the growth, in spite of across-the-board price decreases. Developer product revenues also grew, reflecting the introduction of Microsoft Visual Basic version 4.0.

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM revenues (primarily personal computer operating systems) grew 75% to $672 million in the second quarter from the $385 million recorded in the comparable quarter of the prior year. On a year-to-date basis, OEM revenues were $1.22 billion, compared to $733 million in 1995. The percentage of OEMs preinstalling Windows 95 on new PCs increased during the second quarter of 1996. Also, MS-DOS and Microsoft Windows 3.x continued to be preinstalled on many PCs sold by OEMs. Higher levels of PC shipments was the principal driver of increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $632 million in the second quarter of 1996 compared to $491 million in 1995. Revenues in the first half of 1996 were $1.38 billion, compared to $914 million recorded last year. The increase in revenues of 51% for the first two quarters primarily reflects the release of new versions of Windows 95 and 32-bit versions of desktop applications, particularly Microsoft Office for Windows 95.

Revenues in Europe were $569 million in the second quarter of 1996 compared to $399 million the prior year. European revenues were $995 million in the first half of 1996 compared to $688 million the prior year, an increase of 45%. Revenues in Europe benefited greatly by the release of localized versions of Windows 95 and 32-bit desktop applications.

Other International channel revenues increased 56% to $322 million in the second quarter of 1996 from $207 million in the second quarter of 1995, reflecting the release of Kanji versions of Windows 95 and Microsoft Office in Japan. Year-to-date revenues were $619 million in 1996 compared to $394 million in 1995. As in Europe, many localized versions of Windows 95 and 32-bit desktop applications were released through the Other International channel in the first half of 1996.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the second quarter of the prior year been in effect during the second quarter of 1996, translated revenues in Europe would have been $21 million lower and translated Other International revenues would have been $4 million higher. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues.

COSTS AND EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 15.0% in the second quarters of both 1996 and 1995. For the first two quarters of 1996, cost of revenues was 15.5% of revenues, compared to 15.0% the prior year. The slight increase is principally attributable to a shift in sales mix due to high shipments of retail upgrade versions of Windows 95 and Microsoft Office for Windows 95. The increase in the cost of revenues percentage was somewhat offset by the increased mix of CD-ROM media, which carry lower costs of goods sold than floppy disks.

Research and development expenses increased 57% to $313 million, or 14.3% of revenues in the second quarter of 1996 from $199 million, or 13.4% of revenues in the corresponding quarter of 1995. The increase in research and development expenses in both the second quarter and first half of 1996 resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 44% to $690 million from $479 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 31.4% and 32.3% in the respective second quarters of 1996 and 1995. The increase in sales and marketing expenses in both the second quarter and first half of 1996 was impacted by marketing costs of Windows 95 and Microsoft Office for Windows 95 and increased product support costs.

- --

General and administrative expenses were $76 million (3.5% of revenues) in the second quarter of 1996 and $62 million (4.2% of revenues) in the second quarter of 1995. The increases in absolute dollars incurred in both the second quarter and first half of 1996 were due to growth in the systems and number of people necessary to support overall increases in the scope of the Company's operations.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with higher interest rates. Other income in the second quarter of 1996 included a net gain of $30 million from the disposal of long-term assets.

The effective income tax rate was 35% and 33% in the first halves of 1996 and 1995 with the increase due primarily to changes in the U.S. tax law.

NET INCOME

Net income for the second quarter of 1996 was $575 million. Net income as a percentage of revenues was 26.2% in the second quarter of 1996, compared with 25.2% in the second quarter of 1995. On a year-to-date basis, net income as a percent of revenues was 25.5% compared to 25.2% the prior year. The increase in net income as a percentage of revenues was primarily the result of revenues growing faster than operating expenses other than those for research and development and higher nonoperating income such as interest income and the disposal gain.

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FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $6 billion at December 31, 1995. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management. Stockholders' equity at December 31, 1995 exceeded $6 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, investments will continue in research and development in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff.

The exercise of stock options by employees provides additional cash. These proceeds have funded Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1996.

To enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties during 1995 and 1996. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On December 31, 1995, 10 million warrants were outstanding with strike prices ranging between $82 and $91 per share. The warrants expire at various dates between the fourth quarter of 1996 and the fourth quarter of 1997, are exercisable only at maturity, and are settleable in cash at Microsoft's option. The maximum potential repurchase obligation as of December 31, 1995, $560 million, has been reclassified from stockholders' equity to put warrants.

A subsidiary of Tele-Communications, Inc. (TCI) owns a 20% minority interest in The Microsoft Network, LLC. TCI contributed $125 million of TCI common stock, and Microsoft contributed the business assets of its online service, The Microsoft Network, which began operation in August 1995.

During December 1995, Microsoft and NBC announced the creation of two joint ventures: a 24-hour cable news and information channel and an interactive online news service distributed on The Microsoft Network. Both of these services will be offered worldwide and integrated with the NBC Television Network. Microsoft has agreed to pay $220 million over five years for its interest in the cable venture.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuit of Microsoft's long-term strategies. Additionally, Microsoft shareholders have authorized the issuance of up to 100 million shares of preferred stock, which may be used by Microsoft for any proper corporate purpose.

Microsoft has not paid cash dividends on its common stock.

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See Notes to Financial Statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

11. Computation of Earnings Per Share
27. Financial Data Schedule

(B) Reports on Form 8-K

No reports on Form 8-K were filed by Microsoft during the quarter ended December 31, 1995.

ITEMS 2, 3, 4 AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

- ---

Signature

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

Microsoft Corporation

Date: February 13, 1996 By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting Officer
and Duly Authorized Officer)

- ---

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EXHIBIT 11.

MICROSOFT CORPORATION
Computation of Earnings Per Share
(In millions, except earnings per share) (Unaudited)

- ---

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Three Months

<S>	December 1994 <C>	<
Weighted average number of common shares outstanding	581	
Common stock equivalents from outstanding stock options	44	
Average common and common stock equivalents outstanding	625	
Net income	$ 373	$
Earnings per share (1)	$0.60	$

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(1) Fully diluted earnings per share have not been presented because the effects are not material.

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                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 DE
                FISCAL YEAR END:                        0630

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                STREET 2:               NORTH OFFICE 2211
                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         2068828080

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                              UNITED STATES
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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 1995

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

FOR THE TRANSITION PERIOD FROM _____ TO ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)
ONE MICROSOFT WAY, REDMOND, WASHINGTON (Address of principal executive office)	98052-6399 (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of October 31, 1995 was 592,305,901.

==

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 1995

INDEX

PART I. FINANCIAL INFORMATION

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Item 1. Financial Statements

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<PAGE> 3

Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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	Three Months Ended September 30	
	1994	1995
<S>	<C>	<C>
Net revenues	$1,247	$2,016
Costs and expenses:		
Cost of revenues	186	322
Research and development	178	302
Sales and marketing	395	621
General and administrative	51	63
Total costs and expenses	810	1,308

Operating income	437	708
Interest income - net	36	66
Other expenses	(2)	(4)
Income before income taxes	471	770
Provision for income taxes	155	271
Net income	$ 316	$ 499
Earnings per share	$ 0.51	$ 0.78
Weighted average shares outstanding	622	640

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See accompanying notes.

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

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<S>	June 30 1995 <C>	Sept. 30 1995 (1) <C>
ASSETS		
Current assets:		
Cash and short-term investments	$4,750	$5,064
Accounts receivable - net	581	1,052
Inventories	88	125
Other	201	176
Total current assets	5,620	6,417
Property, plant, and equipment - net	1,192	1,265
Other assets	398	478
Total assets	$7,210	$8,160
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 563	$ 621
Accrued compensation	130	103
Income taxes payable	410	522
Unearned revenues	54	307
Other	190	206
Total current liabilities	1,347	1,759
Minority interest	125	125

Put warrants	405	537
Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 2,000; shares outstanding 588 and 590	2,005	2,172
Retained earnings	3,328	3,567
Total stockholders' equity	5,333	5,739
Total liabilities and stockholders' equity	$7,210	$8,160

</TABLE>

(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

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	Three Months Ended September 30 1994	1995
<S>	<C>	<C>
CASH FLOWS FROM OPERATIONS		
Net income	$ 316	$ 499
Depreciation and amortization	67	69
Current liabilities	96	410
Accounts receivable	(59)	(467)
Inventories	(7)	(37)
Other current assets	(23)	26
Net cash from operations	390	500
CASH FLOWS FROM FINANCING		
Common stock issued	81	98
Common stock repurchased	(242)	(129)
Stock option income tax benefits	39	58
Net cash from financing	(122)	27

CASH FLOWS USED FOR INVESTMENTS

Additions to property, plant, and equipment	(67)	(116)
Other assets	(35)	(98)
Short-term investments	(313)	(370)
Net cash used for investments	(415)	(584)
Net change in cash and equivalents	(147)	(57)
Effect of exchange rates on cash and equivalents	(4)	1
Cash and equivalents, beginning of period	1,477	1,962
Cash and equivalents, end of period	1,326	1,906
Short-term investments, end of period	2,450	3,158
Cash and short-term investments, end of period	$3,776	$5,064

</TABLE>

See accompanying notes.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1995 Annual Report on Form 10-K.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

CONTINGENCIES

The Antitrust Division of the U.S. Department of Justice has stated that it is conducting an investigation concerning Microsoft's inclusion of client-access software for The Microsoft Network in Microsoft Windows(R) 95. Although there is no assurance that this matter will be resolved favorably and that Microsoft's future financial statements will not be adversely affected, Microsoft currently believes that resolution of this matter will not have a material adverse effect on its financial condition or results of operations.

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

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and development tools. Microsoft also offers an online service, sells personal computer books and input devices, and is engaged in the research and potential development of advanced technology software products.

NET REVENUES

Net revenues for the first quarter of fiscal 1996 increased 62% over net revenues for the first quarter of fiscal 1995.

Software license volume (as opposed to price) increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, e.g., Microsoft Office, are less than the sum of the prices for the individual programs included in these products when such programs are licensed separately.

PRODUCT GROUPS

Platforms product group revenues were $1.04 billion in the first quarter of fiscal 1996, compared to $509 million recorded in the same period of fiscal 1995, an increase of 104%. During the quarter, the Company released Microsoft Windows 95, its new personal operating system, which experienced strong demand by users of existing PCs. To prevent stock outs in the retail channel, certain distributors and resellers over-ordered Windows 95 product prior to its formal launch on August 24, 1995 and began returning excess inventory prior to the end of the quarter. The Company provided for management's estimate of additional product that will be returned to Microsoft subsequent to September 30, 1995. The Company's earned retail revenues of Windows 95 were $260 million. Additionally, unearned revenues on the accompanying balance sheet include $130 million attributable to future telephone support and unspecified enhancements to Windows 95 which will be recognized ratably over the product's life cycle as it is earned. The Company also experienced continued revenue growth in Microsoft MS-DOS(R), Microsoft Windows 3.1, and Microsoft Windows for Workgroups 3.11 operating systems, primarily through the OEM channel. (Windows 3.1 and Windows for Workgroups 3.11 are hereafter referred to collectively as "Windows 3.x."). Revenues from business systems products (principally the Windows NT(TM) operating system and server applications in the Microsoft's BackOffice(TM) family of products) also increased, due to greater corporate demand for Windows NT Workstation and Windows NT Server.

Applications and content product group revenues were $977 million in the first quarter of 1996, increasing 32% from $738 million in the first quarter of 1995. Increases in applications and content revenues were led by strong sales of 16-bit and 32-bit versions of Microsoft Office. Microsoft Office Standard includes the Microsoft Word word processor, the Microsoft Excel spreadsheet, and the Microsoft PowerPoint(R) presentation graphics program. The Microsoft Office for Windows 95 (32-bit) version also includes the Microsoft Schedule+ calendar and scheduling program. Microsoft Office Professional includes all of the above plus the Microsoft Access(R) database management program. The accompanying balance sheet also includes $120 million of unearned revenues in connection with the sale of 16-bit versions of desktop productivity programs that will not be earned and recognized as revenues until related coupons for Windows 95 upgrades have been fulfilled.

Microsoft Home, a broad range of consumer products, continued to show growth. New titles and new versions of existing titles both contributed to the growth, as did increased sales of the Microsoft Mouse and the Natural Keyboard(TM).

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM revenues (primarily personal operating systems) grew 57% to $548 million from the $348 million recorded in the comparable quarter of the prior year. MS-DOS and Microsoft Windows 3.x continued to be preinstalled on many PCs sold by OEMs. Certain OEMs began installing Windows 95 on new PCs during the quarter ended September 30, 1995. Higher levels of PC shipments led to increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $745 million in the first quarter of 1996 compared to $423 million in 1995. The growth rate of 76% reflected strong sales of Windows 95 and Microsoft Office.

Revenues in Europe were $426 million in the first quarter of 1996 compared to $289 million the prior year and benefited greatly by the release of several different localized versions of Windows 95 and 32-bit desktop programs. Recently, growth rates have been lower in Europe than in other geographic areas due to general economic slowness, higher existing market shares, and a more dramatic shift to corporate licensing programs.

Other International channel revenues increased 59% to $297 million in the first quarter of 1996 from $187 million in the first quarter of 1995. Growth rates continue to be strong due to customer acceptance of newly localized products, particularly in Japan, and early entrance into emerging markets.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the first quarter of the prior year been in effect during the first quarter of 1996, translated revenues in Europe would have been $55 million lower and translated Other International revenues would have been $14 million lower. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues.

COSTS AND EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 16.0% in the first quarter of 1996, compared to 14.9% in the first quarter of 1995. The increase is principally attributable to a shift in sales mix due to high shipments of retail upgrade versions of Windows 95 and Office for Windows 95. The increase in the cost of revenues percentage was somewhat offset by the increased mix of CD-ROM media, which carry lower costs of goods sold than floppy disks.

Research and development expenses increased 70% to $302 million, or 15.0% of revenues in the first quarter of 1996 from $178 million, or 14.3% of revenues in the corresponding quarter of 1995. The increase in research and development expenses resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 57% to $621 million from $395 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 30.8% and 31.6% in the respective first quarters of 1996 and 1995. The increase in sales and marketing expenses was impacted by costs related to the August 24th launch of Windows 95 and increased product support costs.

General and administrative expenses were 3.1% of revenues in the first quarter of 1996 and 4.1% of revenues in the first quarter of 1995. The decrease was due to a number of factors, including lower legal costs.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with higher interest rates.

The effective income tax rate was 35% and 33% in the first quarters of 1996 and 1995 with the increase due primarily to changes in the U.S. tax law.

NET INCOME

Net income for the first quarter of 1996 was $499 million. Net income as a percentage of revenues was 24.8% in the first quarter of 1996, compared with 25.3% in the first quarter of 1995. The decrease in net income as a percentage of revenues was the result of higher cost of revenues and research and development offset by lower sales and marketing and general and administrative and higher interest income percentages.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $5.1 billion at September 30, 1995. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. Microsoft's portfolio is invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management. Stockholders' equity at September 30, 1995 exceeded $5.7 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, investments will continue in research and development in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff.

The exercise of stock options by employees provides additional cash. These proceeds have funded Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1996.

To enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties during 1995 and 1996. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On September 30, 1995, 10 million warrants were outstanding with strike prices ranging between $80 and $86 per share. The warrants expire at various dates between November 1995 and November 1996, are exercisable only at maturity, and are settleable in cash at Microsoft's option. The maximum potential repurchase obligation of $537 million has been reclassified from stockholders' equity to put warrants as of September 30, 1995.

A subsidiary of Tele-Communications, Inc. (TCI) owns a 20% minority interest in The Microsoft Network, LLC. TCI contributed $125 million of TCI common stock, and Microsoft contributed the business assets of its online service, The Microsoft Network, which began operation on August 24, 1995.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuit of Microsoft's long-term strategies. Additionally, Microsoft shareholders have authorized the issuance of up to 100 million shares of preferred stock, which may be used by Microsoft for any proper corporate purpose.

Microsoft has not paid cash dividends on its common stock.

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See Notes to Financial Statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At the Annual Meeting of Shareholders held on October 27, 1995, the following proposals were adopted by the margins indicated:

1. To elect a Board of Directors to hold office until the next annual meeting of shareholders and until their successors are elected and qualified.

<TABLE>
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	Number of Shares	
	For	Withheld
<S>	<C>	<C>
William H. Gates	530,061,421	1,008,795
Paul G. Allen	530,073,699	996,517
Richard A. Hackborn	530,026,542	1,043,674
David F. Marquardt	530,071,808	998,408
Robert D. O'Brien	529,957,839	1,112,377
William G. Reed, Jr.	530,020,438	1,049,778
Jon A. Shirley	530,076,764	993,452

</TABLE>

2. To ratify the selection of Deloitte & Touche LLP as the independent public auditors of the Company for the current fiscal year.

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<S>	<C>
For	527,183,535
Against	2,857,849
Abstain	1,028,832

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ITEM 5. OTHER INFORMATION

PROPOSALS OF SHAREHOLDERS FOR 1996 ANNUAL MEETING OF SHAREHOLDERS

Proposals of shareholders intended to be presented at the Annual Meeting of Shareholders on October 25, 1996 must be received by the Company no later than May 29, 1996 to be included in the Company's Proxy Statement and form of proxy related to that meeting.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) EXHIBITS

11. Computation of Earnings Per Share is on page 10.
27. Financial Data Schedule.

(B) REPORTS ON FORM 8-K

No reports on Form 8-K were filed by Microsoft during the quarter ended September 30, 1995.

ITEMS 2 AND 3 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

Signature

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

Microsoft Corporation

Date: November 14, 1995

By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and
Accounting Officer and Duly
Authorized Officer)

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EXHIBIT 11.

MICROSOFT CORPORATION
COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share) (Unaudited)

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	Three months ended September 30	
	1994	1995
<S>	<C>	<C>
Weighted average number of common shares outstanding	581	589
Common stock equivalents from outstanding stock options	41	51
Average common and common stock equivalents outstanding	622	640
Net income	$ 316	$ 499
Earnings per share(1)	$0.51	$0.78

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(1) Fully diluted earnings per share have not been presented because the effects are not material.

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FILED AS OF DATE:               19950512
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                CENTRAL INDEX KEY:                      0000789019
                STANDARD INDUSTRIAL CLASSIFICATION:     SERVICES-PREPACKAGED SOFTWAR
                IRS NUMBER:                             911144442
                STATE OF INCORPORATION:                 DE
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                STREET 2:               NORTH OFFICE 2211
                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         2068828080

        MAIL ADDRESS:
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 1995

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

FOR THE TRANSITION PERIOD FROM _____ TO ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

<TABLE>

<S>	<C>
WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)

</TABLE>

ONE MICROSOFT WAY, REDMOND, WASHINGTON (Address of principal executive office)	98052-6399 (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of April 30, 1995 was 585,640,217.

==

<PAGE> 2

MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 1995

INDEX

<PAGE> 3

Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share) (Unaudited)

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	Three Months Ended March 31		Nine Months E March 31	
	1994	1995	1994	
<S>	<C>	<C>	<C>	<
Net revenues	$1,244	$1,587	$3,356	
Costs and expenses:				
Cost of revenues	208	235	552	
Research and development	156	219	440	
Sales and marketing	359	516	1,008	
General and administrative	41	68	118	

Total costs and expenses	764	1,038	2,118
Operating income	480	549	1,238
Interest income-net	26	48	74
Litigation charge	(120)	0	(120)
Other expenses	(4)	(5)	(10)
Income before income taxes	382	592	1,182
Provision for income taxes	126	196	398
Net income	$ 256	$ 396	$ 784
Earnings per share(1)	$ 0.42	$ 0.63	$ 1.29
Weighted average shares outstanding(1)	608	626	607

</TABLE>

(1) Share and per share amounts for the three and nine months ended March 31, 1994 have been restated to reflect a two-for-one stock split in May 1994.

See accompanying notes.

<PAGE> 4

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

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<S>	June 30 1994 <C>	March 31 1995(1) <C>
ASSETS		
Current assets:		
Cash and short-term investments	$3,614	$4,465
Accounts receivable - net	475	580
Inventories	102	87
Other	121	155
Total current assets	4,312	5,287
Property, plant, and equipment - net	930	1,027
Other assets	121	278
Total assets	$5,363	$6,592
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 324	$ 524
Accrued compensation	96	89
Income taxes payable	305	385
Other	188	187

Total current liabilities	913	1,185
Minority interest	-	125
Put warrants	-	352
Stockholders' equity:		
Common stock and paid-in-capital -- shares authorized 2,000; shares outstanding 581 and 584	1,500	1,862
Retained earnings	2,950	3,068
Total stockholders' equity	4,450	4,930
Total liabilities and stockholders' equity	$5,363	$6,592

</TABLE>

(1) Unaudited

See accompanying notes.

<PAGE> 5

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

<TABLE>
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	Nine Months Ended March 31	
	1994	1995
<S>	<C>	<C>
CASH FLOWS FROM OPERATIONS		
Net income	$ 784	$ 1,085
Depreciation and amortization	161	203
Current liabilities	356	237
Accounts receivable	(187)	(40)
Inventories	(5)	17
Other current assets	(21)	(24)
Net cash from operations	1,088	1,478
CASH FLOWS FROM FINANCING		
Common stock issued	193	259
Common stock repurchased	(311)	(664)
Stock option income tax benefits	109	123
Net cash from financing	(9)	(282)
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant and equipment	(191)	(272)

Other assets	(32)	(91)
Short-term investments	(714)	(1,123)
Net cash used for investments	(937)	(1,486)
Net change in cash and equivalents	142	(290)
Effect of exchange rates on cash and equivalents	(3)	18
Cash and equivalents, beginning of period	1,013	1,477
Cash and equivalents, end of period	1,152	1,205
Short-term investments, end of period	1,991	3,260
Cash and short-term investments, end of period	$3,143	$ 4,465

</TABLE>

See accompanying notes.

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<PAGE> 6

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1994 Annual Report.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

STOCK SPLIT

Effective May 6, 1994, outstanding shares of common stock were split two-for-one. All fiscal 1994 share and per share amounts have been restated for the stock split.

PUT WARRANTS

In connection with Microsoft's stock repurchase program, put warrants were sold to independent third parties during the first three quarters of fiscal 1995. The put warrants entitle the holders to sell shares of Microsoft common stock to Microsoft at specified prices. On March 31, 1995, 8.0 million warrants were outstanding, with strike prices ranging from $49.49 to $60.47 per share. The warrants mature on various dates between July 1995 and August 1996, are exercisable only at maturity, and may be settled in cash at Microsoft's option. The maximum potential repurchase obligation of $352 million has been reclassified from stockholders' equity to put warrants as of March 31, 1995. There was no impact on earnings per share for the first three quarters of fiscal 1995.

AGREEMENT TO MERGE

On October 13, 1994, Microsoft announced its agreement to merge with Intuit Inc. (Intuit), a leading developer of personal finance, tax preparation, and small business accounting software. Under the terms of the reorganization agreement, Microsoft will exchange approximately 27 million shares of its common stock for all of the outstanding shares of Intuit. The transaction is anticipated to be accounted for as a pooling of interests. The agreement has been approved by the shareholders of Intuit and is subject to satisfaction of regulatory requirements. See Contingencies note.

MICROSOFT ONLINE SERVICES PARTNERSHIP

During November 1994, a wholly owned subsidiary of Tele-Communications, Inc. (TCI) purchased a 20% minority interest in the newly formed Microsoft Online Services Partnership. TCI contributed $125 million of TCI common stock and Microsoft contributed the business assets of its online service, which is in development. Microsoft owns 80% of the entity, whose operations have not been material to the financial results of Microsoft.

CONTINGENCIES

On July 15, 1994, Microsoft and the U.S. Department of Justice (DOJ) entered into a consent decree resolving the DOJ's non-public investigation of Microsoft. In the consent decree, which involves no admission of wrongdoing on Microsoft's part, Microsoft agreed to make certain changes in its OEM licensing practices. Microsoft also agreed to employ a uniform duration in its nondisclosure agreements for precommercial versions of certain operating system products, and clarified the rights and responsibilities of those signing such nondisclosure agreements. To become final, the consent decree must be approved by the U.S. District Court for the District of Columbia. On February 14, 1995, Judge Stanley Sporkin issued an order denying entry of the consent decree, citing a lack of information sufficient to determine if the consent decree is in the public interest. That order was appealed by the DOJ and Microsoft. Oral argument on the appeal was heard by the United States Court of Appeals for the District of Columbia on April 24, 1995. The appellate court may render its decision at any time.

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On April 27, 1995, the DOJ filed a civil action in U.S. District Court in the Northern District of California challenging the proposed merger of Microsoft and Intuit. The suit alleges that the proposed merger would result in a substantial reduction in competition among personal finance software products and services, including PC-based home banking. To expedite resolution of the matter, the DOJ's motion for a preliminary injunction has been consolidated with the trial on the merits, which is scheduled to begin on June 26, 1995.

Microsoft and Intuit have agreed not to complete the proposed merger prior to completion of the trial and a ruling on the DOJ's motion for an injunction pending appeal if that motion is made within 72 hours following a decision at trial in favor of Microsoft and Intuit.

Although there is no assurance that these matters will be resolved favorably and that Microsoft's future financial statements will not be adversely affected, Microsoft currently believes that their resolution will not have material adverse effects on its financial condition or results of operations.

On April 12, 1995, Microsoft and Wang Laboratories, Inc. (Wang) announced a broad multi-year technical, service, and marketing alliance designed to bring improved document imaging and workflow management capabilities to users of the Microsoft(R) Windows(R) operating system. Under the alliance, Wang's desktop imaging and object controls will be incorporated as standard features in future releases of Windows 95 and Windows NT(TM) and the image controls will be included in the Visual Basic(R) development tool. As part of this agreement, Microsoft will invest in Wang through the purchase of $90 million face amount of 4.5% convertible preferred stock due in 2003 for $84 million. This preferred stock is convertible into the common stock of Wang at $23 per share. Microsoft's investment is subject to a Hart Scott Rodino Act review. In addition, Microsoft will receive a license to Wang's portfolio of software and software-related patents, which will resolve the outstanding litigation between the two companies.

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

RESULTS OF OPERATIONS

OVERVIEW

Microsoft Corporation develops, manufactures, markets, licenses, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and software development tools. Microsoft also markets personal computer books and hardware; and is engaged in the research and potential development of advanced technology software products.

REVENUES

Revenues for the third quarter of fiscal 1995 increased 28% over revenues for the third quarter of fiscal 1994, while revenues for the first three quarters of 1995 grew 29% compared to the same period of prior year.

Software license volume (as opposed to price) increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, in part due to shifts in sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications programs to the Microsoft Office integrated suite. Average revenue per license from OEM licenses and corporate license programs (such as Microsoft Select) is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products, and the price of Microsoft Office is less than the sum of the prices for the individual application programs included in this product when sold separately.

PRODUCT GROUPS

Systems product group revenues are primarily from licenses of personal operating systems and business systems with client-server architectures. Systems revenues were $538 million in the third quarter of 1995, compared to $393 million recorded in the same period of 1994, an increase of 37%. Systems revenues were $1.50 billion in the first three quarters of 1995 compared to $1.12 billion in the first three quarters of 1994. Revenues generated by both Microsoft MS-DOS(R) and Microsoft Windows operating systems increased from the prior year, primarily through the original equipment manufacturer channel. During 1995, more than 80% of Windows units were licensed through the OEM channel. Revenues from Microsoft's business system division's BackOffice line of products also increased, due to greater corporate demand for Windows NT Server and Windows NT Workstation.

Applications product group revenues include primarily licenses of desktop productivity, consumer, and developer programs. Applications revenues were $966 million in the third quarter of 1995, increasing 21% from $798 million in the third quarter of 1994. For the first three quarters of 1995, applications revenues were $2.61 billion, compared to $2.08 billion in 1994. Increases in applications revenues were led by sales of Microsoft Office. Microsoft Office Standard includes Microsoft Excel, Microsoft Word, a Microsoft Mail license, and the Microsoft PowerPoint(R) presentation graphics program. Microsoft Office Professional for Windows includes all of the above plus the Microsoft Access database management program.

Microsoft Home, a broad range of products in Microsoft's consumer applications group, continued to show strong growth. New titles and new versions of existing titles both contributed to the growth.

The hardware product group's principal products are the Microsoft Mouse and the Natural Keyboard(TM). Hardware revenues were $83 million and $53 million in the third quarters of 1995 and 1994. On a year to date basis, hardware revenues increased 31% to $206 million from $157 million.

SALES CHANNELS

Microsoft has four major channels of distribution: OEM; U.S. and Canada; Europe; and Other International. OEM channel revenues are license fees from original equipment manufacturers. Sales in the retail channels are primarily to distributors and resellers.

Microsoft Select was introduced in 1993 and continues to grow in popularity. Select is a retail channel corporate license program under which large accounts download a contracted number of copies of specified software products. Average revenue per license under Select is lower than average revenue per retail copy of the same product shipped through the retail channels, reflecting lower costs of distribution.

OEM revenues (primarily personal operating systems) grew 40% to $451 million from the $323 million recorded in the comparable quarter of the prior year. In the first three quarters of 1995, OEM revenues were $1.18 billion, up 40% from $846 million in the first three quarters of 1994. MS-DOS continues to be preinstalled on many PCs sold by original equipment manufacturers. In addition, many major OEMs preinstall the Microsoft Windows operating system on PCs. Higher levels of PC shipments have led to increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $481 million in the third quarter of 1995 compared to $381 million in 1994. On a year to date basis, revenues increased 23%, to $1.40 billion in 1995 from $1.13 billion in 1994.

- ---

Revenues in Europe were $419 million in the third quarter of 1995 compared to $391 million the prior year. European revenues for the first three quarters of 1995 were $1.11 billion, compared to $989 in 1994. Rates of growth for the European channel have been lower than other retail channels of distribution due to general economic slowness and a more dramatic shift to corporate licensing in Europe. Additionally, the latest version of Microsoft Office for Windows was introduced in Europe during the comparable quarter of the prior year.

Other International channel revenues showed strong growth, increasing 58% to $236 million in the third quarter of 1995 from $149 million in the third quarter of 1994. Revenues increased 62% to $630 million for the first three quarters of 1995, compared to $389 million the prior year. Growth rates continue to be strong due to customer acceptance of newly localized products, particularly in Japan, and early entrance into emerging markets.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the third quarter of the prior year been in effect during the third quarter of 1995, translated revenues in Europe would have been $41 million lower and translated Other International revenues would have been $15 million lower. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues.

COSTS AND EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 14.8% in the third quarter of 1995, compared to 16.7% in the third quarter of 1994. Contributing to the decrease were lower disk prices from vendors and a shift to more revenues from OEM and corporate license programs, offset by greater sales of lower-margin Microsoft Office. While license programs carry lower prices per license than retail versions shipped though the retail channels, there is little cost of revenues associated with such programs.

Research and development expenses increased 40% to $219 million, or 13.8% of revenues in the third quarter of 1995 from $156 million, or 12.5% of revenues in the corresponding quarter of 1994. For the first three quarters of 1995, research and development expenses rose 35%. The increases in research and development expenses resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 44% to $516 million from $359 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 32.5% and 28.9% in the respective third quarters of 1995 and 1994 and 32.2% and 30.1% in the respective first three quarters of 1995 and 1994. The increases in sales and marketing expenses were due to increased personnel related expenses, product support costs, Microsoft brand advertising, and marketing costs.

General and administrative expenses were 4.3% of revenues in the third quarter of 1995 and 3.3% of revenues in the third quarter of 1994. Increases were due to higher legal costs and growth in the systems and people necessary to support overall increases in the scope of Microsoft's operations.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with higher interest rates. In the third quarter of 1994, Microsoft recorded a $120 million charge to reflect the estimated impact of a jury verdict in the Stac Electronics patent litigation and related expenses. In June 1994, Microsoft reached an agreement with Stac to settle the litigation and adjusted its estimate accordingly, resulting in a credit of $30 million in the fourth quarter and a net pretax charge of $90 million for fiscal 1994.

The effective income tax rate was 33% in the third quarters of both 1995 and 1994.

NET INCOME

Net income for the third quarter of 1995 was $396 million. Net income as a percentage of revenues was 25.0% in the third quarter of 1995, compared with 20.6% in the third quarter of 1994 (27.0% excluding the litigation charge). The decrease was the result of higher levels of operating expenses offset by the lower cost of revenues and higher interest income percentages.

- --

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled $4.47 billion at March 31, 1995. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are liquid and primarily investment grade. The portfolio, while invested predominantly in U.S. dollar denominated securities, also includes foreign currency positions in anticipation of local currency funding needs. Microsoft's portfolio is invested in short-term securities to minimize interest rate risk and to facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has $70 million of standby multicurrency lines of credit available. These lines support foreign currency hedging and international cash management. Stockholders' equity at March 31, 1995 exceeded $4.9 billion.

Cash generated from operations has been sufficient to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, research and development investments will continue in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology or to fund strategic ventures. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development; sales and marketing; product support; and administrative staff.

The exercise of stock options by employees provides additional cash. These proceeds have funded Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1995. Additionally, Microsoft enhanced its stock repurchase program by selling put warrants during the first three quarters of 1995. See Notes to Financial Statements.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet Microsoft's operating requirements for the next 12 months. Microsoft's cash and short-term investments are also managed so as to be available for such other strategic investment opportunities or other potential large-scale cash needs as might arise in pursuit of Microsoft's long-term strategies. Additionally, Microsoft shareholders have authorized the issuance of up to 100 million shares of preferred stock, which may be used by Microsoft for any proper corporate purpose.

- --

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See Notes to Financial Statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

11. Computation of Earnings Per Share is on page 11.

27. Financial Data Schedule

(b) Reports on Form 8-K

No reports on Form 8-K were filed by Microsoft during the quarter ended March 31, 1995.

ITEMS 2, 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

- --

Signature

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

Microsoft Corporation

Date: May 12, 1995 By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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EXHIBIT 11.

MICROSOFT CORPORATION

COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share) (Unaudited)

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	Three Months Ended March 31 1994	1995
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Weighted average number of common shares outstanding	571	582
Common stock equivalents from outstanding stock options	37	44
Average common and common stock equivalents outstanding	608	626
Net income	$ 256	$ 396
Earnings per share(1)(2)	$0.42	$0.63

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(1) Share and per share amounts for the three and nine months ended March 31, 1994 have been restated to reflect a two-for-one stock split in May 1994.

(2) Fully diluted earnings per share have not been presented because the effects are not material.

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                CITY:                   REDMOND
                STATE:                  WA
                ZIP:                    98052
                BUSINESS PHONE:         2068828080

        MAIL ADDRESS:
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 1994

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

<TABLE>

<S>	<C>
WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

</TABLE>

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of February 7, 1995 was 581,228,389.

==

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED DECEMBER 31, 1994

INDEX

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PART I. FINANCIAL INFORMATION

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

Income Statements
(In millions, except earnings per share)(Unaudited)
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	Three Months Ended December 31		Six Months Ended December 31	
	1993	1994	1993	1994
<S>	<C>	<C>	<C>	<C>
Net revenues	$1,129	$1,482	$2,112	$2,729
Costs and expenses:				
Cost of revenues	185	222	344	408
Research and development	150	199	284	377
Sales and marketing	337	479	649	874
General and administrative	42	62	77	113
Total costs and expenses	714	962	1,354	1,772

Operating income	415	520	758	957
Interest income - net	25	42	48	78
Other expenses	(2)	(5)	(6)	(7
Income before income taxes	438	557	800	1,028
Provision for income taxes	149	184	272	339
Net income	$ 289	$ 373	$ 528	$ 689
Earnings per share(1)	$ 0.48	$ 0.60	$ 0.87	$ 1.10
Weighted average shares outstanding(1)	608	625	607	624

</TABLE>

(1) Share and per share amounts for the three and six months ended December 31, 1993 have been restated to reflect a two-for-one stock split in May 1994.

See accompanying notes.

MICROSOFT CORPORATION

Balance Sheets
(In millions)

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<S>	June 30 1994 <C>	Dec. 31 1994(1) <C>
ASSETS		
Current assets:		
Cash and short-term investments	$3,614	$3,839
Accounts receivable - net	475	591
Inventories	102	117
Other	121	149
Total current assets	4,312	4,696
Property, plant, and equipment - net	930	977
Other assets	121	288
Total assets	$5,363	$5,961
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 324	$ 431
Accrued compensation	96	110
Income taxes payable	305	364
Other	188	191

Total current liabilties	913	1,096
Minority interest	--	125
Put warrants	--	297
Stockholders' equity:		
Common stock and paid-in capital-- shares authorized 2,000; shares outstanding 581	1,500	1,699
Retained earnings	2,950	2,744
Total stockholders' equity	4,450	4,443
Total liabilities and stockholders' equity	$5,363	$5,961

</TABLE>
(1) Unaudited

See accompanying notes.

<PAGE> 5

MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

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	Six Months Ended December 31	
	1993	1994
<S>	<C>	<C>
CASH FLOWS FROM OPERATIONS		
Net income	$ 528	$ 689
Depreciation and amortization	88	133
Current liabilities	187	194
Accounts receivable	(130)	(134)
Inventories	(5)	(17)
Other current assets	(3)	(30)
Net cash from operations	665	835
CASH FLOWS FROM FINANCING		
Common stock issued	90	140

Common stock repurchased	(164)	(560)
Stock option income tax benefits	64	78
Net cash from financing	(10)	(342)
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(122)	(170)
Other assets	(19)	(90)
Short-term investments	(568)	(785)
Net cash used for investments	(709)	(1,045)
Net change in cash and equivalents	(54)	(552)
Effect of exchange rates on cash and equivalents	(8)	(8)
Cash and equivalents, beginning of period	1,013	1,477
Cash and equivalents, end of period	951	917
Short-term investments, end of period	1,845	2,922
Cash and short-term investments, end of period	$2,796	$3,839

</TABLE>

See accompanying notes.

3

<PAGE> 6

MICROSOFT CORPORATION

Notes to Financial Statements
(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1994 Annual Report.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

STOCK SPLIT

Effective May 6, 1994, outstanding shares of common stock were split two-for-one. All fiscal 1994 share and per share amounts have been restated for the stock split.

PUT WARRANTS

In connection with the Company's stock repurchase program, put warrants were sold to independent third parties during the first two quarters of fiscal 1995. The put warrants entitle the holders to sell shares of Microsoft common stock to the Company at specified prices. On December 31, 1994, 6.4 million warrants were outstanding, with prices ranging from $49.49 to $59.04 per share. The warrants expire at various dates between February 1995 and May 1996, are exercisable only at maturity, and are settleable in cash at the Company's option. The maximum potential repurchase obligation of $297 million has been reclassified from stockholders' equity to put warrants as of December 31, 1994. There was no impact on earnings per share for the first two quarters of fiscal 1995.

AGREEMENT TO MERGE

On October 13, 1994, Microsoft announced its agreement to merge with Intuit Inc., a leading developer of personal finance, tax preparation, and small business accounting software. Under the terms of the reorganization agreement, Microsoft will exchange approximately 27 million shares of its common stock for all of the outstanding shares of Intuit. The transaction is anticipated to be accounted for as a pooling of interests. The agreement is subject to approval by the shareholders of Intuit and satisfaction of regulatory requirements.

MICROSOFT ONLINE SERVICES PARTNERSHIP

During November 1994, a wholly owned subsidiary of Tele-Communications, Inc. (TCI) purchased a 20% minority interest in the newly formed Microsoft Online Services Partnership. TCI contributed $125 million of TCI common stock and Microsoft contributed the business assets of its online service, which is in development. Microsoft owns 80% of the entity, whose operations have not been material to the financial results of Microsoft.

CONTINGENCIES

On July 15, 1994, Microsoft entered into an undertaking with the Commission of the European Communities ("European Commission") resolving a complaint submitted by Novell, Inc. claiming that certain practices of Microsoft violated Articles 85 and 86 of the Treaty of Rome. The undertaking is effective immediately, requires no further approval, and closes the investigation of Novell's complaint by the European Commission's Directorate-General for Competition. In the undertaking, which invloves no admission of wrongdoing on Microsoft's part, Microsoft agreed to make certain changes in its OEM licensing practices. Microsoft also agreed to employ a uniform duration in its nondisclosure agreements for precommerical versions of cetain operating system products, and clarified the rights and responsibilities of those signing such nondisclousre agreements. The European Commission has the right to monitor Microsoft's compliance during the 6-1/2 year term of the settlement agreement.

On July 15, 1994, Microsoft and the U.S. Department of Justice ("DOJ") entered into a consent decree resolving the DOJ's non-public investigation of Microsoft. The consent decree contained the same provisions as the undertaking between Microsoft and the European Commission. To become final, the consent decree must be approved by the U.S. District Court for the District of Columbia. The Court has held three status conferences as well as a hearing on January 20, 1995. The Court is currently considering submissions by the DOJ, Microsoft, and a third party that has requested the opportunity to intervene.

Microsoft does not expect the undertaking with the European Commission or the consent decree with the DOJ to affect its OEM revenues materially.

On March 17, 1988, Apple Computer, Inc. (Apple) brought suit against Microsoft and Hewlett-Packard Company for alleged copyright infringement in the U.S. District Court, Northern District of California. The complaint included allegations that the visual displays of Microsoft Windows version 2.03 (and Windows version 3.0, which was added to the complaint later) infringed Apple's copyrights and exceeded the scope of a 1985 Settlement Agreement between Microsoft and Apple. The complaint sought to enjoin Microsoft from marketing Microsoft Windows versions 2.03 and 3.0 or any derivative work based on Windows 2.03 or 3.0 and from otherwise infringing Apple's copyrights and sought damages resulting from the alleged infringement.

Microsoft answered the complaint, raising affirmative defenses including its claim that the 1985 Settlement Agreement entitled it to use the visual displays in question, denying Apple's allegations that the visual displays in Microsoft Windows version 2.03 and 3.0 infringe any protectible right of Apple, and asserting counterclaims.

On August 24, 1993, the U.S. District Court entered final judgment dismissing all of Apple's claims. Apple appealed a number of the U.S. District Court's decisions in the case to the Ninth Circuit Court of Appeals, which on September 19, 1994 issued a decision affirming the rulings of the U.S. District Court. On December 19, 1994, Apple filed a petition with the U.S. Supreme Court to grant review of the Ninth Circuit Court's decision.

On July 30, 1993 Wang Laboratories, Inc. (Wang) filed suit in U.S. District Court for the District of Massachusetts against Microsoft and Watermark Software, Inc., alleging that unspecified Microsoft products infringe two patents owned by Wang concerning object management and the handling of compound documents (United States Patents 5,206,951 issued on April 27, 1993, and 5,129,061 issued on July 7, 1992, respectively). The suit also alleges that Microsoft induced and continues to induce others, including Watermark Software, Inc., to infringe the Wang patents. Microsoft's OLE technology appears to be the subject of Wang's allegations against Microsoft. The complaint seeks a determination that Microsoft's alleged infringement is willful, an award of treble damages, an award of attorneys' fees, and to preliminarily and permanently enjoin Microsoft from continuing the alleged infringement. In its answer Microsoft denied that any of its products infringe the Wang patents and asked the Court for a declaratory judgment that those patents are invalid and unenforceable for failing to meet patent law requirements. The suit is currently in the early stages of discovery.

Although there is no assurance that these matters will be resolved favorably and that Microsoft's future financial statements will not be adversely affected, Microsoft currently believes that resolution of the undertaking, consent decree, and the lawsuits will not have material adverse effects on its financial condition or results of operations.

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

RESULTS OF OPERATIONS

OVERVIEW

Microsoft Corporation develops, manufactures, markets, licenses, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and software development tools. Microsoft also markets personal computer books and hardware; and is engaged in the research and potential development of advanced technology software products.

REVENUES

Revenues for the second quarter of fiscal 1995 increased 31% over revenues for the second quarter of fiscal 1994, while revenues for the first half of 1995 grew 29% compared to the prior year.

Software license volume (as opposed to price) increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications programs to the Microsoft(#) Office integrated suite. Average revenue per license from OEM licenses and corporate license programs (such as Microsoft Select) is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. The price of Microsoft Office is less than the sum of the prices for the individual application programs included in this product when such programs are sold separately.

PRODUCT GROUPS

Systems product group revenues are primarily from licenses of personal operating systems and business systems with client-server architectures. Systems revenues were $519 million in the second quarter of 1995, compared to $369 million recorded in the same period of 1994, an increase of 41%. Systems revenues were $963 million in the first half of 1995 compared to $724 million in the first half of 1994. Revenues generated by both Microsoft MS-DOS(#) and Microsoft Windows(#) operating systems increased from the prior year, primarily through the original equipment manufacturer channel. During the second quarter of 1995, more than 80% of Windows units were licensed through the OEM channel. Revenues from the Company's business system division's BackOffice line of products also increased, due to greater corporate demand for Windows NT(#) Server and Windows NT Workstation.

Applications product group revenues include primarily licenses of desktop productivity, consumer, and developer programs. Applications revenues were $889 million in the second quarter of 1995, increasing 26% from $707 million in the second quarter of 1994. For the first two quarters of 1995, applications revenues were $1.64 billion, compared to $1.28 billion in 1994. Increases in applications revenues were led by sales of Microsoft Office. Microsoft Office Standard includes Microsoft Excel, Microsoft Word, a Microsoft Mail license, and the Microsoft PowerPoint(#) presentation graphics program. Microsoft Office Professional for Windows includes all of the above plus the Microsoft Access(#)

database management program.

Microsoft Home, a broad range of products in the Company's consumer applications group, continued to show strong growth, particularly during the cyclically higher Christmas season. New titles and new versions of existing titles both contributed to the growth.

The hardware product group's principal products are the Microsoft Mouse and BallPoint(#) mouse pointing devices. Hardware revenues were $74 million and $53 million in the second quarters of 1995 and 1994. On a year to date basis, hardware revenues increased 18% to $123 million from $104 million.

SALES CHANNELS

The Company has four major channels of distribution: OEM; U.S. and Canada; Europe; and Other International. OEM channel revenues are license fees from original equipment manufacturers. Sales in the retail channels are primarily to distributors and resellers.

Microsoft Select was introduced in 1993 and continues to grow in popularity. Select is a corporate license program under which large accounts download a contracted number of copies of specified software products. Average revenue per license under Select is lower than average revenue per retail copy of the same product shipped through the retail channels, reflecting lower costs of distribution.

OEM revenues (primarily personal operating systems) grew 44% to $385 million from the $268 million recorded in the comparable quarter of the prior year. In the first half of 1995, OEM revenues were $733 million, up 40% from $523 million in the first half of 1994. MS-DOS continues to be preinstalled on many PCs sold by original equipment manufacturers. In addition, many major OEMs are also preinstalling the Microsoft Windows operating system on PCs. Higher levels of PC shipments have led to increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $491 million in the second quarter of 1995 compared to $423 million in 1994, an increase of 16%. The latest version of Microsoft Office for Windows was introduced in the U.S. during the comparable quarter of the prior year. On a year to date basis, U.S. and Canada channel revenues increased 22%, to $914 million in 1995 from $751 million in 1994.

Revenues in Europe were $399 million in the second quarter of 1995 compared to $324 million the prior year. European revenues for the first two quarters of 1995 were $688 million, compared to $598 in 1994. Rates of growth for the European channel have been lower than other retail channels of distribution due to general economic slowness and a more dramatic shift to corporate licensing in Europe.

Other International channel revenues showed strong growth, increasing to $207 million in the second quarter of 1995 from $114 million in the second quarter of 1994. Revenues increased 64% to $394 million for the first half of 1995, compared to $240 million the prior year. Growth rates continue to be strong due to customer acceptance of newly localized products and early entrance into emerging markets.

The Company's operating results are affected by foreign exchange rates. Since much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues.

COST OF REVENUES, OPERATING EXPENSES, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 15.0% in the second quarter of 1995, compared to 16.4% in the second quarter of 1994. Contributing to the decrease were lower disk prices from vendors and a shift to more revenues from OEM and corporate license programs, offset by greater sales of lower-margin Microsoft Office and upgrade products. While license programs carry lower prices per license than retail versions shipped though the retail channels, there is little cost of revenues associated with such programs.

Research and development expenses increased 33% to $199 million, or 13.4% of revenues in the second quarter of 1995 from $150 million, or 13.3% of revenues in the corresponding quarter of 1994. The increases in research and development expenses in both the second quarter and first half of 1995 resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 42% to $479 million from $337 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 32.3% and 29.9% in the respective second quarters of 1995 and 1994. The increases in sales and marketing expenses in both the second quarter and first half of 1995 were due to increased personnel related expenses, product support costs, Microsoft brand advertising, and marketing costs.

General and administrative expenses were 4.2% of revenues in the second quarter of 1995 and 3.7% of revenues in the second quarter of 1994. Increases in both the second quarter and first half of 1995 were due to higher legal costs and growth in the systems and people necessary to support overall increases in the scope of Microsoft's operations.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with higher interest rates.

The effective income tax rate was 33% in the second quarter and first half of 1995, compared to 34% in the same periods of 1994.

NET INCOME

Net income for the second quarter of 1995 was $373 million. Net income as a percentage of revenues was 25.2% in the second quarter of 1995, compared with 25.6% in the second quarter of 1994. The slight decrease was the result of higher levels of operating expenses offset by the lower cost of revenues and higher interest income percentages.

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FINANCIAL CONDITION

The Company's cash and short-term investment portfolio totaled $3.84 billion at December 31, 1994 and represented 64% of total assets. The portfolio is diversified among security types, industries, and individual issuers. The Company's investments are liquid and primarily investment grade. The portfolio, while invested predominantly in U.S. dollar denominated securities, also includes foreign currency positions in anticipation of local currency funding needs. The Company's portfolio is invested in short-term securities to minimize interest rate risk and to facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt. The Company has available $70 million of standby multicurrency lines of credit. These lines support foreign currency hedging and international cash management. Stockholders' equity at December 31, 1994 exceeded $4 billion.

Cash generated from operations has been sufficient to fund the Company's investment in research and development activities and facilities expansion. As the Company grows, investments will continue in research and development in existing and advanced areas of technology. The Company's cash will be used to acquire technology or to fund strategic ventures. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development; sales and marketing; product support; and administrative staff. On December 31, 1994, commitments related to the construction of new buildings approximated $235 million.

The exercise of stock options by employees provides additional cash. These proceeds have funded the Company's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1995. Additionally, the Company enhanced its stock repurchase program by selling put warrants during the first half of 1995. See Notes to Financial Statements.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet the Company's operating requirements for the next 12 months. The Company's cash and short-term investments are also managed so as to be available for such other strategic investment opportunities or other potential large-scale cash needs as might arise in pursuit of the Company's long-term strategies. Additionally, on Ocotber 28, 1994, Microsoft shareholders authorized the Company to issue up to 100 million shares of preferred stock, which may be used by the Company for any proper corporate purpose.

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

On July 15, 1994, Microsoft and the U. S. Department of Justice (DOJ) entered into a consent decree resolving the DOJ's nonpublic investigation of Microsoft. To become final, the consent decree must be approved by the U.S. District Court for the District of Columbia. The Court has held three status conferences as well as a hearing on January 20, 1995. Under the Tunney Act, which defines the scope of the Court's review of a consent decree, the Court must determine whether the relief provided in the consent decree is adequate to remedy the antitrust violations alleged in the complaint. The Court may either approve or not approve the consent decree, but cannot require Microsoft or the DOJ to alter any of its terms. The Company is also currently involved in litigation with Apple Computer, Inc., and Wang Laboratories, Inc. See Notes to Financial Statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits
11. Computation of Earnings Per Share is on page 11.

(b) Reports on Form 8-K
No reports on Form 8-K were filed by the Company during the quarter ended December 31, 1994.

ITEMS 2, 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

<PAGE> 12

Signature

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

Microsoft Corporation

Date: February 14, 1995

By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and
Accounting Officer and Duly
Authorized Officer)

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MICROSOFT CORPORATION
Computation of Earnings Per Share
(In millions, exzcept earnings per share)

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	Three Months Ended December 31		Six Months Ended December 31	
	1993	1994	1993	1994
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Weighted average number of common shares outstanding	568	581	568	581
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Average common and common stock equivalents outstanding	608	625	608	624
Net Income	$ 289	$ 373	$ 528	$ 689
Earnings per share(1)(2)	$0.48	$0.60	$0.87	$1.10

</TABLE>

(1) Share and per share amounts for the three and six months ended December 31, 1993 have been restated to reflect a two-for-one stock split in May 1994.
(2) Fully diluted earnings per share have not been presented because the effects are not material.

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COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: 7372
IRS NUMBER: 911144442
STATE OF INCORPORATION: DE
FISCAL YEAR END: 0630

FILING VALUES:
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SEC FILE NUMBER: 000-14278
FILM NUMBER: 94559935

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STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 1994

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

FOR THE TRANSITION PERIOD FROM _____ TO ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1144442 (I.R.S. Employer Identification No.)
ONE MICROSOFT WAY, REDMOND, WASHINGTON (Address of principal executive office)	98052-6399 (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of October 31, 1994 was 582,384,075.

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MICROSOFT CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 1994

INDEX

PART I. FINANCIAL INFORMATION

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Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS
(In millions, except earnings per share)(Unaudited)

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<S>	September 30 1993 <C>	1994 <C>
Net revenues	$ 983	$1,247
Cost of revenues	159	186
Gross profit	824	1,061

Operating expenses:

Research and development	134	178
Sales and marketing	312	395
General and administrative	35	51
	-----	------
Total operating expenses	481	624
	-----	------
Operating income	343	437
Interest income - net	23	36
Other expenses	(4)	(2)
	-----	------
Income before income taxes	362	471
Provision for income taxes	123	155
	-----	------
Net income	$ 239	$ 316
	=====	======
Earnings per share (1)	$0.39	$ 0.51
	=====	======
Weighted average shares outstanding (1)	606	622
	=====	======

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(1) Share and per share amounts for the three months ended September 30, 1993 have been restated to reflect a two-for-one stock split in May 1994.

See accompanying notes.

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MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

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	June 30 1994	Sept. 30 1994(1)
	-------	-------
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ASSETS		
Current assets:		
Cash and short-term investments	$3,614	$3,776
Accounts receivable - net	475	527
Inventories	102	108
Other	121	143
	------	------
Total current assets	4,312	4,554
Property, plant, and equipment - net	930	936

Other assets	121	147
Total assets	$5,363	$5,637
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 324	$ 354
Accrued compensation	96	81
Income taxes payable	305	369
Other	188	200
Total current liabilities	913	1,004
Put warrants	-	203
Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 2,000; shares outstanding 581	1,500	1,606
Retained earnings	2,950	2,824
Total stockholders' equity	4,450	4,430
Total liabilities and stockholders' equity	$5,363	$5,637

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(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

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	Three Months Ended September 30	
	1993	1994
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CASH FLOWS FROM OPERATIONS		
Net income	$ 239	$ 316

Depreciation and amortization	41	67
Current liabilities	25	96
Accounts receivable	(32)	(59)
Inventories	31	(7)
Other current assets	12	(23)
Net cash from operations	316	390
CASH FLOWS FROM FINANCING		
Common stock issued	45	81
Common stock repurchased	(72)	(242)
Stock option income tax benefits	21	39
Net cash from financing	(6)	(122)
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(59)	(67)
Other assets	(3)	(35)
Short-term investments	(412)	(313)
Net cash used for investments	(474)	(415)
Net change in cash and equivalents	(164)	(147)
Effect of exchange rates on cash and equivalents	(6)	(4)
Cash and equivalents, beginning of period	1,013	1,477
Cash and equivalents, end of period	843	1,326
Short-term investments, end of period	1,689	2,450
Cash and short-term investments, end of period	$2,532	$3,776

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See accompanying notes.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

BASIC OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments necessary for their fair presentation. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1994 Annual Report.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

STOCK SPLIT

Effective May 6, 1994, outstanding shares of common stock were split two-for-one. All fiscal 1994 share and per share amounts have been restated for the stock split.

PUT WARRANTS

In connection with the Company's stock repurchase program, put warrants were sold during the first quarter of fiscal 1995. These warrants entitle the warrant holders to sell up to four million shares of Microsoft common stock to the Company at prices ranging from $48.46 to $52.93 per share. The warrants expire at various dates between November 1994 and February 1996. The maximum potential repurchase obligation of $203 million has been reclassified from stockholders' equity to put warrants as of September 30, 1994. There was no impact on earnings per share for the first quarter of fiscal 1995.

CONTINGENCIES

On July 15, 1994, Microsoft and the U.S. Department of Justice (DOJ) entered into a consent decree resolving the DOJ's nonpublic investigation of Microsoft. In the consent decree, which involves no admission of wrongdoing on Microsoft's part, Microsoft agreed to make certain changes in its OEM licensing practices. Microsoft also agreed to employ a uniform duration in its nondisclosure agreements for precommercial versions of certain operating system products, and clarified the rights and responsibilities of those signing such nondisclosure agreements. The DOJ has the right to monitor Microsoft's compliance during the 6-1/2 year term of the consent decree. To become final, the consent decree must be approved by the U.S. District Court for the District of Columbia.

Microsoft does not expect the consent decree with the DOJ to materially affect its OEM revenues.

On March 17, 1988, Apple Computer, Inc. (Apple) brought suit against Microsoft and Hewlett-Packard Company for alleged copyright infringement in the U.S. District Court, Northern District of California. The complaint included allegations that the visual displays of Microsoft Windows version 2.03 (and Windows version 3.0, which was added to the complaint later) infringed Apple's copyrights and exceeded the scope of a 1985 Settlement Agreement between Microsoft and Apple. The complaint sought to enjoin Microsoft from marketing Microsoft Windows versions 2.03 and 3.0 or any derivative work based on Windows 2.03 or 3.0 and from otherwise infringing Apple's copyrights and sought damages resulting from the alleged infringement.

The Company answered the complaint, raising affirmative defenses including its claim that the 1985 Settlement Agreement entitled it to use the visual displays in question, denying Apple's allegations that the visual displays in Microsoft

Windows version 2.03 and 3.0 infringe any protectible right of Apple, and asserting counterclaims.

On August 24, 1993, the Court entered final judgment dismissing all of Apple's claims. Apple appealed a number of the Court's decisions in the case to the Ninth Circuit Court of Appeals, which on September 19, 1994 issued a decision affirming the rulings of the U.S. District Court. Apple has until December 19, 1994 to petition the U.S. Supreme Court to grant review of the Ninth Circuit's decision.

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On July 30, 1993 Wang Laboratories, Inc. (Wang) filed suit in U.S. District Court for the District of Massachusetts against Microsoft and Watermark Software, Inc., alleging that unspecified Microsoft products infringe two patents owned by Wang concerning object management and the handling of compound documents (United States Patents 5,206,951 issued on April 27, 1993, and 5,129,061 issued on July 7, 1992, respectively). The suit also alleges that Microsoft induced and continues to induce others, including Watermark Software, Inc., to infringe the Wang patents. Microsoft's OLE technology appears to be the subject of Wang's allegations against Microsoft. The complaint seeks a determination that Microsoft's alleged infringement is willful, an award of treble damages, an award of attorneys' fees, and to preliminarily and permanently enjoin Microsoft from continuing the alleged infringement. In its answer Microsoft denied that any of its products infringe the Wang patents and asked the Court for a declaratory judgment that those patents are invalid and unenforceable for failing to meet patent law requirements. The suit is currently in the early stages of discovery.

Although there is no assurance that these lawsuits will be resolved favorably and that the Company's financial condition will not be adversely affected, the Company currently believes that resolution of these matters will not have material adverse effects on its financial condition as reported in the accompanying financial statements.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF fINANCIAL CONDITION

RESULTS OF OPERATIONS

OVERVIEW

Microsoft Corporation develops, manufactures, markets, licenses, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and software development tools. The Company also markets personal computer books and hardware; and is engaged in the research and potential development of advanced technology software products.

REVENUES

Revenues for the first quarter of fiscal 1995 increased 27% over revenues for the first quarter of fiscal 1994.

PRODUCT GROUPS

Systems product group revenues are primarily from licenses of personal operating systems and business systems with client-server architectures. Systems revenues were $444 million in the first quarter of 1995, compared to $355 million recorded in the same period of 1994, an increase of 25%. Revenues generated by both Microsoft MS-DOS and Microsoft Windows operating systems increased from the prior year, particularly through the original equipment manufacturer channel. During the first quarter of 1995, more than 80% of Windows units were licensed through the OEM channel.

Applications product group revenues include licenses of desktop productivity, consumer, and developer programs. Applications revenues were $754 million in the first quarter of 1995, increasing 31% from $577 million in the first quarter of 1994. Increases in applications revenues were led by sales of Microsoft Office. Microsoft Office Standard includes Microsoft Excel, Microsoft Word, a Microsoft Mail license, and the Microsoft PowerPoint(R) presentation graphics program. Microsoft Office Professional for Windows includes all of the above plus the Microsoft Access(R) database management program. Additionally, during the first quarter of 1995, the Company released new Macintosh-based versions of Microsoft Excel, Microsoft Word, and Microsoft PowerPoint.

The hardware product group's principal products are the Microsoft Mouse and BallPoint(R) mouse pointing devices. Hardware revenues were $49 million and $51 million in the first quarters of 1995 and 1994.

SALES CHANNELS

The Company has four major channels of distribution: OEM; U.S. and Canada; Europe; and Other International. OEM channel revenues are license fees from original equipment manufacturers. Sales in the retail channels are primarily to distributors and resellers.

OEM revenues (primarily personal operating systems) grew 36% to $348 million from the $255 million recorded in the comparable quarter of the prior year. MS-DOS continues to be pre-installed on many PCs sold by original equipment manufacturers. In addition, many major OEMs are also preinstalling the Microsoft Windows operating system on PCs, leading to increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $423 million in the first quarter of 1995 compared to $328 million in 1994, an increase of 29%. Revenues in Europe were $289 million in the first quarter of 1995 compared to $274 million the prior year. Other International channel revenues showed strong growth, increasing to $187 million in the first quarter of 1995 from $126 million in the first quarter of 1994. Sales in Japan were particularly strong.

The Company's operating results are affected by foreign exchange rates. Since much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the relative impact of exchange rates on net income is less than on revenues.

COST OF REVENUES, OPERATING EXPENSES, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 14.9% in the first quarter of 1995, compared to 16.2% in the first quarter of 1994. Contributing to the decrease were greater sales of higher-margin Microsoft Office, lower disk prices, and a shift to more revenues from OEM and corporate license programs. While license programs carry lower per unit prices than retail versions shipped though the finished goods channels, there is little cost of revenues associated with such programs.

Research and development expenses increased 33% to $178 million, or 14.3% of revenues in the first quarter of 1995 from $134 million, or 13.6% of revenues in the corresponding quarter of 1994. The increase in research and development expenses resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 27% to $395 million from $312 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 31.6% and 31.7% in the respective first quarters of 1995 and 1994. The increase in absolute amounts of sales and marketing expenses was primarily due to increased marketing costs and headcount related expenses.

General and administrative expenses were 4.1% of revenues in the first quarter of 1995 and 3.6% of revenues in the first quarter of 1994.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with slightly higher interest rates. Other expense did not fluctuate significantly.

The effective income tax rate was 33% in the first quarter of 1995, compared to 34% in the same quarter of 1994.

Net income for the third quarter of 1995 was $316 million. Net income as a percentage of revenues was 25.3% in the first quarter of 1995, compared with 24.3% in the first quarter of 1994. The increase was the result of the higher gross margin percentage and interest income offset by higher levels of operating expenses.

FINANCIAL CONDITION

The Company's cash and short-term investment portfolio totaled $3.8 billion at September 30, 1994 and represented 67% of total assets. The portfolio is diversified among security types, industries, and individual issuers. The Company's investments are investment grade and liquid. The portfolio, while invested predominantly in U.S. dollar denominated securities, also includes foreign currency positions in anticipation of continued international expansion.

Microsoft has no material long-term debt. The Company has available $70 million of standby multicurrency lines of credit. These lines support foreign currency hedging and international cash management. Stockholders' equity at September 30, 1994 exceeded $4 billion.

On October 28, 1994, Microsoft shareholders authorized the Company to issue up to 100 million shares of preferred stock, which may be used by the Company for any proper corporate purpose.

Cash generated from operations has been sufficient to fund the Company's investment in research and development activities and facilities expansion. As the Company grows, investments will continue in research and development in existing and advanced areas of technology. The Company's cash will be used to acquire technology or to fund strategic ventures. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development; sales and marketing; product support; and administrative staff.

The exercise of stock options by employees provides additional cash. These proceeds have funded the Company's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1995. Additionally, the Company enhanced its stock repurchase program by selling put warrants. See Notes to Financial Statements.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet the Company's operating requirements for the next 12 months.

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

The Company is currently involved in litigation with Apple Computer, Inc., and Wang Laboratories, Inc. See Notes to Financial Statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At Microsoft's Annual Meeting of Shareholders held on October 28, 1994, the following proposals were adopted by the margins indicated:

1. To elect a Board of Directors to hold office until the next annual meeting of shareholders and until their successors are elected and qualified.

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Paul G. Allen	524,328,464	1,304,575
Richard A. Hackborn	524,648,914	984,125
David F. Marquardt	524,657,599	975,440
Robert D. O'Brien	524,620,859	1,012,180
William G. Reed, Jr.	524,678,984	954,055
Jon A. Shirley	524,375,575	1,257,464

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2. To authorize the Company to issue up to 100,000,000 shares of preferred stock.

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For	343,566,292
Against	103,855,468
Abstain	2,568,088
Broker Non-Votes	75,673,191

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3. To ratify the selection of Deloitte & Touche as the independent public auditors of the Company for the current fiscal year.

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For	520,167,524
Against	4,408,638
Abstain	1,056,877

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

11. Computation of Earnings Per Share is on page 10.

(b) Reports on Form 8-K
The Company filed one report on Form 8-K during the quarter ended September 30, 1994. On July 29, 1994, the Company disclosed revenue and net income amounts for the initial 30 days of combined operations of Microsoft and SOFTIMAGE, Inc., which merged on June 27, 1994 in a share for share exchange. Such transaction has been accounted for as a pooling of interests. This information was reported for purposes of complying with the Securities and Exchange Commission's Accounting Series Release 135.

ITEMS 2, 3, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

Signature

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

Microsoft Corporation

Date: November 14, 1994

By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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EXHIBIT 11.

MICROSOFT CORPORATION
COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share)

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	Three Months Ended September 30,	
	1993	1994
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Weighted average number of common shares outstanding(1)	566	581
Common stock equivalents from outstanding stock options(1)	40	41
Average common and common stock equivalents outstanding(1)	606	622
Net income	$239	$316
Earnings per share(1)(2)	$0.39	$0.51

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(1) Share and per share amounts for the three months ended September 30, 1993 have been restated to reflect a two-for-one stock split in May 1994.

(2) Fully diluted earnings per share have not been presented because the effects are not material.

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FISCAL YEAR END: 0630

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CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 1994

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

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

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<S>	<C>
Washington	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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One Microsoft Way, Redmond, Washington 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of May 1, 1994 was 287,948,000.

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MICROSOFT CORPORATION
FORM 10-Q
For the Quarter Ended March 31, 1994
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Part I. Financial Information

Item 1. Financial Statements

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

<TABLE>
<CAPTION>

	Three Months Ended March 31		Nine Months Ended March 31	
	1994	1993	1994	1993
<S>	<C>	<C>	<C>	<C>
Net revenues	$1,244	$ 958	$3,356	$2,714
Cost of revenues	208	161	552	453
Gross profit	1,036	797	2,804	2,261
Operating expenses:				
Research and development	156	116	440	332
Sales and marketing	359	313	1,008	892
General and administrative	41	30	118	84
Litigation charge	120	--	120	--
Total operating expenses	676	459	1,686	1,308
Operating income	360	338	1,118	953
Interest income - net	26	21	74	59
Other	(4)	(2)	(10)	(1

Income before income taxes	382	357	1,182	1,011
Provision for income taxes	126	114	398	323
Net income	$ 256	$ 243	$ 784	$ 688
Earnings per share	$ 0.84	$0.80	$ 2.58	$ 2.28
Weighted average shares outstanding	304	304	304	302

</TABLE>

See accompanying notes.

MICROSOFT CORPORATION
BALANCE SHEETS
(In millions)

<TABLE>
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<S>	March 31 1994(1) <C>	June 30 1993 <C>
Assets		
Current assets:		
Cash and short-term investments	$3,143	$2,290
Accounts receivable - net	522	338
Inventories	131	127
Other	116	95
Total current assets	3,912	2,850
Property, plant, and equipment - net	918	867
Other assets	96	88
Total assets	$4,926	$3,805
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 296	$ 239
Accrued compensation	71	86
Income taxes payable	219	127
Litigation accrual	120	--
Other	208	111
Total current liabilities	914	563
Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 1,000; shares outstanding 286 and 282	1,373	1,086
Retained earnings	2,639	2,156
Total stockholders' equity	4,012	3,242

Total liabilities and stockholders' equity	$4,926	$3,805

</TABLE>

(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION
CASH FLOWS STATEMENTS
(In millions) (Unaudited)

<TABLE>
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	Nine Months Ended March 31	
	1994	1993
<S>	<C>	<C>
Cash flows from operations		
Net income	$ 784	$ 688
Depreciation and amortization	161	112
Current liabilities	356	151
Accounts receivable	(187)	(212)
Inventories	(5)	(41)
Other current assets	(21)	(25)
Net cash from operations	1,088	673
Cash flows from financing		
Common stock issued	193	185
Common stock repurchased	(311)	(145)
Stock option income tax benefits	109	166
Net cash from financing	(9)	206
Cash flows used for investments		
Additions to property, plant, and equipment	(191)	(161)
Other assets	(32)	(12)
Short-term investments	(714)	(621)
Net cash used for investments	(937)	(794)
Net change in cash and equivalents	142	85
Effect of exchange rates	(3)	(21)
Cash and equivalents, beginning of period	1,013	791
Cash and equivalents, end of period	1,152	855
Short-term investments, end of period	1,991	1,146
Cash and short-term investments, end of period	$3,143	$2,001

</TABLE>

See accompanying notes.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments necessary for their fair presentation. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1993 Annual Report.

Earnings Per Share

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

Agreement to Merge

On February 14, 1994, Microsoft announced its agreement to merge with SOFTIMAGE Inc., a leading developer of high-performance 2D and 3D computer animation and visualization software. Under the terms of the combination agreement, Microsoft will exchange approximately 1.6 million shares of its common stock for all of the outstanding shares of SOFTIMAGE. It is anticipated the transaction will be accounted for as a pooling of interests. Management does not expect the transaction to have a material financial effect on the Company's financial results. The transaction is expected to be completed in late June 1994.

Stock Split

On April 23, 1994, the Company's Board of Directors approved a two-for-one stock split, effective May 6, 1994. Share and per share amounts have not been restated for the upcoming stock split.

Contingencies

On March 17, 1988, Apple Computer, Inc. ("Apple") brought suit against Microsoft and Hewlett-Packard Company for alleged copyright infringement in the U.S. District Court, Northern District of California. The complaint included allegations that the visual displays of Microsoft(R) Windows(TM) version 2.03 infringed Apple's copyrights and exceeded the scope of a 1985 Settlement Agreement between Microsoft and Apple. The complaint sought to enjoin Microsoft from marketing Microsoft Windows version 2.03 or any derivative work based on Windows 2.03 and from otherwise infringing Apple's copyrights and sought damages resulting from the alleged infringement. The complaint also alleged that Microsoft was a contributory infringer as to a Hewlett-Packard(R) product called NewWave(TM).

The Company answered the complaint, denying Apple's allegations that the visual displays in Microsoft Windows version 2.03 infringe any protectible right of Apple, raising affirmative defenses, asserting counterclaims, and seeking damages in an unspecified amount resulting from Apple's actions.

In a June 14, 1991 order, the Court permitted Apple to supplement its complaint to include Windows version 3.0 as an allegedly infringing work. Later in 1991, the Court dismissed Microsoft's counterclaim in which it alleged that Apple had breached an implied covenant not to sue for infringement as to any visual displays covered by the 1985 Agreement.

On February 11, 1992, Microsoft disclosed Apple's written claim for $4.4 billion as damages from Microsoft's alleged infringement of Apple's copyrights. Apple later amended this claim to $5.5 billion and more recently to $4.9 billion. Microsoft considers Apple's damages claim to be insupportable under the copyright law and speculative.

On August 24, 1993, the Court entered final judgment dismissing all of Apple's claims. Apple has appealed a number of the Court's decisions in the case to the Ninth Circuit Court of Appeals. Microsoft has cross-appealed the dismissal of its counterclaim and related issues. All briefing on the appeal and cross-appeal has been completed. The date on which oral argument will be heard on the appeal and cross-appeal has not yet been scheduled.

In June 1990, Microsoft was notified that it was the subject of a nonpublic investigation being conducted by the staff of the Federal Trade Commission ("Commission"). During further communications, the Company learned that the staff wished to determine if Microsoft and the IBM Corporation had entered into an alleged anticompetitive horizontal agreement that was purportedly reflected in a joint press release issued at the COMDEX computer trade show in November 1989. In April 1991, Microsoft learned that, apparently due to complaints from third parties, the staff had decided to broaden the investigation to examine allegations that the Company has monopolized or has attempted to monopolize the market for operating systems, operating environments, computer software, and peripherals for personal computers. The Company produced documents, witnesses, and other information to the FTC staff in connection with the investigation.

In a letter dated August 20, 1993, the Commission notified Microsoft that its investigation had been closed.

The Company was also notified on August 20, 1993 that the U.S. Department of Justice had been granted clearance by the Commission to investigate Microsoft. That investigation is underway, and the Company is cooperating.

On July 20, 1993, Microsoft was notified by the Commission of the European Communities that the Directorate-General for Competition had received a complaint from Novell, Inc. against Microsoft. The complaint claims that certain allegedly anti-competitive practices of Microsoft violated Articles 85 and 86 of the EEC Treaty of Rome, and includes a request for interim measures. Microsoft is cooperating with the investigation of Novell's claims being conducted by the Directorate-General for Competition.

On January 25, 1993, Stac Electronics ("Stac") of Carlsbad, California, filed suit against Microsoft in U.S. District Court in Los Angeles, alleging that

Microsoft's MS-DOS(R) version 6 operating system infringed two patents owned by Stac relating to data compression techniques. Stac sought monetary relief and an injunction prohibiting the sale of products that include Microsoft's DoubleSpace technology. Microsoft denied that its DoubleSpace technology infringed the Stac patents, and asked the Court to declare those patents invalid and unenforceable for failing to meet the patent law requirements. Microsoft also filed counterclaims alleging that Stac's Stacker(R) compression products infringe a patent owned by Microsoft; that Stac engaged in unfair competition; and that Stac misappropriated Microsoft trade secrets relating to Microsoft's proprietary technology for integrating data compression into the MS-DOS operating system.

On November 15, 1993, Judge Edward Rafeedie denied Microsoft's motion for summary adjudication that MS-DOS 6 does not infringe Stac's patents. The trial of the matter commenced on January 18, 1994, and on February 23, 1994 the seven-person jury returned a verdict ruling that Microsoft's MS-DOS 6 operating system infringed the Stac patents and awarded Stac $120 million in compensatory damages. Accordingly, Microsoft recorded a one-time charge of $120 million in its financial statements in the quarter ended March 31, 1994. The jury determined that the infringement was not willful. The jury also found that Stac had misappropriated and used in its Stacker products Microsoft's trade secret pre-loading feature, and awarded Microsoft $13.7 million in compensatory and punitive damages.

Stac filed a motion to permanently enjoin Microsoft from making, using, selling, licensing, offering for sale, or soliciting the sale of MS-DOS 6.0 and MS-DOS 6.2, and all other Microsoft products that include the compression or decompression contained in MS-DOS 6, or otherwise infringing in any manner. Microsoft has opposed Stac's motion. In addition, within days of the jury verdict, Microsoft began to provide its OEM licensees manufacturing in, or shipping to the U.S., a version of MS-DOS that does not include the disk-compression feature in question. On April 11, 1994 Microsoft also began shipping in the U.S. the Microsoft MS-DOS operating system version 6.21 Upgrade, which provides the same functionality as the MS-DOS 6.2 Upgrade without the DoubleSpace disk compression utility.

Microsoft has filed a motion for a permanent injunction preventing Stac from selling any product containing Microsoft's trade secret pre-loading feature. The hearing on both motions is scheduled to occur on May 13, 1994. Following entry of the judgment in the case, Microsoft intends to move to overturn the patent-infringement portion of the verdict or to seek a new trial. If that motion is not successful, Microsoft will appeal the judgment to the Circuit Court of Appeals for the Federal Circuit, the federal appellate court that reviews all patent appeals.

Management currently believes that the resolution of these matters will not have a material adverse financial effect on the Company.

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

Results of Operations

Overview

Microsoft's business strategy emphasizes the development and sale of a broad line of software products, including operating systems for personal computers ("PCs"), office machines, and personal information devices; application programs; languages; and other hardware, book, and multimedia products.

Revenues for the third quarter of fiscal 1994 increased 30% over revenues for the third quarter of fiscal 1993. Revenues were $3.36 billion for the first nine months of fiscal 1994, an increase of 24% over the comparable period of the prior year.

Product Groups

Operating systems sales were $393 million in the third quarter of 1994, compared to $313 million recorded in the same period of 1993. Systems revenues were $1.12 billion in the first nine months of 1994 compared to $854 million in the first nine months of 1993, an increase of 31%. Revenues generated by both Microsoft MS-DOS and Microsoft Windows operating systems increased from the prior year, particularly through the original equipment manufacturer ("OEM") channel. During 1994, more than 80% of Windows units were sold through the OEM channel.

Applications revenues were $798 million in the third quarter of 1994, increasing 33% from $600 million in the third quarter of 1993. For the first three quarters of 1994, applications revenues were $2.08 billion, compared to $1.68 billion in 1993. Increases in applications revenues were led by sales of Windows-based products, particularly Microsoft Office. Microsoft Office Standard includes Microsoft Excel, Microsoft Word, a Microsoft Mail license, and the Microsoft PowerPoint(R) presentation graphics program. Microsoft Office Professional for Windows includes all of the above plus the Microsoft Access(R) database management program. During the third quarter of 1994, the Company released new Windows-based versions of Microsoft Office Standard and Microsoft Office Professional, which contained the latest editions of Microsoft Excel and Microsoft PowerPoint.

Hardware revenues were $53 million and $45 million in the third quarters of 1994 and 1993. On a year-to-date basis, hardware revenues were $157 million in 1994 and $176 million in 1993. The hardware product group's principal products are the Microsoft Mouse and BallPoint(R) mouse pointing devices. Mouse revenues per unit are lower in the OEM channel than in the Company's retail channels, and the percentage of mouse sales through the OEM channel increased from the comparable quarter of the prior year.

Sales Channels

The Company has four major channels of distribution: OEM; U.S. and Canada; Europe; and Other International. OEM channel revenues are license fees from original equipment manufacturers. Sales in the retail channels are primarily to distributors and resellers.

OEM revenues (primarily operating systems) grew 59% to $323 million from the $203 million recorded in the comparable quarter of the prior year. For the first three quarters of 1994, OEM revenues were $846 million, compared to $514 million in the first three quarters of 1993. MS-DOS continues to be pre-installed on many PCs sold by original equipment manufacturers. In addition, many major OEMs are also preinstalling the Microsoft Windows operating system on PCs, leading to increased revenues through the OEM channel.

Revenues in the U.S. and Canada were $381 million in the third quarter of 1994 compared to $322 million in 1993. For the first three quarters of 1994, revenues were $1.13 billion, compared to $975 million in 1993.

Revenues in Europe were $391 million in the third quarter of 1994 compared to $335 million the prior year. For the first three quarters, European revenues were $989 million in 1994 and $963 million in 1993.

Other International channel revenues showed strong growth, increasing to $149 million in the third quarter of 1994 from $98 million in the third quarter of 1993. Sales in Japan were particularly strong. On a year-to-date basis, Other International channel revenues grew 48%, to $389 million in 1994 from $262 million in 1993.

The Company's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the third quarter of the prior year been in effect during the third quarter of 1994, translated revenues would have been approximately 2% higher in the third quarter of 1994. Since much of the Company's international manufacturing costs and operating expenses are incurred in local currencies, the total impact of exchange rates on net income is less than on revenues.

Cost of revenues as a percentage of revenues decreased slightly to 16.7% in the third quarter of 1994 from 16.8% in the third quarter of 1993. On a year-to-date basis, cost of revenues was 16.4% in 1994 and 16.7% in 1993. Cost of revenues varies with the channel mix and product mix within channels.

Research and development expenses increased 34% to $156 million, or 12.5% of revenues in the third quarter of 1994 from $116 million, or 12.1% of revenues in the corresponding quarter of 1993. For the first three quarters of 1994, research and development expenses represented 13.1% of revenues, compared to 12.2% in 1993. The increase in research and development expenses resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 15% to $359 million from $313 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 28.9% and 32.7% in the respective third quarters of 1994 and 1993 and 30.0% and 32.9% in the respective three quarters of 1994 and 1993. The increase in absolute amounts of sales and marketing expenses was primarily due to increased marketing costs associated with the promotion of new products, particularly Microsoft Office.

General and administrative expenses were 3.3% of revenues in the third quarter of 1994 and 3.1% of revenues in the third quarter of 1993.

After a February 1994 jury verdict in the Stac Electronics lawsuit, the Company recorded a one-time charge of $120 million.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations, offset by lower interest rates. Other expense did not fluctuate significantly.

The effective income tax rate was 33% in the third quarter of 1994, compared to 32% in 1993, reflecting newly enacted U.S. income tax laws.

Net income for the third quarter of 1994 was $256 million. Excluding the aforementioned one-time litigation charge, net income would have been $336 million, a 38% increase over the $243 million in the corresponding quarter of 1993. Net income as a percentage of revenues was 20.6% in the third quarter of 1994 (27.0% excluding the litigation charge), compared with 25.4% in the third quarter of 1993. On a year to date basis, net income as a percent of revenues was 23.4% (25.7% excluding the litigation charge) in 1994 and 25.4% in 1993.

Financial Condition

The Company's cash and short-term investment portfolio totaled $3.14 billion at March 31, 1994 and represented 64% of total assets. The portfolio is diversified among security types, industry groups, and individual issuers. The Company's investments are investment grade and liquid. The portfolio, while invested predominantly in U.S. dollar denominated securities, also includes foreign currency positions in anticipation of continued international expansion.

Microsoft has no material long-term debt. The Company has available $70 million of standby multicurrency lines of credit. These lines support foreign currency hedging and international cash management. Stockholders' equity at March 31, 1994 exceeded $4 billion.

Cash generated from operations has been sufficient to fund the Company's investment in research and development activities and facilities expansion. As the Company grows, investments will continue in research and development in existing and advanced areas of technology. Cash may also be used to acquire technology or to fund strategic ventures. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development; sales and marketing; product support; and administrative staff.

The exercise of stock options by employees provides additional cash. Funds received have been used to repurchase the Company's common stock on the open market to provide shares for stock option and stock purchase plans. This practice is continuing in 1994.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet the Company's operating requirements for the next 12 months.

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Part II. Other Information

Item 1. Legal Proceedings

The Company is currently involved in litigation with Apple Computer, Inc. and Stac Electronics. Also, the U.S. Department of Justice and the Directorate-General for Competition of the Commission of the European Communities are investigating the Company. See Notes to Financial Statements.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

11. Computation of Earnings Per Share is on page 10.

(b) Reports on Form 8-K

No reports on Form 8-K were filed by the Company during the quarter ended March 31, 1994.

Items 2, 3, 4 and 5 are not applicable and have been omitted.

Signature

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

Microsoft Corporation

Date: May 3, 1994

By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance

(Principal Financial and
Accounting Officer and
Duly Authorized Officer)

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Exhibit 11.

MICROSOFT CORPORATION
COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share)

<TABLE>
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	Three Months Ended March 31		N
	1994	1993	
	----	----	
<S>	<C>	<C>	

Weighted average number of common shares outstanding	286	280
Common stock equivalents from outstanding stock options	18	24
Average common and common stock equivalents outstanding	304	304
	=====	=====
Net income	$ 256	$ 243
	=====	=====
Earnings per share(1)	$0.84	$0.80
	=====	=====

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(1) Fully diluted earnings per share have not been presented because the effects are not material.

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PUBLIC DOCUMENT COUNT: 1
CONFORMED PERIOD OF REPORT: 19931231
FILED AS OF DATE: 19940214

FILER:

COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: 7372
IRS NUMBER: 911144442
STATE OF INCORPORATION: DE
FISCAL YEAR END: 0630

FILING VALUES:
FORM TYPE: 10-Q
SEC ACT: 34
SEC FILE NUMBER: 000-14278
FILM NUMBER: 94507831

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STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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STREET 2: NORTH OFFICE 2211
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STATE: WA
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 1993

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

For the Transition Period From _____ to _____

Commission File Number 0-14278

MICROSOFT CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

The number of shares outstanding of the registrant's common stock as of January 31, 1994 was 285,955,294.

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<PAGE>

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 1993

INDEX

<TABLE>
<CAPTION>
Part I. Financial Information

<PAGE>

Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

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

<TABLE>
<CAPTION>

	Three Months Ended December 31		Six Months Ended December 31	
	1993	1992	1993	1992
<S>	<C>	<C>	<C>	<C>
Net revenues	$1,129	$ 938	$2,112	$1,756
Cost of revenues	185	157	344	292
Gross profit	944	781	1,768	1,464
Operating expenses:				
Research and development	150	111	284	216
Sales and marketing	337	315	649	579
General and administrative	42	29	77	54
Total operating expenses	529	455	1,010	849
Operating income	415	326	758	615
Interest income - net	25	19	48	38
Other	(2)	2	(6)	1
Income before income taxes	438	347	800	654

Provision for income taxes	149	111	272	209
Net income	$ 289	$ 236	$ 528	$ 445
Earnings per share	$ 0.95	$ 0.78	$ 1.74	$ 1.48
Weighted average shares outstanding	304	303	304	301

</TABLE>

See accompanying notes.

<PAGE>

MICROSOFT CORPORATION

Balance Sheets
(In millions)

<TABLE>
<CAPTION>

<S>	December 31 1993(1) <C>	June 30 1993 <C>
Assets		
Current assets:		
Cash and short-term investments	$2,796	$2,290
Accounts receivable - net	460	338
Inventories	130	127
Other	96	95
Total current assets	3,482	2,850
Property, plant, and equipment - net	913	867
Other assets	91	88
Total assets	$4,486	$3,805
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 242	$ 239
Accrued compensation	99	86
Income taxes payable	211	127
Other	188	111
Total current liabilities	740	563

Stockholders' equity:

Common stock and paid-in capital-- shares authorized 1,000; shares outstanding 284 and 282	1,232	1,086
Retained earnings	2,514	2,156
Total stockholders' equity	3,746	3,242
Total liabilities and stockholders' equity	$4,486	$3,805

</TABLE>

(1) Unaudited

See accompanying notes.

- --

2

<PAGE>

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

<TABLE>
<CAPTION>

	Six Months Ended December 31 1993	1992
<S>	<C>	<C>
Cash flows from operations		
Net income	$ 528	$ 445
Depreciation and amortization	88	74
Current liabilities	187	71
Accounts receivable	(130)	(105)
Inventories	(5)	(23)
Other current assets	(3)	(55)
Net cash from operations	665	407
Cash flows from financing		
Common stock issued	90	117
Common stock repurchased	(164)	(80)
Stock option income tax benefits	64	136
Net cash from financing	(10)	173
Cash flow used for investments		
Additions to property, plant, and equipment	(122)	(100)
Other assets	(19)	(2)
Short-term investments	(568)	(409)
Net cash used for investments	(709)	(511)
Net change in cash and equivalents	(54)	69

Effect of exchange rates	(8)	(20)
Cash and equivalents, beginning of period	1,013	791
	------	------
Cash and equivalents, end of period	951	840
Short-term investments, end of period	1,845	941
	------	------
Cash and short-term investments, end of period	$2,796	$1,781
	======	======

</TABLE>

See accompanying notes.

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<PAGE>

MICROSOFT CORPORATION

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Earnings Per Share

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On February 11, 1992, Microsoft disclosed Apple's written claim for $4.4 billion as damages from Microsoft's alleged infringement of Apple's copyrights. Apple later amended this claim to $5.5 billion and more recently to $4.9 billion. Microsoft considers Apple's damages claim to be insupportable under the copyright law and speculative.

On August 24, 1993, the Court entered final judgment dismissing all of Apple's claims. Apple has appealed a number of the Court's decisions in the case to the Ninth Circuit Court of Appeals. Microsoft has cross-appealed the dismissal of its counterclaim and related issues.

In June 1990, Microsoft was notified that it was the subject of a nonpublic investigation being conducted by the staff of the Federal Trade Commission ("Commission"). During further communications, the Company learned that the staff wished to determine if Microsoft and the IBM Corporation had entered into an alleged anticompetitive horizontal agreement that was purportedly reflected in a joint press release issued at the COMDEX computer trade show in November 1989. In April 1991, Microsoft learned that, apparently due to complaints from third parties, the staff had decided to broaden the investigation to examine allegations that the Company has monopolized or has attempted to monopolize the market for operating systems, operating environments, computer software, and peripherals for personal computers. The Company produced documents, witnesses, and other information to the FTC staff in connection with the investigation.

In a letter dated August 20, 1993, the Commission notified Microsoft that its investigation had been closed.

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The Company was also notified on August 20, 1993 that the U.S. Department of Justice had been granted clearance by the Commission to investigate Microsoft. That investigation is underway, and the Company is cooperating.

On July 20, 1993, Microsoft was notified by the Commission of the European Communities that the Directorate-General for Competition had received a complaint from Novell, Inc. against Microsoft. The complaint claims that certain allegedly anti-competitive practices of Microsoft violated Articles 85 and 86 of the EEC Treaty of Rome, and includes a request for interim measures. Microsoft is cooperating with the investigation of Novell's claims being conducted by the Directorate-General for Competition.

On January 25, 1993, Stac Electronics ("Stac") of Carlsbad, California, filed suit against Microsoft in U.S. District Court in Los Angeles, alleging that Microsoft's MS-DOS(R) version 6 operating system infringes two patents owned by Stac relating to data compression techniques. Stac seeks monetary relief and an injunction prohibiting the sale of products that include Microsoft's DoubleSpace(TM) technology. Microsoft has denied that its DoubleSpace technology infringes the Stac patents, and has asked the Court to declare those patents invalid and unenforceable for failing to meet the patent law requirements. Microsoft has also filed counterclaims alleging that Stac's Stacker(R) compression products infringe a patent owned by Microsoft; that Stac has engaged in unfair competition; and that Stac misappropriated Microsoft trade secrets relating to Microsoft's proprietary technology for integrating data compression into the MS-DOS operating system.

On November 15, 1993, Judge Edward Rafeedie denied Microsoft's motion for summary adjudication that MS-DOS 6 does not infringe Stac's patents. The trial of the matter commenced on January 18, 1994, and the case was submitted to the jury on February 11, 1994. Stac is seeking damages in the amount of $113 million. Should Stac's patents be found to be valid and Microsoft's DoubleSpace technology be determined to infringe them, monetary damages, which could be trebled if the jury finds willful infringement, could be awarded to Stac, and an injunction could be entered prohibiting the manufacture, use and sale of products containing the infringing technology. Such an injunction could cause a temporary disruption in Microsoft's licensing and shipping of the affected products while they are being made non-infringing.

Management currently believes that the resolution of these matters will not have a material adverse financial effect on the Company.

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

Results of Operations

Overview

Microsoft's business strategy emphasizes the development and sale of a broad line of software products, including operating systems for personal computers, office machines, and personal information devices; application programs; languages; and other hardware, book, and multimedia products.

Net revenues for the second quarter of fiscal 1994 increased 20% over net revenues for the second quarter of fiscal 1993. Revenues were $2.11 billion for the first six months of fiscal 1994, an increase of 20% over the comparable period of the prior year.

Product Groups

Operating systems sales were $369 million in the second quarter of 1994, growing 30% from the $283 million recorded in the same period of 1993. Systems revenues were $724 million in the first half of 1994 compared to $541 million in the first half of 1993. Revenues generated by the Microsoft MS-DOS operating system increased from the prior year. During the second quarter of fiscal 1994, the Company released MS-DOS version 6.2, which led to increased sales through the retail channels. Sales of the Microsoft Windows operating system also increased, particularly through the original equipment manufacturer channel. During the second quarter of 1994, more than 80% of Windows units were sold through the OEM channel.

Applications revenues were $707 million in the second quarter of 1994, compared to $590 million in the second quarter of 1993. For the first two quarters of 1994, applications revenues were $1.28 billion, compared to $1.08 billion in 1993. Increases in applications revenues were led by sales of Windows-based products, particularly Microsoft Office. Microsoft Office Standard includes Microsoft Excel, Microsoft Word, a Microsoft Mail license, and the Microsoft PowerPoint(R) presentation graphics program. Microsoft Office Professional for Windows includes all of the above plus the Microsoft Access(R) database management program.

During the second quarter of 1994, the Company released new versions of

Microsoft Office Standard and Microsoft Office Professional for Windows. These products contained vouchers for free upgrades to the next versions of Microsoft Excel and Microsoft PowerPoint. Revenues of approximately $70 million were deferred and will be recognized when upgrades for Microsoft Excel version 5.0 and Microsoft PowerPoint version 4.0 are shipped to users who licensed Microsoft Office and return the vouchers.

The Company introduced several new consumer software products in the second quarter of 1994, which also impacted the increase in applications revenue growth.

Hardware revenues were $53 million and $65 million in the second quarters of 1994 and 1993. On a year to date basis, hardware revenues were $104 million in 1994 and $131 million in 1993. The hardware product group's principal products are the Microsoft Mouse and BallPoint(R) mouse pointing devices. Mouse revenues per unit are lower in the OEM channel than in the Company's retail channels, and the percentage of mouse sales through the OEM channel increased from the comparable quarter of the prior year.

Sales Channels

The Company has three major channels of distribution: U.S. and Canada, International, and OEM. Sales in the U.S. and Canada and International channels are primarily to distributors and resellers. OEM channel revenues are license fees from original equipment manufacturers.

Revenues in the U.S. and Canada grew to $423 million in the second quarter of 1994 from $344 million in 1993, an increase of 23%. For the first half of 1994, revenues were $751 million, compared to $653 million in the first half of 1993.

Revenues in Europe were $324 million in the second quarter of 1994 compared to $345 million the prior year. For the first two quarters, European revenues were $598 million in 1994 and $628 million in 1993. Other international revenues showed strong growth, increasing to $114 million in the second quarter of 1994 from $88 million in the second quarter of 1993. On a year to date basis, other international revenues were $240 million in 1994 and $164 million in 1993, representing growth of 46%.

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The Company's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the second quarter of the prior year been in effect during the second quarter of 1994, translated revenues would have been 3% higher in the second quarter of 1994. Since much of the Company's international manufacturing costs and operating expenses are incurred in local currencies, the total impact of exchange rates on net income is less than on revenues.

OEM revenues (primarily operating systems) grew 66% to $268 million from the $161 million recorded in the comparable quarter of the prior year. For the first half of 1994, OEM revenues were $523 million, compared to $311 million in the first half of 1993. MS-DOS continues to be pre-installed on many personal computers sold by original equipment manufacturers. In addition, many major OEMs are also preinstalling the Microsoft Windows operating system on personal computers, leading to increased revenues through the OEM channel.

Cost of revenues as a percentage of net revenues decreased slightly to 16.4% in the second quarter of 1994 from 16.7% in the second quarter of 1993. On a year to date basis, cost of revenues was 16.3% in 1994 and 16.6% in 1993. Cost of revenues varies with the channel mix and product mix within channels.

Research and development expenses increased 35% to $150 million, or 13.3% of net revenues in the second quarter of 1994 from $111 million, or 11.8% of net revenues in the corresponding quarter of 1993. For the first half of 1994, research and development expenses represented 13.4% of net revenues, compared to 12.3% in 1993. The increase in research and development expenses followed the trend established over the last several years, and resulted primarily from planned hiring of software development staff and higher levels of third-party development costs.

Sales and marketing expenses increased 7% to $337 million from $315 million in the comparable quarter. As a percentage of net revenues, sales and marketing expenses were 29.9% and 33.6% in the respective second quarters of 1994 and 1993 and 30.8% and 32.9% in the respective first halves of 1994 and 1993. The increase in absolute amounts of sales and marketing expenses was primarily due to increased marketing costs associated with the promotion of new products and the new editions of Microsoft Office.

General and administrative expenses were 3.7% of net revenues in the second quarter of 1994 and 3.1% of net revenues in the second quarter of 1993.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations, offset by declining interest rates. Other expense did not fluctuate significantly.

The effective income tax rate was 34% in the second quarter of 1994, compared to 32% in 1993, reflecting newly-enacted U.S. income tax laws.

Net income for the second quarter of 1994 was $289 million, a 22% increase over the $236 million in the corresponding quarter of 1993. Net income as a percentage of net revenues was 25.6% in the second quarter of 1994, compared with 25.2% in the second quarter of 1993. On a year to date basis, net income as a percent of net revenues was 25.0% in 1994 and 25.3% in 1993.

Financial Condition

The Company's cash and short-term investment portfolio totaled $2.80 billion at December 31, 1993 and represented 62% of total assets. The portfolio is diversified among security types, industry groups, and individual issuers. The Company's investments are investment grade and liquid. The portfolio, while invested predominantly in U.S. dollar denominated securities, also includes foreign currency positions in anticipation of continued international expansion.

Microsoft has no material long-term debt. Stockholders' equity at December 31, 1993 was $3.75 billion.

Cash generated from operations has been sufficient to fund the Company's investment in research and development activities and facilities expansion. As the Company grows, investments will continue in research and development in existing and advanced areas of technology. Cash may also be used to acquire technology or to fund strategic ventures. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development; sales and marketing; product support; and administrative staff.

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The exercise of stock options by employees provides additional cash. Funds received have been used to repurchase the Company's common stock on the open market, to provide shares for stock option and stock purchase plans. This practice is continuing in 1994.

The Company has available $70 million of standby multicurrency lines of credit. These lines support foreign currency hedging and international cash management.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet the Company's operating requirements.

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Part II. Other Information

ITEM 1. Legal Proceedings

The Company is currently involved in litigation with Apple Computer, Inc. and Stac Electronics. Also, the U.S. Department of Justice and the Directorate-General for Competition of the Commission of the European Communities are investigating the Company. See Notes to Financial Statements.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits
    11. Computation of Earnings Per Share is on page 10.

(b) Reports on Form 8-K
    No reports on Form 8-K were filed by the Company during the quarter ended December 31, 1993.

Items 2, 3, 4 and 5 are not applicable and have been omitted.

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Exhibit 11.

MICROSOFT CORPORATION

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

<TABLE>
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<S>	Three Month December 1993 <C>
Weighted average number of common shares outstanding	284
Common stock equivalents from outstanding stock options	20
Average common and common stock equivalents outstanding	304
Net income	$ 289
Earnings per share (1)	$0.95

</TABLE>

(1) Fully diluted earnings per share have not been presented because the effects are not material.

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Signature

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

Microsoft Corporation

Date: February 11, 1994

By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance; Treasurer

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

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-----END PRIVACY-ENHANCED MESSAGE-----

Mr. Ballmer was named Executive Vice President, Sales and Support in February 1992. He had been Senior Vice President, Systems Software since 1989. From 1984 until 1989, Mr. Ballmer served as Vice President, Systems Software. He joined Microsoft in 1980.

Mr. Herbold joined Microsoft as Executive Vice President and Chief Operating Officer in November 1994. Mr. Herbold had been with The Procter & Gamble Company since 1968, with experience in information services, advertising and market research. Most recently, he was P&G's Senior Vice President, Information Services and Advertising.

Mr. Higgins was named Group Vice President, Applications and Content in May 1995. He was named Senior Vice President, Desktop Applications Division in March 1993. He had been Vice President, Desktop Applications Division since 1992 and previously, Vice President, Analysis Business Unit since 1991. Mr. Higgins joined Microsoft in 1983.

Mr. Maritz was named Group Vice President, Platforms in May 1995. He was named Senior Vice President, Product and Technology Strategy in November 1994 and had been Senior Vice President, Systems Division since February 1992. He had been Vice President, Advanced Operating Systems since 1989. Mr. Maritz joined Microsoft in 1986.

Mr. Myhrvold was named Group Vice President, Applications and Content in May 1995. He was named Senior Vice President, Advanced Technology in July 1993. He had been Vice President, Advanced Technology and Business Development since 1989. Mr. Myhrvold joined Microsoft in 1986.

Mr. Raikes was named Group Vice President, Sales and Marketing in July 1996. He was named Senior Vice President, Microsoft North America in January 1992 and had been Vice President, Office Systems since 1990. Mr. Raikes joined Microsoft in 1981.

Mr. Allchin was named Senior Vice President, Desktop and Business Systems Division in February 1996. He was named Senior Vice President, Business Systems Division in November 1994 and had been Vice President, Business Systems Division, since July 1991. Mr. Allchin joined Microsoft in 1991.

Mr. Kempin was named Senior Vice President, OEM Sales in August 1993. He had been Vice President, OEM Sales since 1987. Mr. Kempin joined Microsoft in 1983.

Mr. Mundie was named Senior Vice President, Consumer Platforms Division in February 1996. He was named Senior Vice President, Consumer Systems Division in May 1995 and had been Vice President, Advanced Consumer Technology since July liquidated.

Mr. Neukom was named Senior Vice President, Law and Corporate Affairs in February 1994. He joined Microsoft in 1985 as Vice President.

Mr. Silverberg was named Senior Vice President, Internet Platform and Tools Division in February 1996. He was named Senior Vice President, Personal Systems Division in November 1994 after joining Microsoft in August 1990 as Vice President, Personal Operating Systems Division.

Ms. Stonesifer was named Senior Vice President, Interactive Media Division in February 1996. She was named Senior Vice President, Consumer Division in November 1994, after having been Vice President, Consumer Division since June 1993. She had been Vice President, Support since 1992 and General Manager of Product Support Services since 1991. Ms. Stonesifer joined Microsoft in 1988.

Mr. Vergnes is a Senior Vice President of Microsoft and was named President, Microsoft Europe in April 1992. He had been Vice President, Europe since 1989. Mr. Vergnes joined Microsoft in 1983.

Mr. Brown was named Chief Financial Officer in August 1994 and Vice President, Finance in April 1993. He was named Treasurer shortly after joining Microsoft in January 1990.

Item 11. Executive Compensation

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" on pages 4 through 8 and "Information Regarding the Board and its Committees" on page 2 is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information set forth under the caption "Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management" on page 3 of the Proxy Statement is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

None.

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PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) Financial Statements and Schedules

The financial statements as set forth under Item 8 of this report on Form

Jill E. Barad	Director
/s/ Richard A. Hackborn Richard A. Hackborn	Director
/s/ David F. Marquardt David F. Marquardt	Director
/s/ Robert D. O'Brien Robert D. O'Brien	Director
/s/ Wm. G. Reed, Jr. Wm. G. Reed, Jr.	Director
/s/ Jon A. Shirley Jon A. Shirley	Director
/s/ Michael W. Brown Michael W. Brown	Vice President, Finance; Chief Financial Officer (Principal Financial and Accounting Officer)

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EXHIBIT 11.

COMPUTATION OF EARNINGS PER SHARE
(In millions, except earnings per share)

<TABLE>
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	Year Ended June 30		
	1994	1995	1996

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Weighted average common shares outstanding	571	582	592
Common equivalent shares from stock options	39	45	48
Average common and equivalent shares outstanding (1)	610	627	640
Net income	$1,146	$1,453	$2,195
Earnings per share (1)	$ 1.88	$ 2.32	$ 3.43

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(1) Fully diluted earnings per share have not been presented because the effects are not material.

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EXHIBIT 13.1

QUARTERLY INFORMATION
(In millions, except per share data) (Unaudited)

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	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
1994					
Net revenues	$ 983	$ 1,129	$ 1,244	$ 1,293	$ 4,649
Operating income	343	415	480	488	1,726
Net income	239	289	256	362	1,146
Earnings per share	0.39	0.48	0.42	0.59	1.88
Common stock price per share:					
High	44-1/4	43-1/4	44-5/8	54-5/8	54-5/8

Low	35-1/8	38	39	41	35-1/8
1995					
Net revenues	$ 1,247	$ 1,482	$ 1,587	$ 1,621	$ 5,937
Operating income	437	520	549	532	2,038
Net income	316	373	396	368	1,453
Earnings per share	0.51	0.60	0.63	0.58	2.32
Common stock price per share:					
High	59-1/4	65-1/8	74-1/8	92-3/8	92-3/8
Low	46-7/8	53-7/8	58-1/4	68-3/4	46-7/8
1996					
Net revenues	$ 2,016	$ 2,195	$ 2,205	$ 2,255	$ 8,671
Operating income	708	786	774	810	3,078
Net income	499	575	562	559	2,195
Earnings per share	0.78	0.90	0.88	0.87	3.43
Common stock price per share:					
High	109-1/4	103-3/8	107-1/16	125-7/8	125-7/8
Low	85	80-3/8	79-7/8	99-5/8	79-7/8

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The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1996, there were 37,883 holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

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EXHIBIT 13.2

FINANCIAL HIGHLIGHTS
(In millions, except earnings per share)

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	Year Ended June 30				
	1992	1993	1994	1995	1996
<S>	<C>	<C>	<C>	<C>	<C>
Net revenues	$2,759	$3,753	$4,649	$5,937	$ 8,671
Net income	708	953	1,146	1,453	2,195
Earnings per share	1.20	1.57	1.88	2.32	3.43
Return on net revenues	25.7%	25.4%	24.7%	24.5%	25.3%
Cash and short-term investments	$1,345	$2,290	$3,614	$4,750	$ 6,940
Total assets	2,640	3,805	5,363	7,210	10,093

Stockholders' equity	2,193	3,242	4,450	5,333	6,908

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EXHIBIT 13.3

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR 1994, 1995, AND 1996

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs) and servers, server applications for client/server environments, business and consumer productivity applications, interactive media programs, and Internet platform and development tools. Microsoft also offers online services, sells personal computer books and input devices, and researches and develops advanced technology software products.

NET REVENUES

The Company's net revenues grew 28% in the fiscal year ended June 30, 1995 and 46% in fiscal year 1996. Software license volume increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately.

PRODUCT GROUPS. Microsoft has a Platforms Product Group and an Applications and

Content Product Group.

Platforms Product Group revenues were $1.83 billion, $2.36 billion, and $4.11 billion in 1994, 1995, and 1996.

The Company's principal desktop operating system product in 1996 was Microsoft Windows 95. Released in August 1995, Windows 95 was a successor to MS-DOS(R) and Microsoft Windows 3.X operating systems. Windows 95, and before its release, MS-DOS and Windows 3.X, were preinstalled on PCs by most OEMs. Desktop operating systems increasingly contributed to revenues as new PCs preinstalled with such systems increased rapidly during the three-year period. Additionally, retail sales of Windows 95 were a major factor in the platforms revenue increase in 1996, reflecting the typical sales pattern for operating systems upgrades.

Business systems products offer an enterprise-wide distributed client/server environment based on the Microsoft Windows NT operating system and the server applications in the Microsoft BackOffice family of products. Revenues from these products increased strongly in 1994, 1995, and 1996 due to greater corporate demand for Windows NT Workstation and Windows NT Server.

During 1996, Microsoft implemented its policy of offering customers the latest Internet technology at no additional cost. Given this strategy, and because Internet browsers are a fundamental and integral part of Windows-based operating systems, ratable revenue recognition is required for a portion of all Windows-based operating system license fees, including those licensed through retail and OEM channels. Unearned revenues as of June 30, 1996 on the accompanying balance sheet include $425 million for future support commitments, Internet browser updates, and other unspecified enhancements to Windows-based operating systems that will be recognized ratably over the products' life cycles.

Revenues from developer products increased steadily in all three years, as more independent software vendors, corporate developers, and solutions developers licensed tools such as the Microsoft Visual Basic(R) programming system to develop software for Windows 95, Windows NT, and the Internet.

Applications and Content Product Group revenues were $2.82 billion, $3.58 billion, and $4.56 billion in 1994, 1995, and 1996.

Increases in desktop applications revenues were led by strong sales of 16-bit and 32-bit versions of Microsoft Office. The Microsoft Office Standard product includes the Microsoft Excel spreadsheet; Microsoft Word, a word-

processing program; and the Microsoft PowerPoint presentation graphics program. The Microsoft Office for Windows 95 (32-bit) version also includes the Microsoft Schedule+ calendar and scheduling program. Microsoft Office Professional version includes all of the above plus the Microsoft Access database management system.

Sales of stand-alone versions of Microsoft Excel and Microsoft Word continued to decrease as the sales mix shifted to integrated product suites. Sales of Microsoft Project and Microsoft Works also increased during the three-year period.

Microsoft licenses a broad range of consumer software products, which also showed continued growth. Products include CD-ROM multimedia reference titles and programs for home and small office productivity, children's creativity, and entertainment.

The Company also markets input devices. Mouse and keyboard sales increased during the three-year period, while the joystick's initial introduction increased revenues in 1996.

SALES CHANNELS. The Company distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: the United States and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM channel revenues were $1.18 billion in 1994, $1.65 billion in 1995, and $2.50 billion in 1996. The primary source of OEM revenues is the licensing of desktop operating systems. As such, OEM channel revenues are highly dependent on PC shipment volume.

Corporate licenses continued to grow in popularity across all geographic areas during the three-year period. Packaged product volume increased in 1996 due to the release of retail upgrade versions of Windows 95 and 32-bit desktop applications. U.S. and Canadian channel revenues were $1.58 billion, $1.88 billion, and $2.68 billion in 1994, 1995, and 1996. Revenues in Europe were $1.36 billion, $1.49 billion, and $2.02 billion in 1994, 1995, and 1996. Growth rates have been lower in Europe than in other geographic areas due to general economic slowness, higher existing market shares, and a more dramatic shift to corporate licensing programs. Other International channel revenues were $532 million in 1994, $924 million in 1995, and $1.47 billion in 1996. Growth rates continue to be strong due to customers accepting newly localized products, particularly in Japan, and early entrance into emerging markets.

The Company's operating results are affected by foreign exchange rates. Approximately 40%, 37%, and 38% of the Company's revenues were collected in foreign currencies during 1994, 1995, and 1996. Since much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates on net income is less than on revenues.

OPERATING EXPENSES

COST OF REVENUES. As a percentage of revenues, cost of revenues was 16.4% in 1994, 14.8% in 1995, and 13.7% in 1996. The percentage decreased due to a greater proportion of licenses to OEMs and corporations, a higher proportion of CD-ROM versions, and manufacturing efficiencies. These factors were offset somewhat by increased sales of lower-margin products such as integrated suites and retail upgrades.

RESEARCH AND DEVELOPMENT. Microsoft invested heavily in the future by funding research and development (R&D). Expense increases of 41% in 1995 and 67% in 1996 resulted primarily from development staff headcount growth and higher levels of third-party development costs in many areas, including development efforts for Windows 95 in 1995 and Windows NT and the Internet in 1996. R&D costs also increased for business systems, consumer systems, desktop applications, and interactive media products such as The Microsoft Network and other online services.

SALES AND MARKETING. The increase in the absolute dollar amount of sales and marketing expenses in the three-year period was due primarily to increased product-specific marketing programs, particularly for Windows 95 during 1996. Also, expenses increased due to higher levels of Microsoft brand advertising and product support.

GENERAL AND ADMINISTRATIVE. Increases in general and administrative expenses were primarily attributable to growth in the number of people and computer systems necessary to support overall increases in the scope of the Company's operations.

NONOPERATING ITEMS

Interest income increased primarily as a result of a larger investment portfolio generated by cash from operations. Other expenses increased in 1996 due to recognition of Microsoft's share of joint venture operational expenses, including DreamWorks Interactive and the MSNBC entities. During 1995, Microsoft paid a $46 million breakup fee to Intuit Inc. in connection with the termination of a planned merger. During 1994, the Company recorded a net pretax charge of $90 million, reflecting the patent litigation settlement with Stac Electronics.

PROVISION FOR INCOME TAXES

The effective tax rate was 33.5% in 1994, 33.0% in 1995, and 35.0% in 1996. The 1996 increase was primarily attributable to the research and experimental credit expiring in the United States.

NET INCOME

Net income as a percent of revenues increased in 1996 due to the lower relative cost of revenues, sales and marketing expenses, general and administrative expenses, and nonoperating expenses, offset by higher relative research and development expenses and the higher tax rate. The net income percentage decreased in 1995 due to increased relative research and development, sales and marketing, and general and administrative expenses, offset by the lower relative cost of revenues and the higher relative net nonoperating income.

FINANCIAL CONDITION

The Company's cash and short-term investments equaled $6.94 billion at June 30, 1996. The portfolio is diversified among security types, industries, and individual issuers. The Company's investments are generally investment grade and liquid. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The Company's portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt. The Company has $70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management.

Stockholders' equity at June 30, 1996 exceeded $6.9 billion.

Cash generated from operations has been sufficient historically to fund the Company's investment in research and development activities and facilities expansion. As the Company grows, investments will continue in research and development in existing and advanced areas of technology. The Company's cash will also be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including facilities and computer systems for research and development, sales and marketing, product support, and administrative staff. On June 30, 1996, commitments for constructing new buildings approximated $293 million.

Employees exercising stock options provides additional cash. These proceeds have funded the Company's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This program will continue in 1997.

To enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices.

A subsidiary of Tele-Communications, Inc. (TCI) owns a 20% minority interest in The Microsoft Network. TCI contributed $125 million of TCI common stock, and Microsoft contributed the business assets of this online service.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel, and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements in 1997. The Company's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuing the Company's long-term strategies.

Microsoft shareholders have also authorized issuing up to 100 million shares of preferred stock, which may be used for any proper corporate purpose.

OUTLOOK: ISSUES AND UNCERTAINTIES

Microsoft does not provide forecasts of future financial performance. While Microsoft's management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

RAPID TECHNOLOGICAL CHANGE. The PC software industry is characterized by rapid change and uncertainty due to new and emerging technologies. The pace of change has recently accelerated due to the Internet, online services, networking, and new programming languages, such as Java.

PC GROWTH RATES. The underlying PC unit growth rate, which may increase at a slower rate in the future, impacts software revenue growth.

CUSTOMER ACCEPTANCE. While the Company performs extensive usability and beta testing of new products, user acceptance and corporate penetration rates ultimately dictate the success of development and marketing efforts.

PRODUCT SHIP SCHEDULES. Delays in new-product releases impact revenue growth rates and can cause operational inefficiencies that impact manufacturing and distribution logistics, independent software vendor (ISV) and OEM relationships, and telephone support staffing.

PRICES. Future prices the Company can obtain for its products may decrease from historical levels, depending on competitive market or cost factors. European and Far Eastern software prices are generally higher than in the United States to cover localization costs and higher costs of distribution. Such price uplifts could erode in the future.

EARNINGS PROCESS. An increasingly higher percentage of the Company's revenues is earned after the initial shipment or licensing of the software product. Microsoft also offers product support, Internet browsers and add-ons, and other unspecified enhancements, so the applicable portion of revenues is recognized over the product's life cycle. This policy may be required for future products such as Microsoft Office 97, depending on specific license terms and conditions.

SATURATION. Product upgrades, which enable users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices and margins than new products. As the desktop applications market has become saturated, the sales mix has shifted from standard products to upgrade products. This trend is likely to continue.

CORPORATE LICENSES. Average revenue per unit from corporate license programs is lower than average revenue per unit from retail versions shipped through the finished goods channels. Unit sales under corporate licensing programs may continue to increase.

CHANNEL MIX. Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenues was achieved through the OEM channel during 1995 and 1996.

INTEGRATED SUITES. The price of integrated suites, such as Microsoft Office, is less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. Revenues from integrated suites may continue to increase as a percentage of total revenues.

COST OF REVENUES. Although cost of revenues as a percentage of net revenues decreased in 1995 and 1996, it varies with channel mix and product mix within channels. Such mix factors may increase cost of revenues as a percentage of revenues in 1997.

PAY AND PARTICIPATION MODEL. Microsoft employees currently receive salaries, incentive bonuses, other fringe benefits, and stock options. New government regulations, low stock prices, or other factors could diminish the value of the option program and force the Company into more of a cash compensation model. Had the Company paid employees in cash the grant date Black-Scholes value of options vested in 1994, 1995, and 1996, the pretax expense would have been approximately $360 million, $410 million, and $570 million.

LONG-TERM RESEARCH AND DEVELOPMENT INVESTMENT CYCLE. Developing and localizing software is expensive and the investment in product development often involves a long payback cycle. The Company plans to continue significant investments in software research and development and related product opportunities from which significant revenues are not anticipated for a number of years. Management expects total spending for research and development in 1997 to increase over spending in 1996.

SALES AND MARKETING AND SUPPORT INVESTMENTS. The Company's plans for 1997 include continued investments in its sales and marketing and support groups.

FOREIGN EXCHANGE. A large percentage of the Company's sales, costs of manufacturing, and marketing is transacted in local currencies. As a result, the Company's international results of operations are subject to foreign exchange rate fluctuations.

INTELLECTUAL PROPERTY RIGHTS. Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenues to the Company. While this adversely affects U.S. revenues, revenue loss is even more significant outside of the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenues positively.

FUTURE GROWTH RATE. The revenue growth rate in the first two quarters of 1997 may not approach the level attained in 1996, which was high due to Windows 95 upgrades. As discussed above, operating expenses are expected to increase in 1997. Because of the fixed nature of a significant portion of such expenses, coupled with the possibility of slower revenue growth, operating margins in 1997 may decrease from those in 1996.

LITIGATION. Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks.

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EXHIBIT 13.4

MICROSOFT CORPORATION

FINANCIAL STATEMENTS

Income Statements for the three years ended June 30, 1996

Cash Flows Statements for the three years ended June 30, 1996

Balance Sheets as of June 30, 1995 and 1996

Stockholders' Equity Statements for the three years ended June 30, 1996

Notes to Financial Statements

Independent Auditors' Report

<PAGE> 2

INCOME STATEMENTS
(In millions, except earnings per share)

<TABLE>
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	Year Ended June 30		
	1994	1995	1996
<S>	<C>	<C>	<C>
Net revenues	$4,649	$5,937	$8,671
Operating expenses:			
Cost of revenues	763	877	1,188
Research and development	610	860	1,432
Sales and marketing	1,384	1,895	2,657
General and administrative	166	267	316
Total operating expenses	2,923	3,899	5,593
Operating income	1,726	2,038	3,078
Interest income	102	191	320
Noncontinuing items	(90)	(46)	--
Other expenses	(16)	(16)	(19)
Income before income taxes	1,722	2,167	3,379

Provision for income taxes	576	714	1,184
Net income	$1,146	$1,453	$2,195
Earnings per share	$ 1.88	$ 2.32	$ 3.43
Weighted average shares outstanding	610	627	640

</TABLE>

See accompanying notes.

<PAGE> 3

CASH FLOWS STATEMENTS
(In millions)
<TABLE>
<CAPTION>

	Year Ended June 30		
	1994	1995	1996
<S>	<C>	<C>	<C>
CASH FLOWS FROM OPERATIONS			
Net income	$1,146	$1,453	$2,195
Depreciation and amortization	237	269	480
Current liabilities	360	419	1,090
Accounts receivable	(146)	(91)	
(71)			
Other current assets	(4)	(60)	25
Net cash from operations	1,593	1,990	3,719
CASH FLOWS USED FOR FINANCING			
Common stock issued	280	332	504
Common stock repurchased	(348)	(649)	(1,261)
Stock option income tax benefits	151	179	352
Net cash used for financing	83	(138)	(405)
CASH FLOWS USED FOR INVESTMENTS			
Additions to property, plant, and equipment	(278)	(495)	(494)
Other assets	(64)	(230)	(625)
Short-term investments	(860)	(651)	(1,551)
Net cash used for investments	(1,202)	(1,376)	(2,670)
Net change in cash and equivalents	474	476	644
Effect of exchange rates on cash	(10)	9	(5)
Cash and equivalents, beginning of year	1,013	1,477	1,962
Cash and equivalents, end of year	1,477	1,962	2,601
Short-term investments	2,137	2,788	4,339
Cash and short-term investments	$3,614	$4,750	$6,940

</TABLE>

See accompanying notes.

<PAGE> 4

BALANCE SHEETS
(In millions)
<TABLE>
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	June 30	
	1995	1996
<S>	<C>	<C>
ASSETS		
Current assets:		
Cash and short-term investments	$4,750	$ 6,940
Accounts receivable	581	639
Other	289	260
Total current assets	5,620	7,839
Property, plant, and equipment	1,192	1,326
Other assets	398	928
Total assets	$7,210	$10,093
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 563	$ 808
Accrued compensation	130	202
Income taxes payable	410	484
Unearned revenues	54	560
Other	190	371
Total current liabilities	1,347	2,425
Minority interest	125	125
Put warrants	405	635
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 2,000; shares issued and outstanding 588 and 597	2,005	2,924
Retained earnings	3,328	3,984
Total stockholders' equity	5,333	6,908
Total liabilities and stockholders' equity	$7,210	$10,093

</TABLE>

See accompanying notes.

STOCKHOLDERS' EQUITY STATEMENTS
(In millions)

<TABLE>
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	Year Ended June 30		
	1994	1995	1996
<S>	<C>	<C>	<C>
COMMON STOCK AND PAID-IN CAPITAL			
Balance, beginning of year	$1,086	$1,500	$2,005
Common stock issued	280	332	504
Common stock repurchased	(17)	(30)	(41)
Proceeds from sale of put warrants	--	49	124
Reclassification of put warrant obligation	--	(25)	(20)
Stock option income tax benefits	151	179	352
Balance, end of year	1,500	2,005	2,924
RETAINED EARNINGS			
Balance, beginning of year	2,156	2,950	3,328
Common stock repurchased	(331)	(668)	(1,344)
Reclassification of put warrant obligation	--	(380)	(210)
Net income	1,146	1,453	2,195
Equity adjustments	(21)	(27)	15
Balance, end of year	2,950	3,328	3,984
Total stockholders' equity	$4,450	$5,333	$6,908

</TABLE>

See accompanying notes.

CASH AND SHORT-TERM INVESTMENTS

<TABLE>
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	June 30	
	1995	1996
<S>	<C>	<C>
Cash and equivalents:		
Cash	$ 135	$ 64
Commercial paper	1,035	1,447
Money market preferreds	255	105
Certificates of deposit	492	768
Bank loan participations	45	217
Cash and equivalents	1,962	2,601
Short-term investments:		
Municipal securities	1,291	1,357
Corporate notes and bonds	866	1,125
U.S. Treasury securities	444	1,591
Commercial paper	187	266
Short-term investments	2,788	4,339
Cash and short-term investments	$4,750	$ 6,940

</TABLE>

PROPERTY, PLANT, AND EQUIPMENT
<TABLE>
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	June 30	
	1995	1996
<S>	<C>	<C>
Land	$ 206	$ 183
Buildings	607	787
Computer equipment	707	885
Other	387	491
Property, plant, and equipment -- at cost	1,907	2,346
Accumulated depreciation	(715)	(1,020)
Property, plant, and equipment -- net	$1,192	$ 1,326

</TABLE>

During 1995 and 1996, depreciation expense, of which the majority related to computer equipment, was $227 million and $363 million; disposals were immaterial.

holders to sell shares of Microsoft common stock to the Company at specified prices, are exercisable only at maturity, and are settleable in cash at Microsoft's option. On June 30, 1995 and 1996, 8.0 million and 13.0 million warrants were outstanding. The outstanding warrants at June 30, 1996 expire on various dates between December 1996 and December 1997 and have strike prices ranging from $95 per share to $104 per share. The maximum potential repurchase obligations of $405 million and $635 million at June 30, 1995 and 1996 have been reclassified from stockholders' equity to put warrants. There was no impact on earnings per share in 1995 or 1996.

EMPLOYEE STOCK AND SAVINGS PLANS

EMPLOYEE STOCK PURCHASE PLAN. The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1994, 1995, and 1996, employees purchased 1.0 million, 1.1 million, and .9 million shares at average prices of $34.16, $46.76, and $75.44 per share. At June 30, 1996, 1.2 million shares were reserved for future issuance.

SAVINGS PLAN. The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Under the plan, participating U.S. employees may defer up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. The Company's matching contributions to the savings plan were $9 million, $12 million, and $15 million in 1994, 1995, and 1996.

STOCK OPTION PLANS. The Company has stock option plans for directors, officers, and all employees, which provide for nonqualified and incentive stock options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. Options granted prior to 1995 generally vest over four and one-half years and expire ten years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after ten years. At June 30, 1996, options for 60.2 million shares were vested and 67.8 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

<TABLE>
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		Price per Share	
	Number	Range	Weighted Average
<S>	<C>	<C>	<C>
Balance, June 30, 1993	114.1	$0.31 - 44.25	$18.06
Granted	26.2	35.50 - 50.13	37.47
Exercised	(20.9)	1.51 - 44.25	11.42
Canceled	(5.5)	5.01 - 44.13	28.67
Balance, June 30, 1994	113.9	0.31 - 50.13	23.29

Granted	21.7	47.75 - 83.13	50.50
Exercised	(17.6)	0.31 - 47.75	15.81
Canceled	(4.2)	5.11 - 75.00	35.40
Balance, June 30, 1995	113.8	1.54 - 83.13	29.12
Granted	28.5	80.19 - 117.88	89.97
Exercised	(19.6)	1.54 - 90.50	21.49
Canceled	(3.6)	5.17 - 110.88	55.70
Balance, June 30, 1996	119.1	2.19 - 117.88	44.14

</TABLE>

THE MICROSOFT NETWORK

During 1995, a wholly owned subsidiary of Tele-Communications, Inc. (TCI) purchased a 20% minority interest in The Microsoft Network. TCI contributed $125 million of TCI common stock and Microsoft contributed the business assets of this online service. Microsoft owns 80% of the entity, whose operations have not been material to the financial results of Microsoft.

NONCONTINUING ITEMS

During 1995, Microsoft paid a $46 million breakup fee to Intuit Inc. in connection with the termination of a planned merger. During 1994, the Company recorded a net pretax charge of $90 million, reflecting the settlement of patent litigation with Stac Electronics.

COMMITMENTS AND CONTINGENCIES

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $68 million, $86 million, and $92 million in 1994, 1995, and 1996. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1997, $89; 1998, $76; 1999, $58; 2000, $28; 2001, $24; and thereafter, $19.

In connection with the Company's communications infrastructure and the operation of The Microsoft Network, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 1997, $65; 1998, $78; 1999, $106; 2000, $80; and 2001, $11. Also, Microsoft has committed to certain volumes of outsourced manufacturing of packaged product in the United States and has committed $293 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two

MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture and to pay one-half of operational funding of both joint ventures for a multiyear period.

Microsoft is subject to various legal proceedings and claims that arise in the ordinary course of business. Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

GEOGRAPHIC INFORMATION

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NET REVENUES			
U.S. operations	$3,472	$4,495	$ 6,614
European operations	1,401	1,575	2,241
Other international operations	375	558	965
Eliminations	(599)	(691)	(1,149)
Total net revenues	$4,649	$5,937	$ 8,671
OPERATING INCOME			
U.S. operations	$1,394	$1,709	$ 2,408
European operations	346	412	680
Other international operations	31	91	376
Eliminations	(45)	(174)	(386)
Total operating income	$1,726	$2,038	$ 3,078
IDENTIFIABLE ASSETS			
U.S. operations	$4,397	$5,862	$ 8,193
European operations	1,366	1,806	2,280
Other international operations	423	689	1,042
Eliminations	(823)	(1,147)	(1,422)
Total identifiable assets	$5,363	$7,210	$10,093

</TABLE>

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the United States, licensing to OEMs, and exports of finished goods directly to international customers, primarily in Canada, South America, and Asia. Exports and international OEM transactions are primarily in U.S. dollars and totaled $787 million, $1,263 million, and $2,148 million in 1994, 1995, and 1996. "Other international operations" primarily include subsidiaries in Australia, Japan, Korea, and Taiwan. International revenues, which include European operations, other international operations, exports, and OEM distribution, were 54%, 55%, and 60% of total revenues in 1994, 1995, and 1996.

SUBSIDIARIES

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399

GraceMac Corporation (NEVADA)
Microsoft FSC Corp. (U.S. VIRGIN ISLANDS)
Microsoft Manufacturing B.V. (THE NETHERLANDS)
Microsoft Puerto Rico, Inc. (Manufacturing) (DELAWARE)
Vermeer Technologies, Inc. (DELAWARE)
Microsoft de Argentina S.A.
Microsoft Pty Limited (AUSTRALIA)
Microsoft Gesellschaft m.b.H. (AUSTRIA)
Microsoft N.V. (BELGIUM)
Microsoft Informatica Limitada (BRAZIL)
Microsoft Canada Inc.
Softimage, Inc. (CANADA)
Microsoft Chile S.A.
Microsoft Colombia Inc. (DELAWARE)
Microsoft De Centroamerica S.A. (COSTA RICA)
Microsoft s.r.o. (CZECH REPUBLIC)
Microsoft Danmark ApS (DENMARK)
CorporacionMicrosoft Del Ecuador S.A.
Microsoft Corporation (Representative Office) (EGYPT)
Microsoft Oy (FINLAND)
Microsoft France S.A.R.L.
Softimage France S.A.R.L.
Microsoft G.m.b.H. (GERMANY)
Softimage G.m.b.H. (GERMANY)
Microsoft Hellas S.A. (GREECE)
Microsoft De Guatemala, S.A.
Microsoft Hong Kong Limited
Microsoft Kft (HUNGARY)
Microsoft Corporation (India) Private Limited
PT. Microsoft Indonesia
Microsoft Israel Ltd.
Microsoft S.p.A. (ITALY)
Microsoft Company, Limited (JAPAN)
Microsoft CH (KOREA)
Microsoft (Malaysia) Sdn. Bhd.
Microsoft Mexico, S.A. de C.V.
Microsoft Maroc S.A.R.L. (MOROCCO)
Microsoft B.V. (THE NETHERLANDS)
Microsoft International B.V. (THE NETHERLANDS)
Microsoft New Zealand Limited
Microsoft Norge AS (NORWAY)
Microsoft De Panama, S.A.
Microsoft (China) Company Limited (THE PEOPLE'S REPUBLIC OF CHINA)
Microsoft Peru, S.A.
Microsoft Philippines, Inc.
Microsoft sp. z.o.o. (POLAND)
MSFT-Software Para Microcomputadores, LDA (PORTUGAL)

Microsoft Caribbean, Inc. (DELAWARE)
Microsoft Taiwan Corporation (REPUBLIC OF CHINA)
Microsoft A.O. (RUSSIA)
Microsoft Singapore Pte Ltd
Microsoft Slovakia s.r.o. (SLOVAK REPUBLIC)
Microsoft d.o.o., Ljubljana (SLOVENIA)
Microsoft (S.A.) (Proprietary) Limited (SOUTH AFRICA)
Microsoft Iberica S.R.L. (SPAIN)
Microsoft Aktiebolag (SWEDEN)
Microsoft AG (SWITZERLAND)
Microsoft (Thailand) Limited
Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (TURKEY)
Microsoft Corporation (Dubai Branch) (UNITED ARAB EMIRATES)
Microsoft Limited (UNITED KINGDOM)
Softimage U.K. Limited
Microsoft Uruguay S.A.
Corporation MS 90 de Venezuela S.A.
The Resident Representative Office of Microsoft Corporation in Hanoi (VIETNAM)
DreamWorks Interactive L.L.C. (WASHINGTON, 50% owned)
The Microsoft Network L.L.C. (DELAWARE, 80% owned)
MSNBC Cable L.L.C. (DELAWARE, 50% owned)
MSNBC Interactive News L.L.C. (DELAWARE, 50% owned)

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1995 and 1996, and the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1995 and 1996, and the results of their operations and their cash flows for each of the three years ended June 30, 1996 in conformity with accounting principles generally accepted in the United States and International Accounting Standards.

/S/ DELOITTE & TOUCHE LLP

Deloitte & Touche LLP

Seattle, Washington
July 22, 1996

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EXHIBIT 23.

INDEPENDENT AUDITORS' CONSENT

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981 Stock Option Plan), 33-44302 and 33-51583 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors) and 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors) of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, 33-63471, 33-64870, 333-857, 333-1177, 333-2759, 333-5961, and 333-8081 of Microsoft Corporation on Forms S-3 of our report dated July 22, 1996 appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 1996.

/S/ DELOITTE & TOUCHE LLP

Deloitte & Touche LLP

Seattle, Washington
September 25, 1996

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EXHIBIT 99.1

MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN

FINANCIAL STATEMENTS FOR THE
THREE YEARS ENDED JUNE 30, 1996
AND INDEPENDENT AUDITORS' REPORT

<PAGE> 2

INDEPENDENT AUDITORS' REPORT

Plan Administrator
Microsoft Corporation
1991 Employee Stock Purchase Plan
Redmond, Washington

We have audited the accompanying statements of assets available for benefits of the Microsoft Corporation 1991 Employee Stock Purchase Plan (the Plan) as of June 30, 1996 and 1995, and the related statements of changes in assets available for benefits for each of the three years ended June 30, 1996. These financial statements are the responsibility of the Plan Administrator. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the assets available for benefits of the Plan as of June 30, 1996 and 1995, and the changes in assets available for benefits for each of the three years ended June 30, 1996 in conformity with generally accepted accounting principles.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP

Seattle, Washington
August 19, 1996
<PAGE> 3
MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN
STATEMENTS OF ASSETS AVAILABLE FOR BENEFITS
JUNE 30, 1996 AND 1995

<TABLE>
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	1996	1995
<S>	<C>	<C>
ASSETS:		
Cash	$ 545,574	$ 295,579
ASSETS AVAILABLE FOR BENEFITS	$ 545,574	$ 295,579

</TABLE>

See accompanying notes.

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MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN
STATEMENTS OF CHANGES IN ASSETS AVAILABLE FOR BENEFITS
YEARS ENDED JUNE 30, 1996, 1995, AND 1994

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	1996	1995	1994
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ASSETS AVAILABLE FOR BENEFITS, beginning of period	$ 295,579	$ 492,243	$ 961,962
ADDITIONS:			
Employee contributions	67,117,845	48,835,431	38,614,990
DEDUCTIONS:			
Cost of shares purchased	66,867,850	49,032,095	39,084,709

CHANGES IN ASSETS AVAILABLE FOR BENEFITS	249,995	(196,664)	(469,719)
ASSETS AVAILABLE FOR BENEFITS, end of period	$ 545,574	$ 295,579	$ 492,243

</TABLE>

See accompanying notes.

MICROSOFT CORPORATION
1991 EMPLOYEE STOCK PURCHASE PLAN
NOTES TO FINANCIAL STATEMENTS
YEARS ENDED JUNE 30, 1996, 1995, AND 1994

NOTE 1: THE PLAN

The following description of the Microsoft Corporation 1991 Employee Stock Purchase Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

GENERAL: The Plan Administrator believes the Plan meets the qualification standards of Section 423 of the Internal Revenue Code of 1986. The Plan is not subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

The Plan covers substantially all employees of Microsoft Corporation (the Company) whose customary employment is greater than 20 hours per week and more than five months in any calendar year.

CONTRIBUTIONS: Participants may make contributions to the Plan through payroll deductions (not exceeding 10% of their compensation) for the purpose of purchasing the Company's common stock. The Plan commenced on January 1, 1991, and participants are given the opportunity to purchase shares on each June 30 and December 31 until such time as the Plan is terminated (see Termination of the Plan). The maximum number of shares that will be offered under the Plan is 6,750,000.

OPTIONS GRANTED AND WITHDRAWALS: Participants are granted the option to purchase shares of Microsoft Corporation common stock from the Company at 85% of the lesser of the fair market value on the first or last day of each six-month period ending June 30 or December 31. If, prior to the end of any six month period, a participant elects to withdraw from the Plan or has terminated, the Plan refunds any amounts withheld in that period plus any carryover from the previous period. Such withdrawals have been immaterial. The Plan purchased 886,221, 1,049,695, and 1,147,508 shares during the years ended June 30, 1996, 1995, and 1994, respectively. A total of 5,572,281 shares have been purchased under the Plan since inception with 1,177,719 shares reserved for future issue.

ASSETS AVAILABLE FOR BENEFITS: Assets available for benefits represent cash in participant accounts that was less than the amount necessary to purchase a full share and cash contributed to the Plan greater than the cost of the maximum number of shares allowed to be purchased in a six-month period (see Limitations). Participants may carry over such amounts to the next period or may request a refund from the Plan.

LIMITATIONS: No employee shall be permitted to subscribe for any shares under the Plan if such employee owns shares representing 5% or more of the total combined voting power or value of all classes of shares of the Company. Additionally, no participant may purchase more than 2,250 shares of stock during a six-month period or purchase shares through the Plan with an aggregate fair market value in excess of $25,000 in any one calendar year.

TERMINATION OF THE PLAN: The Plan shall terminate at the earliest of the following:

- December 31, 1996

- The date of the filing of a statement of intent to dissolve by the Company or the effective date of a merger or consolidation (except with a related company) where the Company is not to be the surviving corporation

- The date the Board acts to terminate the Plan

- The date when all shares reserved under the Plan have been purchased

In the event of a dissolution, merger, or acquisition, the Company may permit a participating employee to exercise options to the extent that employee payroll deductions have accumulated. In the event of termination, Plan assets will be distributed to the participants.

PLAN ADMINISTRATION: All expenses for Plan administration are paid by the Company and are not reflected in the accompanying statements.

NOTE 2: REPLACEMENT PLAN

The current Plan terminates on December 31, 1996. The Company's Board of Directors has approved submission of a similar plan to a vote of the shareholders at the 1996 annual shareholders' meeting. If approved, the replacement plan would commence on January 1, 1997 and would terminate December 31, 2001 or earlier under the same provisions of the current Plan (see Note 1, Termination of the Plan).

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FILED AS OF DATE: 19960927
SROS: NASD

FILER:

COMPANY DATA:
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CENTRAL INDEX KEY: 0000789019
STANDARD INDUSTRIAL CLASSIFICATION: SERVICES-PREPACKAGED SOFTWARE [7372]
IRS NUMBER: 911144442
STATE OF INCORPORATION: WA
FISCAL YEAR END: 0630

FILING VALUES:
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SEC ACT: 1934 Act
SEC FILE NUMBER: 000-14278
FILM NUMBER: 96635668

BUSINESS ADDRESS:
STREET 1: ONE MICROSOFT WAY #BLDG 8
STREET 2: NORTH OFFICE 2211
CITY: REDMOND
STATE: WA
ZIP: 98052
BUSINESS PHONE: 2068828080

MAIL ADDRESS:
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PART I

Item 1. Business

GENERAL

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs) and servers; server applications for client/server environments, business and consumer productivity applications; interactive media programs; and Internet platform and development tools. Microsoft also offers online services, sells personal computer books and input devices, and researches and develops advanced technology software products. Microsoft(R) products are available for most PCs, including Intel microprocessor-based computers and Apple computers.

Microsoft's business strategy emphasizes the development of a broad line of PC software products for business and personal use, marketed through multiple channels of distribution. The Company is divided into four main groups: the Platforms Product Group; the Applications and Content Product Group; the Sales and Support Group; and the Operations Group.

The Platforms Product Group is comprised of three divisions, each responsible for a particular area of platforms software development and marketing. The Desktop and Business Systems Division develops PC and server operating systems and a suite of server applications. The Internet Platform and Tools Division creates software development tools, Internet browser technology, and other Internet and online products and technologies. The Consumer Platforms Division develops system software for non-PC devices, integrated software systems for public networks, and software for the creation of content for digital media productions.

schedule planning tool.

OTHER PRODUCTIVITY PRODUCTS: The Company also offers other productivity products, including Microsoft Works, Microsoft Publisher, and Microsoft FrontPage. Microsoft Works is an integrated software program that contains basic word processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Microsoft Publisher is an easy-to-use, entry-level desktop publishing program. Microsoft FrontPage is a Web authoring and management tool for Web sites on the Internet or intranets.

INTERACTIVE MEDIA PRODUCTS

The Microsoft Interactive Media Division develops and markets interactive entertainment and information products across a variety of media, including the Internet, The Microsoft Network, and CD-ROM.

INFORMATION: Reference titles include Microsoft Encarta(TM) and Microsoft Bookshelf(R). The Encarta multimedia encyclopedia database blends text in articles with a wealth of innovative, interactive information presented through animations, videos, maps, charts, sounds, and pictures. Bookshelf is a multimedia reference library that integrates seven well-respected and authoritative works, including a dictionary, world atlas, world almanac, thesaurus, concise encyclopedia, and two books of quotations.

Personal interest titles include Microsoft Cinemania(TM), an interactive guide to the movies with entries for 19,000 films, Microsoft Dinosaurs, and many musical titles.

Geography and travel products include Automap Road Atlas, a comprehensive route-planning program with detailed maps and road information for routes in North America.

KIDS: Titles for children include Microsoft Creative Writer and Microsoft Fine Artist. Creative Writer is a full-featured creative writing and publishing program; Fine Artist is a comprehensive art program. Both products take advantage of the computer's ability to integrate text, high-quality graphics, sound, and animation to produce an enriching creative experience for children. The Company also has a series of products based on the popular children's books and television series, The Magic School Bus.

ENTERTAINMENT: The Company also has a line of entertainment products. Microsoft Flight Simulator is a popular aircraft flight simulation product available for MS-DOS and Macintosh operating systems. Games include Space Simulator, Microsoft Golf, Microsoft Fury(3), and Microsoft Arcade. Most games are available for the

Windows 95 environment.

THE MICROSOFT NETWORK: The Microsoft Network is an interactive online service. MSN provides easy and inexpensive access for users to a wide range of graphically-rich online content, a compelling business model and platform for independent content providers (ICPs), and rich and powerful development tools. The online service provides access to the Internet, electronic mail, bulletin boards, and a myriad of additional services offered by Microsoft and by ICPs. Content and service providers aligned with MSN have flexibility in creating products and pricing their services, such as subscriptions, online transactions, and ticket events. Services may be supported by advertising and commerce.

MSN is owned by The Microsoft Network L.L.C. Microsoft owns 80% of the entity while a wholly owned subsidiary of Tele-Communications, Inc. (TCI) owns the remaining 20%.

JOINT VENTURES: The Company has entered into joint venture arrangements to leverage creative talent and content from other organizations. Microsoft owns 50% of DreamWorks Interactive L.L.C., a software company that develops interactive and multimedia products. DreamWorks SKG owns the remaining 50%. Microsoft owns 50% of MSNBC Cable L.L.C., a 24-hour cable news and information channel; and 50% of MSNBC Interactive News L.L.C., an interactive online news service. National Broadcasting Company (NBC) owns the remaining 50% of these two joint ventures.

PC INPUT DEVICES

The Company's major input device is the Microsoft Mouse, a hand-held pointing device that facilitates use of a PC. It can be used with MS-DOS and Windows operating systems and works with most applications products from Microsoft and other companies. Microsoft also offers a mouse designed for the home and a mouse for young children. The Company also markets the Microsoft Natural Keyboard(TM), an ergonomically-designed keyboard. Additionally, Microsoft sells two versions of Sidewinder(TM), a joystick for games.

DESKTOP FINANCE

Microsoft Money is a financial organization product that allows users to computerize their household finances. Microsoft Money is available for systems running Windows 95. It is visually appealing, easy to use, and focuses on the financial tasks that people do most often. Microsoft Money provides enhanced online home-banking services with 17 different banks in the U.S. Users who are customers of participating banks are able to pay bills online, access up-to-date statements and balances, transfer funds, and send email messages and inquiries to their banks.

MICROSOFT PRESS

Microsoft Press publishes books about software products from Microsoft and other software developers and about current developments in the industry. Books published by Microsoft Press typically are written and copyrighted by independent authors who submit their manuscripts to the Company for publication and who receive royalties based on net revenues generated by the book.

Microsoft Press contracts with an independent commercial printer for the manufacturing of its books. Publisher's Resources, Inc. acts as the Company's main fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press books. Books are marketed by independent sales representatives and by Microsoft Press sales personnel. Internationally, Microsoft Press has numerous international agreements with publishers for the worldwide distribution of its books. Microsoft Press has granted a publisher in England the right to distribute English language versions of its books in all countries except the United States, Canada, Central and South America, and certain Asian countries. In most cases, Microsoft Press provides each publisher with a book's manuscript, and the publisher arranges for its translation and the printing, marketing, and distribution of the translated version.

PRODUCT DEVELOPMENT

The PC software industry is characterized by extremely rapid technological change, which requires constant attention to software technology trends and shifting consumer demand, and rapid product innovation. The pace of change has recently become even greater due to the surge of interest in the Internet, other forms of online services, networking generally, and new programming languages, such as Java.

Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third party development for certain products. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved development methodologies for creating and enhancing its products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, or computers. Product documentation is generally created internally.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to new user needs or advances in PCs, servers, peripherals, and the Internet, without compromising product quality. The Company strives to become as informed as possible at the earliest possible time about changing usage patterns and hardware advances that may affect software design.

During fiscal years 1994, 1995, and 1996, the Company spent $610 million, $860 million, and $1,432 million, respectively, on product research and development activities. Those amounts represented 13.1%, 14.5%, and 16.5%, respectively, of net revenues in each of those years. The Company is committed to continued high expenditures for research and product development.

LOCALIZATION

In order to best serve the needs of users in foreign countries, Microsoft "localizes" many of its products to reflect local languages and conventions. In France, for example, all user messages and documentation are in French and all monetary references are in French francs, and in the United Kingdom, monetary references are in British pounds and user messages and documentation reflect certain British conventions. Various Microsoft products have been localized into more than 30 languages.

MANUFACTURING

Microsoft contracts a substantial portion of its manufacturing activity to third parties. Outside manufacturers produce various retail software packaged products, documentation, and hardware such as mouse pointing devices, keyboards, and joysticks. There are other custom manufacturers in the event that outsourced manufacturing becomes unavailable from current sources.

In recent years the Company's sales mix has shifted to corporate and OEM licenses from packaged products. Online distribution of software may increase in the future. During July 1996, Microsoft sold its domestic manufacturing and distribution operation.

The Company's remaining manufacturing facilities are located in Puerto Rico and Ireland. The Irish manufacturing facility replicates disks, assembles other purchased parts, and packages final product. The Puerto Rican facility manufactures CD-ROMs, assembles other purchased parts, and packages final product. Quality control tests are performed on purchased parts, finished disks and CD-ROMs, and other products. The chief materials and components used in Microsoft products include disks or CD-ROMs, books, and multicolor printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.

MARKETING AND DISTRIBUTION

Microsoft aligns its sales and marketing people with several customer types, including end-users, organizations and enterprises, and OEMs. The Company's sales and marketing staff seeks to build long-term relationships with customers of Microsoft products. In addition to the OEM channel, Microsoft has three major geographic sales and marketing organizations: the U.S. and Canada, Europe, and elsewhere in the world (Other International).

The end-user customer unit has responsibility for activities that target end-users who make individual buying decisions for the PCs they use at work or home. Most sales and marketing activities aimed at end-user customers are performed by this unit, including developing and administering reseller relationships; reseller sales terms and conditions; channel marketing and promotions; end-user marketing programs; support policies; and seminars, events, and sales training for resellers. The key products licensed and sold are the Company's desktop operating systems, desktop applications, and interactive media products.

The organization customer unit has responsibility for activities that target groups of users in small and medium organizations. The unit works with channel partners such as distributors, aggregators, value-added resellers, and Solution Providers to provide complete business solutions to this customer segment. The unit's sales and marketing activities include providing technical training of Solution Providers and channel resellers; developing support policies; and supporting and providing seminars, events, and sales training for channel partners.

The enterprise customer unit has responsibility for sales and marketing activities that target large organizations (enterprises). The unit works directly with these organizations, and through large account resellers, to create enterprisewide, mission critical solutions to business computing problems.

Key products for the organization and enterprise customer units are the Company's business systems; applications and Internet developer software; desktop productivity applications; and desktop operating systems.

The OEM customer unit includes the sales force which works with original equipment manufacturers that preinstall Microsoft software on their PCs.

FINISHED GOODS CHANNELS

DISTRIBUTORS AND RESELLERS: The Company markets its products in the finished goods channels primarily through independent non-exclusive distributors and resellers. Distributors include Computer 2000, Ingram Micro, Tech Data, and Merisel. Resellers include Egghead Software, Softbank, Software Spectrum, and Stream International. Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

LARGE ACCOUNTS: The Company has a program designed to make it easier for large organizations to acquire and maintain Microsoft products. The program, Microsoft Select, offers flexible software acquisition, licensing, and maintenance options specially designed to meet the needs of large multinational organizations. Targeted audiences include technology specialists and influential end-users in large enterprises. Marketing efforts and fulfillment are generally coordinated with the Microsoft network of large account resellers.

SOLUTION PROVIDERS: Microsoft's Solution Providers program is a comprehensive support relationship with independent organizations that provide network and system integration, custom development, training, and technical support for business computing solutions. The program supports value-added resellers (VARs), system integrators, consultants, custom application developers, solution developers, Internet service and hosting organizations, independent content providers, and sitebuilders (companies that build Web sites for other companies), as well as technical support and training organizations. Under this business partnership strategy, the Company provides sales and product information, development services, early access to Microsoft products, and customer support tools including priority telephone support, education, and business development support. To ensure high-quality technical services for the Company's products, Microsoft Solution Providers are required to have Microsoft-certified professionals on staff.

CONSULTING SERVICES: The Company's Consulting Services Division assists customers in using the Company's computer operating systems, applications, and communications products. The group works with Solution Providers and helps create enterprisewide computing solutions for large corporate accounts.

DIRECT MARKETING: Microsoft promotes some of its products through direct marketing techniques directed toward existing and potential users of the Company's products. Promotional materials are typically delivered through the

mail, utilizing lists of targeted individuals. Fulfillment of product to the end-user is accomplished by either direct shipment or through resellers.

INTERNATIONAL SALES SITES: The Company has established marketing and/or support subsidiaries in more than 60 countries. Sales are generally made by the local sales subsidiary, while product is delivered by either the Company's owned or outsourced manufacturing operations. In some locations, sales are made directly by the Company from the U.S.

The Company's international operations, both OEM and finished goods, are subject to certain risks common to foreign operations in general, such as governmental regulations, import restrictions, and foreign exchange rate fluctuations. Microsoft hedges a portion of its foreign exchange risk.

OEM CHANNEL

The Company's operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of Microsoft's products with their computers. The Company also markets certain desktop applications and interactive media programs to OEMs under similar arrangements. In addition, the Company markets the Microsoft Mouse and Natural Keyboard to OEMs for distribution to buyers of their computers. In almost all cases, the products are distributed under Microsoft trademarks. The Company has OEM agreements covering one or more of its products with virtually all of the major PC OEMs, including AST Research, Acer, Compaq, Digital Equipment Corporation, Dell, Fujitsu, Gateway 2000, Hewlett-Packard, IBM, NEC, Olivetti, Packard Bell, Siemens, Toshiba, and Vobis.

ADVERTISING

The Company works closely with large advertising and direct marketing firms. Advertising, direct marketing, worldwide packaging, and marketing materials are targeted to various end-user segments. The Company utilizes broad consumer media (television, radio, and business publications) and trade publications. Microsoft has programs under which qualifying resellers and OEMs are reimbursed for certain advertising expenditures. Microsoft also invests in direct marketing and customer satisfaction areas. The Company maintains a broad advertising campaign emphasizing the Microsoft brand identity.

CUSTOMERS

As described above, Microsoft has four customer types: end-users, organizations, enterprises, and OEMs. Most end-users of Microsoft products are individuals in businesses, government agencies, educational institutions, and at home. These end-users obtain Microsoft products primarily through distributors, resellers, and OEMs, which include certain Microsoft products with their hardware. Notes to Financial Statements (see Item 8) describe customers that represent more than 10% of the Company's revenues. The Company's practice is to ship its products promptly upon receipt of purchase orders from its customers and, consequently, backlog is not significant.

PRODUCT SUPPORT

The Company provides product support coverage options to meet the needs of users of Microsoft products. Support personnel are located in various sites in the U.S. and in various Microsoft subsidiaries. Certain support is also supplied by qualified third-party support organizations. The Company hires individuals with product expertise and provides them with productivity tools, continuous product education and training, and consistent processes to deliver quality support for Microsoft products. Coverage options range from standard no-charge toll telephone support to fee-based offerings providing unlimited 800 number telephone and electronic technical support for all Microsoft products 24 hours per day, 7 days per week.

Users have access to Microsoft KnowledgeBase, a library of thousands of technical articles that is updated regularly with useful information regarding Microsoft products. Microsoft provides access to KnowledgeBase via MSN, America Online, CompuServe, GEnie, Prodigy, and the Internet. Additionally, the Company offers two information subscription services: Microsoft TechNet and Microsoft Developer Network.

As a supplement or alternative to direct support, the Company enhances the third party support channel by providing Microsoft Solution Providers with education, training, tools, and support. Microsoft Solution Providers include Authorized Training Centers, which offer advanced product education and certification on Microsoft products; and Authorized Support Centers, which provide a wide spectrum of multinational support, multivendor support, and integration services.

COMPETITION

The PC software business is intensely competitive and subject to extremely rapid technological change. Microsoft faces formidable competition in all areas of its business activity (including competition from many companies much larger than Microsoft). The extremely rapid pace of technological change constantly creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. The Company also faces constant competition from software pirates who unlawfully copy and distribute Microsoft's copyrighted software products.

THE INTERNET: The Company faces intense competition in the development and marketing of Internet (and intranet) software from a wide variety of companies and organizations including IBM, Netscape, Novell, Oracle, O'Reilly, Sun Microsystems, Apache Group, the National Center for Supercomputing Applications (NCSA), and the European Laboratory for Particle Physics (CERN).

OPERATING SYSTEMS: Microsoft's operating system products face substantial competition from a wide variety of companies. Major competitors such as IBM, Apple Computer, Digital Equipment Corporation, Hewlett-Packard, Sun Microsystems, and others, are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on computers of their own manufacture. Many of these operating system software products are also licensed to third party OEMs for preinstallation on their machines. Microsoft's operating system products compete with UNIX-based operating systems from a wide range of companies including IBM, AT&T, Hewlett-Packard, Sun Microsystems, The Santa Cruz Operation, and others. Variants of UNIX run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems. As PC technology increasingly moves toward connectivity and communications, Microsoft's operating system products will face increased competition from network server operating systems such as Novell NetWare, Banyan Vines, the many variants of UNIX, OS/2, "middleware" products such as Lotus Notes from IBM, and intranet servers from Netscape and others. In addition, Netscape is seeking to position its browser software as a computing platform that would perform many of the functions performed by operating systems from Microsoft and other vendors.

BUSINESS SYSTEMS: The Company is a fairly recent entrant into the business of providing enterprisewide computing solutions. Several competitors enjoy a larger share of sales and larger installed bases. Many companies offer operating system software for mainframes and midrange computers, including IBM, DEC, Hewlett-Packard, and Sun Microsystems. Since legacy business systems are typically support-intensive, these competitors also offer substantive support services. Software developers that provide competing server applications for PC-based distributed client/server environments include Oracle, Sybase, and Informix. There are also several software vendors who offer connectivity servers. As mentioned above, there are numerous companies and organizations that offer Internet and intranet server software which compete against the Company's business systems. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with the Company's workgroup and mail products.

DESKTOP APPLICATIONS: The Company's competitors include many software application vendors, such as IBM (Lotus), Oracle, Apple (Claris), and Corel. IBM and Corel have large installed bases with their spreadsheet and word processor products, respectively, and both appear to have adopted aggressive pricing strategies in recent months. Also, IBM and Apple preinstall certain of their software products on various models of their PCs, competing directly with Microsoft application software.

ONLINE SERVICES: An enormous range of companies, including media conglomerates, telephone companies, cable companies, retailers, hardware manufacturers, and software developers, are competing to make online services widely available to computer users. Microsoft's new online services network, MSN, faces formidable competition from both established online networks, such as America Online, CompuServe, Prodigy, and impending entrants. MSN also faces competition from online services that are offered to users directly via the Internet, including, in particular, the World Wide Web.

INTERACTIVE MEDIA: The Company's Interactive Media division faces many smaller but focused competitors, particularly in the areas of entertainment and education. Many of these competitors have strong brand identification. Consolidation in this area of software development has made certain competitors even stronger. Examples of competitors include Intuit, Broderbund, Electronic Arts, Softkey (including The Learning Company and Compton's), Voyager, Edmark, CUC International (including Sierra On Line and Davidson Associates), and Dorling Kindersley. Still other competitors own branded content, such as Disney and Lucas Arts. Additionally, as platforms become more powerful, PC-based games will compete head-to-head with games created for proprietary systems such as Nintendo and Sega. Input devices face substantial competition from computer manufacturers, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices.

NEWS SERVICES: The Company's MSNBC joint ventures face formidable competition from another, more established 24-hour cable and Internet news organization, CNN. Additionally, the Fox network has announced plans for its own 24-hour cable news service. MSNBC also competes with traditional news media such as newspapers and broadcast TV, and Internet news services.

DEVELOPER: The Company's developer products compete against offerings from

Borland, Oracle, Sun Microsystems, Sybase, Symantec, and many other companies.

The Company believes that the principal competitive factors in marketing PC software are a product's features and functions, ease of use, reliability, price relative to performance, timeliness of delivery, reputation, and availability and quality of support services. There is no assurance that the Company's competitive position will not be adversely affected by one or more of these factors in the future, particularly in view of the fast pace of technological change in the software industry.

EMPLOYEES

As of June 30, 1996, the Company employed 20,561 people on a full-time basis, 13,991 domestically and 6,570 internationally. Of the total, 6,861 were in product research and development, 10,097 in sales, marketing, and support, 1,485 in manufacturing and distribution, and 2,118 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees are subject to collective bargaining agreements. The Company believes relations with its employees are excellent.

Item 2. Properties

The Company's corporate offices consist of approximately 3.1 million square feet of office building space located in King County, Washington. There are two sites that total approximately 300 acres of land. The Company is constructing three office buildings comprising approximately 350,000 square feet of space, which are expected to be completed in the summer of 1997. Additionally, construction is continuing on another series of office buildings with approximately 565,000 square feet of space. Occupancy on this site will be phased starting in the winter of 1997 and completed by spring of 1998. The Company owns all of its corporate campus.

The Company sold its domestic manufacturing and distribution operation in Snohomish County, Washington, in July 1996 but retains a 45,000 square foot disk duplication facility in Humacao, Puerto Rico. The Puerto Rican facility, which began operation in April 1990, is leased under a 10-year lease, with an option to renew for an additional 10 years. The Company's European manufacturing operation consists of a 161,000 square foot facility situated on 12 acres in Dublin, Ireland. The Ireland site also includes office buildings with 157,000 square feet for international localization. The Ireland facilities are fully owned by the Company.

The Company is constructing an office building complex with 225,000 square feet on 33 acres of land near Redding, England. Occupancy is expected in the fall of 1997. In Les Ulis, France, the Company owns a 199,000 square foot office building on four acres of land. In addition, the Company leases office space in numerous locations in the United States and many other countries.

Item 3. Legal Proceedings

In connection with an ongoing investigation, the Antitrust Division of the U.S. Department of Justice requested information from Microsoft in September 1996 concerning Web browsers. Management currently believes that resolution of this matter will not have a material adverse impact on its financial position or results of operations.

Additionally, the information set forth in Notes to Financial Statements--Commitments and Contingencies on page 27 of the 1996 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

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

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 1996.

PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

The information set forth on page 28 of the 1996 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.1.

Item 6. Selected Financial Data

The information set forth on page 4 of the 1996 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.2.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The information set forth on pages 16-19, 22, and 23 of the 1996 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

Item 8. Financial Statements and Supplementary Data

The following financial statements for the Company and independent auditors' report set forth on pages 14, 15, 20, 21, 24-29, and 31 of the 1996 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

- Income Statements for the three years ended June 30, 1996
- Cash Flows Statements for the three years ended June 30, 1996
- Balance Sheets as of June 30, 1995 and 1996
- Stockholders' Equity Statements for the three years ended June 30, 1996

- Notes to Financial Statements

- Independent Auditors' Report

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" on pages 1 and 2 of the Company's Proxy Statement dated September 27, 1996, for the Annual Meeting of Shareholders to be held November 12, 1996 (the "Proxy Statement"). Such information is incorporated herein by reference.

The executive officers of Microsoft as of September 9, 1996 were as follows:

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NAME	AGE	POSITION WITH THE COMPANY
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William H. Gates	40	Chairman of the Board; Chief Executive Officer
Steven A. Ballmer	40	Executive Vice President, Sales and Support
Robert J. Herbold	54	Executive Vice President; Chief Operating Officer
Frank M. (Pete) Higgins	38	Group Vice President, Applications and Content
Paul A. Maritz	41	Group Vice President, Platforms
Nathan P. Myhrvold	37	Group Vice President, Applications and Content
Jeffrey S. Raikes	38	Group Vice President, Sales and Marketing
James E. Allchin	44	Senior Vice President, Desktop and Business Systems Division
Joachim Kempin	54	Senior Vice President, OEM Sales
Craig J. Mundie	47	Senior Vice President, Consumer Platforms Division
William H. Neukom	54	Senior Vice President, Law and Corporate Affairs; Secretary
Brad A. Silverberg	42	Senior Vice President, Internet Platform and Tools Division
Patricia Q. Stonesifer	40	Senior Vice President, Interactive Media Division
Bernard P. Vergnes	51	Senior Vice President, Microsoft; President, Microsoft Europe
Michael W. Brown	50	Vice President, Finance; Chief Financial Officer

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Mr. Gates co-founded Microsoft in 1975 and has been its Chief Executive Officer and Chairman of the Board since the original partnership was incorporated in 1981.