Microsoft_1999_Annual Report

FINANCIAL HIGHLIGHTS

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In millions, except earnings per share

Year Ended June 30	1995	1996	1997	1998	**1999**
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 share1	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**

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

FELLOW SHAREHOLDERS

> Microsoft continued to perform strongly in 1999 Our customers count on us to provide great software that helps them communicate more effectively, work more productively, learn more creatively, and make the most of their leisure time We worked hard to meet those needs and to set the standard for features, functionality, simplicity, and seamless integration with the Internet in all of our products. The result was remarkable growth and record revenue

In the years ahead, we will see accelerating change in the software industry, as the computing needs of our customers start to move beyond the PC into a "PC-Plus" world. The PC will undoubtedly remain at the heart of computing at home, work, and school, but it will be joined by numerous new intelligent devices and appliances, from handheld computers and auto PCs to Internet-enabled cellular phones More software will be delivered over the Internet, and the boundary between online services and software products will blur The Internet will continue to change everything by offering a level of connectivity that was unimaginable only a few years ago — and every home, business, and school will want to be hooked up to that incredible global database.

Microsoft's vision is to empower people through great software — any time, any place, and on any device That means helping companies build friction-free knowledge-management systems, so information flows effortlessly through their businesses, and to implement flawless e-commerce operations. It means helping developers create great Web-enabled products for a wide range of devices It means making PCs simpler and more reliable. It means helping consumers transform the Internet into their own "personal Internet" — a resource that learns from them over time and empowers them with all of the information they need, while protecting their privacy Everything we do focuses on allowing people and organizations to create and manage their information.

BUILT AROUND YOU

> In a world of increasing technological complexity, one of our primary goals must be to make our products easier and more effective for customers to use. In part, this entails developing simpler interfaces, natural-language processing, and voice control to help hide the underlying complexity from users We're working hard to achieve those breakthroughs But it also means getting closer to our customers and working harder to understand their needs We must help customers integrate technology by learning about how they work, how information flows through their organization, what they'll need in the future — and about where we're succeeding or failing. Customer-centric thinking must permeate everything we do.

Our growth is always forcing us to look at the best way to stay close to our customers and respond to their needs. This year we organized the company so that its structure is customer-based rather than product-based. The leaders of each of Microsoft's newly defined divisions now have end-to-end management accountability in their respective customer segments. Guided by the company's overall vision, they have total responsibility for setting a clear mission and priorities for their division, including all product planning and marketing strategies. The divisional leaders also have freedom to form business relationships both inside and outside Microsoft — freedom to work with the parties they need to do the best job for their customers

Microsoft's mission has always been to connect customers with the information they need. But today there is more information to connect with than ever before, stored in more places than ever before, and accessible in more ways than ever before. By refocusing totally on offering customers what they want rather than what technology can provide, we will help them succeed in the PC-Plus world. We will also build a solid foundation for Microsoft well into the 21st century.

MANAGING KNOWLEDGE

> An organization's most valuable asset is its knowledge base. It is also the hardest to manage For the majority of knowledge workers, getting the information they need is still more difficult than it should be Mostly, it involves creating and distributing paper documents or telephoning and meeting with fellow employees. New digital approaches enabled by our software will make knowledge workers far more efficient

With its Web-based collaboration tools, Microsoft® Office 2000 is already a powerful component of a knowledge management solution In the coming year, we will augment it with several other key initiatives. Windows® 2000 Active Directory™ service will simplify administration and make it easier for knowledge workers to find resources throughout their organization Future versions of Microsoft Exchange will offer both a platform for unified messaging and our Web Store technology, creating a powerful, centralized communications and knowledge management solution. In the future, we plan to introduce document library and search server technology that will help companies leverage their knowledge bases Because 50% of work is now done in teams — compared with only 20% a decade ago — we have added team productivity features to the BackOffice® family and other products. And to help organizations realize the dream of a paperless office, our ClearType technology offers on-screen resolution and readability that equals or exceeds that of paper

To help knowledge workers access information more efficiently, we're also developing what we call a digital dashboard The digital dashboard is a customized Office 2000 solution that pulls together all of the information that is important to you — regardless of whether it's on your PC, corporate network, or the Internet — and makes it available in one place. A digital dashboard helps you manage and prioritize messages, tasks, information, meetings — in fact, whatever you want It also gives you access to all of the analytical tools you need to process your data. And it makes all of this available wherever you are, whether on your handheld computer, PC, or smart telephone The digital dashboard will bring the concept of empowerment any time, any place, and on any device even closer to reality.

CONNECTING EVERYWHERE

> Microsoft's fundamental vision for Windows is one of total scalability — from embedded operating systems in smart devices such as thermostats and light switches, through Windows CE on handheld PCs, and Web-enabled telephones, to the largest mission-critical server farms Windows 2000, SQL Server™ 7 0, and the next version of Exchange will take our high-end scalability and around-the-clock availability far beyond what was thought possible just five years ago, and we expect to make even greater progress in the years ahead A key to this is using Windows 2000 breakthrough load-balancing to provide scaling and reliability beyond that of the most expensive systems of the past. Web sites can use Windows to easily add capacity and avoid having a single point of failure. The Windows 2000 load-balancing technology automatically redirects tasks to the server that is operating under the least load.

A core requirement of knowledge workers is access to their information wherever they are Our IntelliMirror™ technology in Windows 2000 will help make that possible, by transparently and automatically backing up and synchronizing your data so that it is available on PCs or intelligent devices.

Your handheld computer, Web-enabled telephone, and PC will synchronize with each other wirelessly and automatically, whether you are in your office or on the road At Microsoft, some of our employees already use Windows 2000 with a wireless network When they walk into a meeting room, their laptop is automatically recognized and a "virtual workgroup" of everyone in the room is created Wireless networks will transform the workplace.

Ubiquitous connectivity will also revolutionize the home, enabling consumers to leverage the power and richness of the PC on any intelligent device, thanks to fast, low-cost wireless networks that will make high-quality audio and video available in every room. For example, our Windows Media™ audio player downloads music twice as fast as previous formats, has double the storage capacity, and offers powerful anti-piracy protection. We're also evolving the WebTV Network™ service, which today has more than 800,000 subscribers, with on-demand programming, personalized viewing, more Web-enhanced content, great games, and powerful communications for the whole family. We aim to help millions of Americans enjoy the digital lifestyle at home as well as at work with exciting offerings such as the CarPoint™ online automotive service, HomeAdvisor™ online real estate service, MoneyCentral™ personal finance service, plus the MSNTM Hotmail Web-based e-mail service, which now has more than 40 million members

EXPANDING BANDWIDTH

> Microsoft's vision of empowering people through great software — any time, any place, and on any device — depends on helping consumers and businesses advance from today's narrow-band world into a broadband future Even now, the majority of consumers — along with many small and medium-sized businesses — still access the Internet via their regular telephone lines The result is that the rich world of real-time interactivity remains a dream for most consumers, while many businesses are reluctant to put videoconferencing or multimedia on their networks, because they fear it will crowd out transaction traffic and other high-priority communications

Our core strategy here is to make investments that will accelerate the deployment of high-speed broadband networks and to collaborate on the technology that will make interactive services for consumers and businesses run seamlessly across these networks. To that end, we are working with companies that will play a leading role in making broadband Internet and multimedia access widely available. We are enthusiastic about the many technologies that will deliver this, which is why we continue to invest in various infrastructures such as wired and wireless telecommunications, cable, and interactive television Some of our exciting relationships include AT&T, Nextel Communications, NTL, Rogers Communications, WirelessKnowledge, Concentric Networks, Wink Communications, and more.

THE PC-PLUS ERA

> The enduring popularity of the PC — more than 100 million should be sold worldwide this year — is amazing, but not surprising. In a single, economical package, the PC offers individual students, knowledge workers, and consumers the kind of computing power that was found only in corporate computing departments just a decade ago. Whether you want to communicate, learn, work, or play, the PC can enrich and improve the experience

In the new millennium, the remarkable power and flexibility of the PC will be available wherever it is needed The PC-Plus era will be about connectivity, scalability, and simplicity. It will be an era when people are at the center, where technology is a natural extension of the way consumers and businesses think about themselves and their interactions with others The combination of experience, resources, and research that is unique to Microsoft puts us in a strong position to transform this vision into reality.

We are investing heavily in the future — from world-class customer support to the $3 8 billion we plan to spend in fiscal 2000 on research and development for the products of tomorrow. There is, however, no guarantee of success. Competition continues to intensify, and regulatory pressures are unlikely to ease. Although global PC sales have proved remarkably robust, some slowdown is likely in the coming year And as Microsoft's business becomes more complex, the strategic challenges and risks we face grow exponentially.

I remain optimistic, because the new opportunities for great software products are still incredible I appreciate the unwavering support and trust of our shareholders and customers as Microsoft enters the 21st century

Bill Gates

Bill Gates

MICROSOFT IS BUILT AROUND YOU.

MAKING YOUR WORLD WORK BETTER

- Improving information flow
- Increasing scalability, reliability, and availability
- Building an architecture that supports the broadest range of intelligent devices
- Bringing online consumers and businesses together
- Developing a new generation of consumer-friendly PCs
- Ensuring power and connectivity any time, any place, and on any device

YOUR BUSINESS HAS A LOT TO TELL YOU.

INTEGRATED SOLUTIONS FOR MANAGING
THE INFORMATION OF YOUR ENTERPRISE

- Office 2000 for developing ideas and sharing knowledge
- Windows Platforms for reliable, robust, and cost-effective desktop and network operating environments
- Systems Management Server for centralized change and configuration management
- Exchange Server for complete messaging and enterprise collaboration
- SQL Server for scalable and reliable database and data-warehousing solutions
- Site Server Commerce Edition for comprehensive Internet commerce transactions

YOU'RE CONNECTED.

INTEGRATED AND EFFECTIVE

Today
- Office 2000 for increasing integration between the Web and you
- Excel 2000 featuring new PivotTable® options and more Web-connected capabilities
- FrontPage 2000 helping you with true collaboration capabilities to create compelling Web pages

Tomorrow
- Windows 2000 Professional desktop and mobile operating system incorporating simplified user interface
- Windows 2000 Standard Server for integrating reliable application, Internet and networking services, advanced remote computing, and security technologies
- Windows 2000 Advanced Server for building on the Standard Server services, plus higher availability and scalability for demanding enterprise applications
- Windows 2000 Datacenter Server for large data warehouses, Internet Service Providers and Web site hosting

BE AT THE HEART OF WHAT MATTERS TO YOU.

LET THE INFORMATION FOLLOW YOU

- MSN network of Internet services is a customizable Internet portal
- Microsoft Windows CE for pocket PCs and Web phones
- Microsoft Digital Sound System
- Internet Explorer 5.0 Web browser software lets you access your information from any place
- Passport automatically fills in only the personal information that you choose to share
- MapPoint™ 2000 business mapping software will make any map you want

WIRELESS AND ONLINE.

EXTENDING YOUR REACH

- Windows CE
- MSN Mobile Internet portal
- MSN MoneyCentral
- MSN Hotmail
- Microsoft microbrowser for cellular phones and handheld PCs
- Windows 2000 mobile operating system
- Microsoft Cordless Phone System
- TVPAK

YOU'RE FREE TO WORK, LIVE, AND PLAY BETTER.

EVERYTHING YOU NEED ONLINE

- WebTV service and MSN Internet access for going online quickly
- MSN.com for getting stuff done
- MSNBC.com for up-to-the-minute news from around the globe
- Encarta® multimedia encyclopedia and Encarta World English Dictionary for finding answers fast
- Expedia.com for travel planning and savings
- CarPoint for making better informed car-buying decisions
- A better, richer environment for working, living, and playing

INCOME STATEMENTS

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In millions, except earnings per share

Year Ended June 30	1997	1998	**1999**
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 share1:			
Basic	$ 0.72	$ 0.92	**$ 1.54**
Diluted	$ 0 66	$ 0.84	**$ 1.42**

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

See accompanying notes

MANAGEMENT'S DISCUSSION AND ANALYSIS

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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 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.

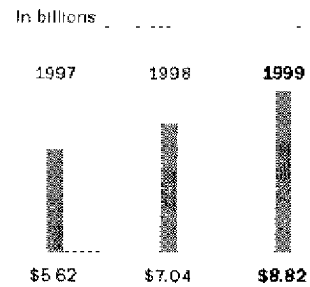
> WINDOWS PLATFORMS revenue was $4.92 billion, $6.28 billion, and $8 50 billion in 1997, 1998, and 1999 Platform revenue is primarily licenses of PC operating systems and business and enterprise server systems with client/server, Internet, and intranet architectures.

The Company's principal PC operating systems are Windows 95, Windows 98, and Windows NT® 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.

PRODUCTIVITY APPLICATIONS AND DEVELOPER REVENUE



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® 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® presentation graphics program, Microsoft FrontPage® 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.

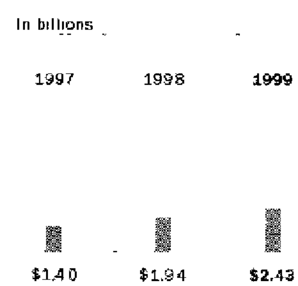
Server applications, based on Microsoft Windows NT Server, offer an enterprise-wide distributed client/server, Internet, and intranet environment Products include Microsoft Exchange Server, Microsoft SQL Server, and other server applications in the Microsoft BackOffice family of products. Microsoft Exchange is an enterprise messaging and collaboration server while Microsoft SQL Server is a scalable 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® development system, which includes the Microsoft Visual Basic® 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®, and vertical properties such as MSN Hotmail Web-based e-mail service, Expedia.com™ travel site, CarPoint car buying site, and MoneyCentral personal finance site.

CONSUMER, COMMERCE, AND OTHER REVENUE



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 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.

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 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 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 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.

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 3,000 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 the 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 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 it 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

CASH FLOWS STATEMENTS

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In millions

Year Ended June 30	1997	1998	**1999**
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**

See accompanying notes

BALANCE SHEETS

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In millions

June 30	1998	1999
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**

See accompanying notes

STOCKHOLDERS' EQUITY STATEMENTS

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In millions

Year Ended June 30	1997	1998	**1999**
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**

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

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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 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 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.

NOTES continued (in millions)

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.

CASH AND SHORT-TERM INVESTMENTS

June 30	1998	1999
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**

PROPERTY AND EQUIPMENT

June 30	1998	1999
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**

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.

NOTES continued (in millions)

EQUITY AND OTHER INVESTMENTS

June 30, 1999	Cost Basis	Net Unrealized Gains	Recorded Basis
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

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.

NOTES continued (in millions)

INCOME TAXES

> The provision for income taxes consisted of:

Year Ended June 30	1997	1998	1999
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**

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

Year Ended June 30	1997	1998	1999
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**

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the non-deductible 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

June 30	1998	1999
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)**

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.

NOTES continued (in millions)

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

Year Ended June 30	1997	1998	**1999**
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**

> 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

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

NOTES continued (in millions, except per share amounts)

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:

		Price per Share	
	Shares	Range	Weighted Average
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**

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

	Outstanding Options			Exercisable Options	
Range of Exercise Prices	Shares	Remaining Life (Years)	Weighted Average Price	Shares	Weighted Average Price
$ 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**	**–**	**–**

NOTES continued (in millions, except per share amounts)

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:

Year Ended June 30	1997		1998		**1999**	
	Reported	Pro forma	Reported	Pro forma	**Reported**	**Pro forma**
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**

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 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:

Year Ended June 30	1997	1998	**1999**
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**

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, Inc 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 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

NOTES continued

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++® 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. 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® 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.

NOTES continued (in millions)

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

SEGMENT INFORMATION

Year Ended June 30	Windows Platforms	Productivity Applications and Developer	Consumer, Commerce, and Other	Reconciling Amounts	Consolidated
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**

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 $6 0 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.

QUARTERLY INFORMATION (in millions, except per share amounts, unaudited)

	Quarter Ended				
	Sept 30	Dec 31	Mar 31	June 30	Year
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**

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.

REPORTS OF MANAGEMENT AND INDEPENDENT AUDITORS

Management is responsible for preparing the Company's financial statements and the other information that appears in this annual report Management believes that the financial statements fairly reflect the form and substance of transactions and reasonably present the Company's financial condition and results of operations in conformity with generally accepted accounting principles. Management has included in the Company's financial statements amounts that are based on estimates and judgments, which it believes are reasonable under the circumstances

The Company maintains a system of internal accounting policies, procedures, and controls intended to provide reasonable assurance, at appropriate cost, that transactions are executed in accordance with Company authorization and are properly recorded and reported in the financial statements, and that assets are adequately safeguarded.

Deloitte & Touche LLP audits the Company's financial statements in accordance with generally accepted auditing standards and provides an objective, independent review of the Company's internal controls and the fairness of its reported financial condition and results of operations

The Microsoft Board of Directors has an Audit Committee composed of nonmanagement Directors The Committee meets with financial management, internal auditors, and the independent auditors to review internal accounting controls and accounting, auditing, and financial reporting matters.

Gregory B. Maffei
Senior Vice President, Finance and Administration, Chief Financial Officer

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, appearing on pages 17 and 27 through 42. 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

Deloitte & Touche LL
Seattle, Washington
July 19, 1999

DIRECTORS

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Chief Executive Officer,
Microsoft Corporation

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Vulcan Northwest Inc

Jill Barad
President and
Chief Executive Officer,
Mattel, Inc

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General Partner,
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Technology Venture
Investors

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Simpson Investment
Company (retired)

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Chief Operating Officer,
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Chief Executive Officer

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President

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Executive Vice President,
Chief Operating Officer

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Group Vice President
(on leave)

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Group Vice President,
Developer

Jeffrey S. Raikes
Group Vice President,
Sales and Support

James E Allchin
Senior Vice President,
Platforms

Orlando Ayala Lozano
Senior Vice President,
South Pacific and Americas

Joachim Kempin
Senior Vice President,
OEM Sales

Michel Lacombe
Senior Vice President,
President, Microsoft
Europe, Middle East,
and Africa

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Business Productivity

Craig Mundie
Senior Vice President.
Consumer Strategy

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Law and Corporate
Affairs, Secretary

Bernard P Vergnes
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Chairman, Microsoft
Europe, Middle East,
and Africa

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Deborah N. Willingham
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Enterprise Marketing

WORLDWIDE MARKETING LOCATIONS*

www.microsoft.com/worldwide/

SOUTH PACIFIC AND AMERICAS REGION

Argentina	www.microsoft.com/argentina/
Australia	www.microsoft.com/australia/
Brazil	www.microsoft.com/brasil/
Canada	www.microsoft.com/canada/
Caribbean Islands	www.microsoft.com/latam/
Chile	www.microsoft.com/chile/
Colombia	www.microsoft.com/colombia/
Costa Rica	www.microsoft.com/latam/
Dominican Republic	www.microsoft.com/dominicana/
Ecuador	www.microsoft.com/ecuador/
El Salvador	www.microsoft.com/latam/
Guatemala	www.microsoft.com/latam/
México	www.microsoft.com/mexico/
New Zealand	www.microsoft.com/nz/
Panama	www.microsoft.com/latam/
Peru	www.microsoft.com/peru/
Puerto Rico	www.microsoft.com/puertorico/
United States of America	www.microsoft.com/usa/
Uruguay	www.microsoft.com/uruguay/
Venezuela	www.microsoft.com/venezuela/

EUROPE, MIDDLE EAST, AND AFRICA REGION

Austria	www.microsoft.com/austria/
Belgium	www.microsoft.com/benelux/
Bulgaria	www.microsoft.com/europe/
Croatia	www.microsoft.com/croatia/
Czech Republic	www.microsoft.com/cze/
Denmark	www.microsoft.com/danmark/
Egypt	www.microsoft.com/middleeast/
Finland	www.microsoft.com/finland/
France	www.microsoft.com/france/
Germany	www.microsoft.com/germany/
Greece	www.microsoft.com/hellas/
Hungary	www.microsoft.com/hun/
Indian Ocean Islands	www.microsoft.com/africa/southeast/
Ireland	www.microsoft.com/ireland/
Israel	www.microsoft.com/israel/
Italy	www.microsoft.com/italy/
Ivory Coast	www.microsoft.com/northafrica/
Kenya	www.microsoft.com/africa/southeast/
Kuwait	www.microsoft.com/middleeast/
Latvia	www.microsoft.com/europe/
Lebanon	www.microsoft.com/middleeast/
Mauritius	www.microsoft.com/africa/southeast/
Morocco	www.microsoft.com/northafrica/
The Netherlands	www.microsoft.com/benelux/
Norway	www.microsoft.com/norge/
Poland	www.microsoft.com/poland/
Portugal	www.microsoft.com/portugal/
Romania	www.microsoft.com/romania/
Russia	www.microsoft.com/rus/
Saudi Arabia	www.microsoft.com/middleeast/
Slovakia	www.microsoft.com/slovakia/
Slovenia	www.microsoft.com/slovenija/
South Africa	www.microsoft.com/southafrica/
Spain	www.microsoft.com/spain/
Sweden	www.microsoft.com/sverige/
Switzerland	www.microsoft.com/switzerland/
Turkey	www.microsoft.com/turkiye/
United Arab Emirates	www.microsoft.com/middleeast/
United Kingdom	www.microsoft.com/uk/
Zimbabwe	www.microsoft.com/africa/southeast/

ASIA REGION

Hong Kong	www.microsoft.com/hk/
India	www.microsoft.com/india/
Indonesia	www.microsoft.com/indonesia/
Japan	www.microsoft.com/japan/
Korea	www.microsoft.com/korea/
Malaysia	www.microsoft.com/malaysia/
The People's Republic of China	www.microsoft.com/china/
Philippines	www.microsoft.com/philippines/
Singapore	www.microsoft.com/singapore/
Taiwan	www.microsoft.com/taiwan/
Thailand	www.microsoft.com/thailand/
Vietnam	www.microsoft.com/worldwide/phone/ph_vietn.htm

* For a complete list of subsidiaries, joint ventures, and other legal entities, see the Company's Form 10-K at www.microsoft.com/msft/

INVESTOR RELATIONS

www.microsoft com/msft/

As a Microsoft shareholder, you're invited to take advantage of shareholder services or to request more information about Microsoft.

ACCOUNT QUESTIONS

Our transfer agent can help you with a variety of shareholder-related services, including

> Change of address
> Lost stock certificates
> Transfer of stock to another person
> Additional administrative services

You can call our transfer agent toll-free at (800) 285-7772.

You can also write them at:
ChaseMellon
Shareholder Services
P O. Box 3315
South Hackensack, NJ
07606-1915

Or you can e-mail our transfer agent at·
msft@chasemellon.com

Shareholders of record who receive more than one copy of this annual report can contact our transfer agent and arrange to have their accounts consolidated Shareholders who own Microsoft stock through a brokerage can contact their broker to request consolidation of their accounts

ANNUAL MEETING

Microsoft shareholders are invited to attend our annual meeting, which will be held on Wednesday, November 10, 1999 from 8 to 9 A M at the Meydenbauer Center, 11100 NE 6th Street, Bellevue, Washington. Parking at the Center is limited: please plan ahead if you are driving to the meeting.

INVESTOR RELATIONS

You can contact Microsoft's Investor Relations group any time to order financial documents such as this annual report and the Form 10-K. Call us toll-free at (800) 285-7772. [Outside the United States, call (425) 936-4400.] Or send a fax to (425) 936-8000. We can be contacted during West Coast business hours to answer investment-oriented questions about Microsoft

In addition, you can write us at.
Investor Relations
Microsoft Corporation
One Microsoft Way
Redmond, Washington
98052-6399

Or better yet, send us an e-mail at
msft@microsoft com

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www.microsoft com/msft/

Microsoft Corporation Income Statements

In millions, except earnings per share

	Year Ended June 30		
	1997	1998	**1999**
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**

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

See accompanying notes.