Microsoft_2000 Annual Report

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Letter to Shareholders

In 1975, Microsoft had three employees, $16,000 in revenue and a single software product – a version of the BASIC computer language that ran the first personal computer, the Altair 8800.

In 2000, as we mark our 25th year, Microsoft is the world's largest software company, with nearly 40,000 employees, $23 billion in revenue, and a wide range of powerful software and Internet products, including the most popular PC operating system, productivity software and Internet network.

It's been truly amazing to be at the focal point of two revolutions that have swept the world since Microsoft's modest beginnings: a PC revolution that has made powerful and affordable computing available to hundreds of millions of people around the globe, and an Internet revolution that is fundamentally changing how people communicate, learn and share information, and the way entire industries operate.

At the core of these remarkable advances is software – the magic that makes this technology useful. At Microsoft, software is our passion, the reason we're excited to come to work every morning. As we look to the future, our commitment to advance the frontiers of software technology offers extraordinary opportunities for consumers, businesses and our company.

With the release of Windows® 2000, the continuing strength of Microsoft® Office, our expanding enterprise server family and the surging popularity of MSN®, we have strong core businesses. At the same time, we are making significant strategic investments for the future in key growth areas, including wireless technologies, digital devices, games, TV, small business and, most important, the new Microsoft .NET platform. Over the next year, we will invest more than $4 billion in research and development to advance our core businesses, build on our strategic investments and deliver on the promise of our most important software initiative ever – Microsoft .NET.

Microsoft .NET

Just as our development of PC operating systems and other software technologies have driven growth in the industry over the past quarter century, today we are working to enable a new era of empowerment for computer users, and growth opportunities for both businesses and software developers. Microsoft .NET comprises the software and services that will power the Next Generation Internet.

As anyone who has used a PC knows, today's Internet experience can be fun, exciting and informative. It also can be confusing and difficult. For example, Web browsing, content authoring and editing, e-mail, calendaring and contacts each require separate applications that have widely varying functionality and compatibility. Communicating between devices such as PCs, mobile phones and handheld devices is challenging at best. Meanwhile, information on the Internet continues to exist on "digital islands" of independent Web sites. This information is easy to browse, but difficult to edit or manipulate in any useful way. There is enormous benefit and opportunity in linking these isolated islands of data, services and devices in ways that will enable people and businesses to communicate and collaborate more easily. This is where Microsoft .NET comes into play, enabling easier, more personalized and more productive Internet experiences by harnessing constellations of smart devices and Web sites with advanced software based on open Internet standards and protocols, including XML. In addition, Microsoft .NET will offer computer users a unified interface that adapts to whatever they are doing, wherever they are, and is device-independent – a kind of "universal canvas" for the Digital Age.

Microsoft .NET will create immense opportunity for hundreds of thousands of developers and industry partners, by providing the tools to build a new generation of truly distributed Web services that will transform the Internet and every other aspect of computing. Microsoft .NET will revolutionize computing and communications in the first decade of the 21st century, by being the first platform that takes full advantage of both. Microsoft .NET will take several years to come to full fruition, but we are tremendously excited about the potential.

The Foundations of Microsoft .NET

Microsoft .NET will build extensively on Microsoft's current core businesses, including the Windows family of desktop and server operating systems, enterprise server applications, Microsoft Office and MSN, each of which is performing strongly today. Windows 2000 has met with strong customer adoption and highly favorable reviews among IT managers, office users and industry analysts, making it the most powerful business operating system ever released by Microsoft. Underscoring its reliability and the value of its new features, General Motors, Royal Dutch/Shell, Xerox Corp., and leading PC manufacturers – such as Compaq Computer Corp., Dell Computer Corp., Hewlett-Packard Co., IBM Corp., and Toshiba Corp. – are all deploying Windows 2000.

Windows Me, the latest version of the Windows operating system designed specifically for home users, released in September, provides consumers with an improved user and Internet experience, enhanced home-based networking features and compelling new digital media tools.

Today, Windows 2000 servers are powering the World Wide Web. A majority of the top Internet retail sites, business-to-business Web sites and secure Web sites are running on Windows 2000 Server or Windows 2000 Advanced Server, and more Fortune 500 sites are running on Windows 2000 technology than any other technology. Windows 2000 Datacenter Server, launched in September 2000, will provide even more power and reliability for high-traffic networks.

If Windows 2000 is the foundation of Microsoft's .NET strategy, our .NET Enterprise Server products are the cornerstones. In the year ahead we are launching seven new and updated enterprise server products. Microsoft's range of server applications, combined with the power and reliability of Windows 2000, offer versatility and affordability unrivaled by any of our competitors. They also represent significant new opportunities to enhance Microsoft's revenue stream.

Microsoft Office revenue was strong as major enterprise accounts continued to adopt the world's most popular productivity suite. The growing deployment of Windows 2000 on the desktop is expected to further stimulate sales of Office 2000. New technologies that integrate Web services directly into the Office user experience, as well as tools that enable users to more efficiently store, access and analyze crucial business information, are being developed for future versions of Microsoft Office. Office.NET will offer a powerful productivity and communications service designed to meet the needs of 21st century knowledge workers. Use of Microsoft's Visio® and Microsoft Project applications is also continuing to grow and empower knowledge workers in important new ways.

Fiscal year 2000 was a defining year for MSN. In June, the MSN network of Internet services became the #1 worldwide Internet destination for consumers. In the United States, MSN grew significantly faster than Yahoo! or AOL. With MSN services available in 33 international markets and 17 languages, it is the #1 site among consumers in many countries around the world. Our MSN Internet Access business grew by more than 50 percent. Key to this remarkable growth is MSN best-of-breed services, including MSN Hotmail®, the world's largest e-mail system with more than 67 million active accounts; MSN Messenger Service, our instant messaging service with more than 18 million users; MSN Search, the second most popular search service on the Web; and MSN eShop, which experienced a significant increase in holiday traffic last year.

Investments in Tomorrow

One of the keys to Microsoft's success over our first 25 years is the long-term view we have taken toward the development of technologies such as Windows, Office, MSN and other products. In the coming year, we will continue to focus on promising new technological advances in a number of key fields.

Television

Digital and enhanced television products and services represent a significant growth opportunity for Microsoft and one that will give consumers more choice and control over when and what they watch, richer participation with TV programming, and convenient access to the Internet and family and friends. Microsoft is investing in three areas:

—> Working with television service operators – including AT&T in the United States, UPC in Europe, Rogers in Canada, and Towngas/iCare in Hong Kong – to deploy enhanced TV to more than 15 million subscribers via the Microsoft platform;

—> Joining with DIRECTV, Thomson, and Sony to produce UltimateTV, a one-box, one-service enhanced TV solution that will include two digital tuners to enable background recording, and a 40-gigabyte hard drive capable of recording 35 hours of TV programming.

—> Continuing to grow the WebTV® service, which now has more than 1 million subscribers who can participate in new ways with their favorite TV shows, vote in live polls, receive up-to-the-minute news coverage, and send and receive e-mail using their TV set at home.

Games

In the last few years, Microsoft has emerged as one of the top PC games publishers in the United States. In calendar 1999, Microsoft had two of the top five best sellers: Flight Simulator and Age of Empires®. During the 1999 holiday season, we were the only games publisher with three titles on the Top 10 list. Building on this success, Microsoft is investing significant resources to develop Xbox™, which will compete with the Sony PlayStation and game consoles by Sega and Nintendo in a multi-billion-dollar industry. The hardware design for Xbox is already complete, and Microsoft has 30 game titles for it under development in-house, with more in the works by third-party developers. The fall 2001 launch of Xbox will be Microsoft's biggest ever – larger even than Windows 95.

Wireless

Microsoft will invest substantially in the coming year to enable truly intelligent communications that fluidly traverse the boundaries of work, individual and family time, while offering ways to control the tremendous volume of available information. Alliances are key to our wireless strategy. For example, we are working with AT&T and British Telecommunications on mobile applications for next-generation data networks; with NTT DoCoMo of Tokyo to develop wireless portals; and with Ericsson to create end-to-end solutions and services for the wireless Internet.

One of the biggest opportunities is working with network operators and carriers to empower their service platforms with Microsoft's existing and emerging technologies. The building blocks of .NET will further enhance the types of services we will be able to provide. Microsoft is developing platforms and applications for a variety of mobile handheld devices, including cellular/mobile phones, Pocket PCs and smart phones. These devices will offer both voice and rich data capabilities, including true HTML Web browsing on color displays. Our research in smart cards, location-based services, and speech technologies will also have important applications in the wireless arena.

Small Business

A great opportunity exists for Microsoft to help small businesses increase productivity and take advantage of the Internet to connect in new ways with customers, industry partners, and suppliers. Today, small businesses represent nearly 60 percent of the global economy. Yet their investments in software are far smaller per desktop than larger enterprises, even as they are being increasingly impacted by the digital economy.

The emergence of the Internet and .NET services will make technology more accessible and relevant to small businesses than ever before. By providing complete business solutions that include productivity, customer management and collaboration software, as well as technologies to power the specific needs of small-business operations and e-commerce, Microsoft can enable small businesses to better use technology to their business advantage. Over the next four years, technology spending by small businesses is forecast to increase by more than $50 billion. With more than 1 million registered users, bCentral™, Microsoft's Web-based small-business portal is already #1 in terms of reach. Over the next year, bCentral will deliver a number of new Web services, as well as launch in five additional countries. We will also be launching a new version of the leading small-business server suite, Small Business Server 2000.

Building the Future Together

In partnership with thousands of other technology companies that share our vision of high-performance, affordable computing, Microsoft has helped build a high-tech industry that is thriving on innovation and competition, and driving growth in the U.S. economy. That is one of the reasons why we believe the appellate courts will rule in Microsoft's favor in the antitrust lawsuit and uphold the well-established legal precedent that U.S. antitrust law should encourage, not discourage, firms to improve their products rapidly to meet customer needs. We also believe the appellate courts will recognize that the district court's order to break up Microsoft and impose crippling regulations reached far beyond the facts of the case, and would lead to less innovation, fewer choices and higher prices.

Finally, on the occasion of Microsoft's 25th anniversary, we would like to take a moment to acknowledge the passionate, smart, dedicated employees who have helped make Microsoft the global leader in software, as well as our millions of shareholders, thousands of business partners, and hundreds of millions of customers around the world who have enabled the company to succeed over the years. The future is filled with amazing possibilities and opportunities, and our passion for improving people's lives through great software will allow us to contribute even more than in our first 25 years.

Bill Gates

Bill Gates
Chairman and Chief Software Architect

Steven A. Ballmer

Steven A. Ballmer
President and Chief Executive Officer

A wide range of .NET experiences will open the door to significant new benefits for consumers and business users, as well as revenue opportunities for Microsoft. These include:

Windows.NET

The next generation of Windows will be designed to put users in control of their digital information through customized applications and services created by Microsoft and a wide range of third-party providers.

MSN.NET

Will enable consumers to create a single digital identity, and use smart services to ensure consistent, seamless and safe access to information, entertainment and people any time, any place and on any device.

Subscription Services

Building on the depth of our experience creating software for personal use, these subscription services will offer many of the benefits of today's desktop applications with the flexibility, integration and "roaming" support of the new .NET family of user experiences.

Office.NET

Will include a new natural user interface, a new architecture based on smart clients, and services to provide rich functionality and performance and universal collaboration services.

bCentral.NET

Our small-business Web services will be built on .NET infrastructure and be greatly expanded to deliver commerce and collaboration solutions as well as business automation services such as customer lead-tracking.

Visual Studio.NET

An XML-based programming model and rapid application development tool that will enable the easy delivery of highly distributed programmable services running across stand-alone machines, corporate data centers and the Internet.

Microsoft's lineup of new enterprise server products includes:

Microsoft SQL Server™ 2000

The newest version of Microsoft's database and analysis server enables customers to rapidly build scalable e-commerce, line-of-business and data warehousing solutions. SQL Server 2000 is fully Web-enabled, with end-to-end support for XML and a new, integrated data-mining engine.

Microsoft Exchange 2000 Server

The latest version of Microsoft's messaging and collaboration server, designed to meet the needs of businesses of all sizes, provides a single infrastructure and user model for working with messages, documents and applications to increase knowledge worker productivity.

BizTalk™ Server 2000

BizTalk Server's document routing, transformation, and tracking infrastructure enables companies to integrate, manage and automate business processes by exchanging business documents, such as purchase orders and invoices, between applications within, or across, organizational boundaries.

Application Center 2000

Application Center 2000 enables organizations to use off-the-shelf PC servers, rather than expensive proprietary hardware, to manage Web applications across multiple servers by simplifying the tasks involved in software scaling, adding new servers, and deploying and managing distributed applications. With software scaling there is no single point of failure, and capacity can be added economically and as needed.

Host Integration Server 2000

The follow-on release to SNA Server extends Windows to other systems by providing application, data, and network integration that enables businesses to preserve their investments in existing mainframe, AS/400 and Unix networks, applications and databases.

Commerce Server 2000

Commerce Server 2000 provides the infrastructure that enables organizations to build an effective online business. User profiling and management, product and service management, transaction processing, and targeted marketing and merchandising are all integrated to create a comprehensive, customizable system.

Internet Security and Acceleration Server 2000

By combining enterprise firewall and high-performance Web cache functions, Microsoft Internet Security and Acceleration Server delivers secure, fast, manageable Internet connectivity.

“Microsoft .NET really brings to the Web what we’ve been missing, and that’s the ability to drive greater consistency and simplicity. Compaq’s full range of products and services, coupled with our longstanding relationship with Microsoft, puts us in a unique position to take .NET to market.”

Michael D. Capellas, President and CEO, Compaq Computer Corp.

“Microsoft’s vision for Microsoft .NET is a whole new level of capability, interaction and customization in the user experience – it will really leverage the power of the Internet.”

Michael Dell, CEO, Dell Computer Corp.

“When Qwest looks at leveraging Microsoft .NET, what we have in our minds eye is to change the way people access software, not just from where they are but from the devices they use, from the ease of use, from the ability to write applications in a more efficient way and distribute them more efficiently. I think that has a profound effect on how software is used as an enabling technology. Qwest sees itself helping its clients change the way they do business by helping them understand the power of this new technology.”

Joseph P. Nacchio, Chairman and CEO, Qwest

“Verio shares Microsoft’s vision of .NET, that businesses want to have a complete package that allows them to integrate applications, share data and compete effectively in this new online economy. First, we’ll roll out the Microsoft .NET Passport service. This will allow us to help attract consumers and customers to our business Web sites. In the future, we see a lot of excitement in the collaboration tools, messaging services and commerce services that Microsoft plans to bring to the fold.”

Justin Jaschke, CEO, Verio Inc.

“Andersen Consulting is really excited about Microsoft .NET because this is a big win for our clients. It lets our clients leverage their IT investments. It lets them move to the Web-enabled world. It lets them simplify systems integration so that they can concentrate on what they do best, and that is changing their business to compete in the new economy.”

Joe W. Forehand, Managing Partner & CEO, Andersen Consulting

Financial Highlights

In millions, except earnings per share

Year Ended June 30	1996	1997	1998	1999	**2000**
Revenue	$ 9,050	$ 11,936	$ 15,262	$ 19,747	**$ 22,956**
Net income	2,195	3,454	4,490	7,785	**9,421**
Diluted earnings per share	0.43	0.66	0.84	1.42	**1.70**
Cash and short-term investments	6,940	8,966	13,927	17,236	**23,798**
Total assets	10,093	14,387	22,357	38,625	**52,150**
Stockholders' equity	6,908	10,777	16,627	28,438	**41,368**

See accompanying notes.

Income Statements

In millions, except earnings per share

Year Ended June 30	1998	1999	**2000**
Revenue	$ 15,262	$ 19,747	**$ 22,956**
Operating expenses:			
Cost of revenue	2,460	2,814	**3,002**
Research and development	2,601	2,970	**3,775**
Acquired in-process technology	296	–	–
Sales and marketing	2,828	3,231	**4,141**
General and administrative	433	689	**1,009**
Other expenses	230	115	**92**
Total operating expenses	8,848	9,819	**12,019**
Operating income	6,414	9,928	**10,937**
Investment income	703	1,803	**3,182**
Gain on sales	–	160	**156**
Income before income taxes	7,117	11,891	**14,275**
Provision for income taxes	2,627	4,106	**4,854**
Net income	$ 4,490	$ 7,785	**$ 9,421**
Earnings per share:			
Basic	$ 0.92	$ 1.54	**$ 1.81**
Diluted	$ 0.84	$ 1.42	**$ 1.70**

See accompanying notes.

Management's Discussion and Analysis

Results of Operations for 1998, 1999, and 2000

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

This Management's Discussion and Analysis contains statements that are forward-looking. These statements are based on current expectations that are subject to risks and uncertainties. Actual results will vary because of factors discussed below under "Issues and Uncertainties."

Revenue

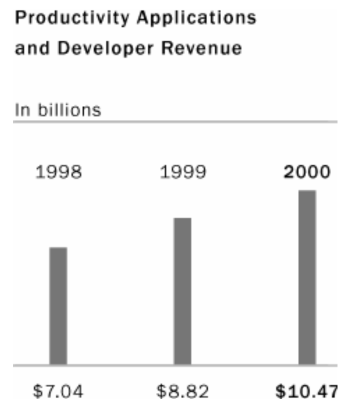
The Company's revenue growth rate was 28% in fiscal 1998, 29% in fiscal 1999, and 16% in fiscal 2000. Revenue growth in fiscal 2000 was driven by strong licensing of the Microsoft suite of products including Microsoft Windows NT® Workstation, Windows 2000 Professional, Windows NT Server, Windows 2000 Server, Microsoft Office 2000, and SQL Server 7.0. Windows 2000, released during fiscal 2000, is the next version of the Windows NT operating system. Consumer revenue, including Internet access, the online properties, entertainment software, and hardware peripherals also grew strongly. Partially offsetting those items was slower growth from Windows operating systems sold through the original equipment manufacturer (OEM) channel due to slow demand for business PCs throughout a significant portion of fiscal 2000. Revenue growth in fiscal 1998 and 1999 reflected the continued adoption of Windows operating systems and Microsoft Office. Software organizational license increases in 1998, 1999, and 2000 have been a significant factor in the Company's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from OEM licenses and organizational license programs is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. See accompanying notes to financial statements.

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

In fiscal 1999, Microsoft made two changes related to the ratable recognition of revenue for a portion of its revenue for certain products. American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions,* requires companies to use the average sales price of each undelivered element of software arrangements to unbundle revenue. Prior authoritative guidance allowed a comparison of the total price differential between a licensed product sold through different channels of distribution to derive the value of undelivered elements offered to customers acquiring product from one channel but not the other. Upon adoption of this new rule in the fourth quarter of fiscal 1999, the percentages of the total arrangement treated as unearned decreased. This change reduced the amount of Microsoft Windows and Microsoft Office sales treated as unearned and increased the amount of revenue recognized upon shipment. Additionally, as part of the Company's long range planning process and a review of product shipment cycles, it was determined that the life cycle of Windows should be extended from two years to three years.

Business Divisions

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



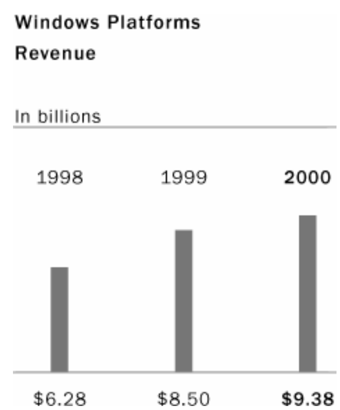
Productivity Applications and Developer

Productivity Applications and Developer revenue was $7.04 billion, $8.82 billion, and $10.47 billion in 1998, 1999, and 2000. Productivity Applications and Developer products include desktop applications such as Microsoft Office, server applications such as Microsoft SQL Server and Microsoft Exchange Server, and software developer tools.

In fiscal 2000, revenue growth from Microsoft Office integrated suites, including the Premium, Professional, Small Business, and Standard Editions was very solid. Revenue from server applications grew strongly compared to fiscal 1999, largely due to the strong success of SQL Server 7.0. Software developer tools revenue declined, due to increased suite licensing versus stand-alone licenses, and the lack of a release upgrade of the Visual Studio® development system.

In fiscal 1999, revenue growth from Microsoft Office integrated suites was strong. Revenue from server applications also grew strongly, reflecting, in part, the release of SQL Server 7.0. The Visual Studio 6.0 development system drove healthy software developer tools revenue growth. In fiscal 1998, revenue from the various Microsoft Office integrated suites increased strongly, while revenue from stand-alone versions of Microsoft Excel, Microsoft Word, Microsoft Access, and Microsoft PowerPoint® presentation graphics program decreased.

Windows Platforms

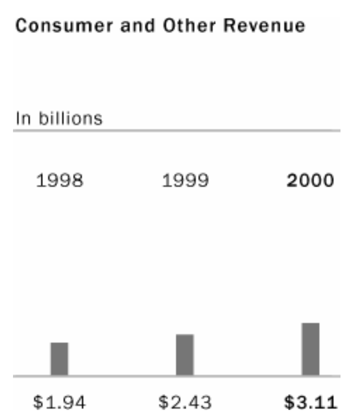


Windows Platforms revenue was $6.28 billion, $8.50 billion, and $9.38 billion in 1998, 1999, and 2000. Windows Platforms products include primarily Windows 98, Windows 2000 Professional, Windows 2000 Server, Windows NT Workstation, and Windows NT Server.

In fiscal 2000, Windows desktop operating systems revenue growth was modest due to soft demand for business PCs during most of the year; a slowdown in shipments in anticipation of the post mid-year availability of Windows 2000 operating systems; and, as expected, a longer business migration cycle for the newest Windows operating system offerings. In addition, Windows desktop operating systems average earned revenue per licensed operating system decreased compared to fiscal 1999. Windows Platform Server revenue growth over fiscal 1999 was particularly strong led by increased adoption by customers of Windows NT Server and Windows 2000 Server.

In fiscal 1999, Windows units licensed through the OEM channel, particularly Windows NT Workstation, increased strongly over the prior year. Organizational licensing of Windows NT Workstation and Windows 98 also contributed to the growth. The revenue growth rate for Windows NT Server was healthy. In fiscal 1998, Windows units licensed through the OEM channel, including Windows 95, Windows 98, and Windows NT Workstation, exhibited robust growth over the prior year.

Consumer and Other



Consumer and Other revenue was $1.94 billion, $2.43 billion, and $3.11 billion in 1998, 1999, and 2000. Consumer and Other products include Internet access and online services; learning and entertainment software; hardware devices; consulting services; and training and certification.

In fiscal 2000, online revenue growth was very strong and reflected higher subscriber totals, offset by lower net prices for Internet access subscriptions compared to the prior year. Additionally, the continued success of the Company's new hardware device offerings and strong sell-through of entertainment software produced robust revenue growth.

In fiscal 1999, online advertising revenue and consulting services rose substantially and Internet access revenue increased moderately, while revenue from hardware devices, consumer software, and Microsoft Press was relatively flat. In fiscal 1998, online revenue increased due to higher Internet access subscriber levels and hardware and learning and entertainment revenue increased.

Distribution Channels

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

OEM revenue was $4.72 billion in 1998, $6.40 billion in 1999, and $7.01 billion in 2000. The relatively low growth rate in fiscal 2000 was due to lower business PC shipment growth percentages, especially as a result of the soft demand for business PCs and component shortages for part of the year. These issues combined with post mid-year availability of the newest business operating system, Windows 2000 Professional, resulted in lower revenue growth. Average earned revenue per license also declined compared to the prior year, due in part to a mix shift to the lower-priced Windows 98 operating system reflecting the softness in demand for business PCs and lower prices on operating systems licensed through certain OEM channel sectors. In both fiscal 1999 and 1998, PC shipment growth coupled with an increased penetration of higher value 32-bit operating systems drove the OEM revenue increases.

South Pacific and Americas Region revenue was $5.57 billion, $7.25 billion, and $8.33 billion in 1998, 1999, and 2000. In fiscal 2000, Office 2000 integrated suites, Windows 2000 Server, online revenue, and SQL Server sales were the primary drivers of the revenue growth. Strong retail sales of hardware devices and consumer software also contributed to the growth over the prior year. Revenue growth was particularly strong in Latin America and Australia, moderate in Canada, and modest in the United States. In fiscal 1999, server applications, Windows NT Server, Windows NT Workstation, and Microsoft Office all exhibited solid year-over-year growth rates. Organizational licensing activity was strong. Revenue growth was solid in the United States and moderate in Latin America and the South Pacific. In fiscal 1998, revenue growth reflected strong licensing of Microsoft Office.

Europe, Middle East, and Africa Region revenue was $3.50 billion, $4.33 billion, and $5.02 billion in 1998, 1999, and 2000. In fiscal 2000, retail sales of Windows operating systems and Office licensing produced moderate growth in the region. Growth from SQL Server licensing, new hardware device offerings, and entertainment software was exceptionally strong. Revenue growth, measured in constant dollars, was very healthy in Germany and Italy, robust in the Middle East, and low in the United Kingdom. In fiscal 1999, all major products grew strongly over the prior year. Revenue growth was solid in the United Kingdom, Germany, and France, and was particularly high in Sweden, the Netherlands, and Spain. In fiscal 1998, organizational licensing of desktop applications and business systems grew strongly. Revenue growth was particularly high in the United Kingdom.

Asia Region revenue was $1.48 billion in 1998, $1.78 billion in 1999, and $2.60 billion in 2000. In fiscal 2000, the region’s growth rate reflected strong performance resulting from improved local economic conditions. Revenue growth was also influenced by robust growth of localized versions of Microsoft Office 2000, especially the Office Personal Edition sold in Japan; Windows platform and server licensing; and strong adoption of SQL Server. Revenue grew strongly in nearly all countries in the Asia region. In fiscal 1999, Japan, Taiwan, China, Hong Kong, and Southeast Asia had moderate revenue growth, while revenue grew very strongly in Korea. In fiscal 1998, revenue was relatively flat in Japan and Southeast Asia due to economic issues and weak currencies.

The Company’s operating results are affected by foreign exchange rates. Approximately 32%, 29%, and 30% of the Company’s revenue was collected in foreign currencies during 1998, 1999, and 2000. Since a portion of local currency revenue is hedged and much of the Company’s international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

Operating Expenses

Cost of Revenue

Cost of revenue as a percent of revenue was 16.1% in 1998, 14.3% in 1999, and 13.1% in 2000. Cost of revenue in fiscal 2000 reflected lower costs associated with WebTV Networks’ operations, partially offset by the growth in hardware peripherals costs. The percentage decreases in fiscal 1999 and 1998 resulted primarily from the trend in mix shift to OEM and organizational licenses. The decreases were also due to the shifts in mix to CD-ROMs, which carry lower cost of goods than floppy disks, and higher-margin Windows NT Server, other servers, and client access licenses in the BackOffice® product family. Additionally, cost of revenue in 1999 was positively impacted by a reduction in estimates of obsolete inventory and other manufacturing costs of $67 million. As discussed previously, the Company’s business model continues to evolve toward licensing from sales of packaged products through distribution channels. Consequently, risks associated with manufacturing and holding physical product have declined.

Research and Development

Microsoft continued to invest heavily in the future by funding research and development (R&D). The increase in fiscal 2000 was driven primarily by higher headcount-related costs. The increase in fiscal 1999 reflected higher development headcount-related costs offset by lower infrastructure and third-party development costs. Fiscal 1998 expenses were driven primarily by higher development headcount-related costs and third-party development costs.

In fiscal 1998, the Company acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $425 million in stock and cash. The accompanying fiscal

1998 income statement reflects a one-time write-off of in-process technologies under development by WebTV Networks of $296 million.

Sales and Marketing

In fiscal 2000, sales and marketing expenses as a percentage of revenue increased due to higher relative marketing costs associated with new product releases and online marketing. In fiscal 1999, sales and marketing expense as a percentage of revenue decreased due to lower relative sales expenses and lower relative marketing costs. In fiscal 1998, the sales and marketing expense as a percent of revenue decreased due to lower relative sales expenses.

General and Administrative

Fiscal 2000 general and administrative expenses included a charge for the settlement of a lawsuit with Caldera, Inc. and also reflected increased legal fees and certain employee stock option-related expenses. The increase in fiscal years 1999 and 1998 were attributable to higher legal fees, settlement costs, and headcount-related costs necessary to support the Company's expanding operations.

Other Expenses

Other expenses incorporate miscellaneous items, including certain gains; recognition of Microsoft's share of joint venture activities for the MSNBC entities, TransPoint, and other joint venture activities; and charitable contributions and miscellaneous taxes.

Investment Income, Gain on Sales, and Income Taxes

Investment income increased primarily as a result of a larger investment portfolio generated by cash from operations in 1998, 1999, and 2000, coupled with realized gains from the sale of securities in 1999 and 2000.

In fiscal 2000, Microsoft sold the entertainment city guide portion of MSN Sidewalk to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution arrangement. Microsoft recognized a gain of $156 million on the sale and will recognize revenue amounts related to the distribution arrangement over the terms of the agreement. In fiscal 1999, Microsoft sold its Softimage, Inc. subsidiary to Avid Technology, Inc. for a pretax gain of $160 million.

The effective tax rate for fiscal 2000 was 34.0%. Excluding the impact of the gain on the sale of Softimage, Inc., the effective tax rate for fiscal 1999 was 35.0%. The effective income tax rate for fiscal 1998 was 36.9%, reflecting the nondeductible write-off of WebTV in-process technologies.

Financial Condition

The Company's cash and short-term investment portfolio totaled $23.80 billion at June 30, 2000. The portfolio consists primarily of fixed-income securities, diversified among industries and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in order to diversify financial risk. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft works with many technology companies and often provides investment funding as part of these alliances. During fiscal 2000, the Company purchased approximately $400 million of Rogers Communications Inc. convertible preferred securities and $200 million of Best Buy Co., Inc. common stock. Also, subsequent to fiscal year-end, Microsoft acquired an additional shareholding in Telewest Communications plc for approximately $2.6 billion. During fiscal 1999, the Company purchased $5.0 billion of AT&T convertible preferred securities and warrants, $600 million of Nextel Communications, Inc. common stock, $500 million of NTL, Inc. convertible preferred stock, $330 million of United Pan-Europe Communications common stock, and $200 million of Qwest Communications International Inc. common stock.

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

Microsoft has no material long-term debt and has $164 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at June 30, 2000 was $41.37 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $299 million on June 30, 2000. Cash will also be used to fund ventures and other strategic opportunities.

Since fiscal 1990, Microsoft has repurchased 765 million common shares while 1.99 billion shares were issued under the Company's employee stock option and purchase plans. Microsoft enhanced its repurchase program by selling put warrants. In

January 2000, the Company terminated its stock buyback program. Subsequent to fiscal year-end 2000, the Company announced a share repurchase program which will provide shares for issuance to employees under the Company's stock option and stock purchase programs. The market value of all outstanding stock options was $67 billion as of June 30, 2000. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements. The Company's cash and short-term investments are available for strategic investments, mergers and acquisitions, and other potential large-scale cash needs that may arise. Microsoft has not paid cash dividends on its common stock.

Recently Issued Accounting Standards

Statement of Financial Accounting Standards (SFAS) 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended by SFAS 137, *Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement No. 133,* and SFAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* is effective for the Company as of July 1, 2000. SFAS 133 requires that an entity recognize all derivatives as either assets or liabilities measured at fair value. The accounting for changes in the fair value of a derivative depends on the use of the derivative. Adoption of these new accounting standards will result in cumulative after-tax reductions in net income of approximately $350 million and other comprehensive income of approximately $50 million in the first quarter of fiscal 2001. The adoption will also impact assets and liabilities recorded on the balance sheet.

The Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 101, *Revenue Recognition in Financial Statements,* in December 1999. The SAB summarizes certain of the SEC staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. In June 2000, the SEC issued SAB 101B, which delays the implementation date of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. The Company does not believe that adoption of this SAB will have a material impact on its financial statements.

In March 2000, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) 44, *Accounting for Certain Transactions involving Stock Compensation,* which clarifies the application of APB 25 for certain issues. The interpretation is effective July 1, 2000, except for the provisions that relate to modifications that directly or indirectly reduce the exercise price of an award and the definition of an employee, which are effective after December 15, 1998. The Company does not believe that adoption of FIN 44 will have a material impact on its financial statements.

Issues and Uncertainties

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

Rapid Technological Change and Competition

Rapid change, uncertainty due to new and emerging technologies, and fierce competition characterize the software industry, which means that Microsoft's market position is always at risk. Microsoft's ability to maintain its current success is dependent upon the Company's ability to develop and introduce new products and enhance existing products to satisfy consumer demand for new computer technologies. This process is challenging because the pace of change continues to accelerate, creating new opportunities for competitors and subjecting business planning to substantial uncertainty. Competitors, working with new technology, may arrive at a technology that creates a new market altogether and renders the Company's product offerings obsolete. "Open source" software, new computing devices, new microprocessor architectures, the Internet, and Web-based computing models are current examples of the rapid pace of change and intensifying competition. If Microsoft does not successfully identify new product opportunities and develop and bring new products to market in a timely and efficient manner, the Company's business growth will suffer and demand for its products will decrease. Competing operating systems, platforms, and products may gain popularity with customers, computer manufacturers, and developers, reducing Microsoft's future revenue.

Future Initiatives

The Company plans to continue significant investments in software research and development including Microsoft .NET, wireless technologies, digital devices, games, television, and small business. Microsoft is also making significant investments in strategic relationships with third parties, and in online products and services such as MSN, CarPoint™ online automotive service, and HomeAdvisor™ online real estate service, where the Company has the opportunity to establish leadership in new businesses. It is anticipated that these investments in research and development will increase over historical spending levels without corresponding growth in revenue in the near future. Significant revenue from these product opportunities may not be achieved for a number of years, if at all.

PC Growth Rates

The nature of the PC marketplace is changing in ways that may reduce Microsoft's software sales and revenue growth. Recently, manufacturers have sought to reach more consumers by developing and producing lower cost PCs – PCs that come without pre-installed software or contain software with reduced functionality. In addition to the influx of low-cost PCs, a market for handheld computing and communication devices has developed. While these devices are not as powerful or versatile as PCs, they threaten to erode sales growth in the market for PCs with pre-installed software. This may affect Microsoft's revenue growth because manufacturers may choose not to install Microsoft software in these low-cost PCs or consumers may purchase alternative intelligent devices that do not utilize Microsoft software. These lower-priced devices require Microsoft to provide lower-priced software with a subset of the original functionality. As a result, the Company may generate less revenue from the sale of software produced for these devices than from the sale of software for PCs.

Product Ship Schedules

The PC software industry is inherently complex. New products and product enhancements can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could damage Microsoft's business.

Saturation

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

Prices

The competitive factors described above may require Microsoft to lower product prices to meet competition, reducing the Company's net income.

Earnings Process

An increasingly higher percentage of the Company's revenue is subject to ratable recognition, which impacts the timing of revenue and earnings recognition. This policy may be required for additional products, depending on specific license terms and conditions. Also, maintenance and new subscription programs such as the application service provider (ASP) model are increasing in popularity.

Employee Compensation

Microsoft employees currently receive salaries, incentive bonuses, other benefits, and stock options. New government regulations, poor stock price performance, or other factors could diminish the value of the option program to current and prospective employees and force the Company into more of a cash compensation model.

International Operations

Microsoft develops and sells products throughout the world. The prices of the Company's products in countries outside of the United States are generally higher than the Company's prices in the United States because of the costs incurred in localizing software for non-U.S. markets. The costs of producing and selling the Company's products in these countries are also higher. Pressure to globalize Microsoft's pricing structure might require that the Company reduce the sales price of its software in other countries, even though the costs of the software continue to be higher than in the United States. Negative changes in software "piracy" trade protection laws, policies and measures and other regulatory requirements affecting trade and investment; unexpected changes in regulatory requirements for software; social, political, labor or economic conditions in a specific country or region; difficulties in staffing and managing foreign operations; and potential adverse foreign tax consequences; among other factors, could also have an impact on the Company's business and results of operations outside of the United States.

Market Risk

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

The Company uses a value-at-risk (VAR) model to estimate and quantify its market risks. The VAR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. Assumptions applied to the VAR model at June 30, 1999 and 2000 include the following: normal market conditions; Monte Carlo modeling with 10,000 simulated market price paths; a 97.5% confidence interval; and a 20-day estimated loss in fair value for each market risk category.

Accordingly, 97.5% of the time the estimated 20-day loss in fair value would be nominal for foreign currency denominated investments and accounts receivable at June 30, 1999 and 2000, and would not exceed $95 million and $211 million at June 30, 1999 and 2000 for interest-sensitive investments or $1.38 billion or $1.02 billion at June 30, 1999 and 2000 for equity securities.

Intellectual Property Rights

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

Litigation

Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks. The Company is a defendant in a lawsuit filed by the Antitrust Division of the U.S. Department of Justice and a group of nineteen state Attorneys General alleging violations of the Sherman Act and various state antitrust laws. After the trial, the District Court entered Findings of Fact and Conclusions of Law stating that Microsoft had violated sections of the Sherman Act and various state antitrust laws. A Judgment was entered on June 7, 2000 ordering, among other things, the breakup of Microsoft into two companies. On June 20, 2000, the District Court entered an order staying the Judgment of June 7, 2000 in its entirety until the appeal therefrom is heard and decided, unless the stay is earlier vacated by an appellate court. Although Microsoft believes it will obtain ultimate relief from the Judgment, the Company cannot predict with certainty when or the extent to which such relief will be obtained. The failure to obtain relief from certain provisions of the Judgment through the appeal would likely have a material adverse effect on the Company. A large number of antitrust class action lawsuits have been initiated against Microsoft. These cases allege that Microsoft has competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications and seek to recover alleged overcharges that the complaints contend Microsoft charged for these products. Although Microsoft believes the claims are without merit and is vigorously defending the cases, the Company cannot predict with certainty the outcome of these lawsuits.

Future Growth Rate

The revenue growth rate in 2001 may not approach the level attained in prior years. As discussed previously, certain operating expenses are expected to increase in 2001. Because of the fixed nature of a significant portion of operating expenses, coupled with the possibility of slower revenue growth, operating margins in 2001 may decrease from those in 2000.

Cash Flows Statements

In millions

Year Ended June 30	1998	1999	**2000**
Operations			
Net income	$ 4,490	$ 7,785	**$ 9,421**
Depreciation, amortization, and other noncash items	1,024	926	**748**
Write-off of acquired in-process technology	296	–	–
Gain on sales	–	(160)	**(156)**
Stock option income tax benefits	1,553	3,107	**5,535**
Unearned revenue	3,268	5,877	**6,177**
Recognition of unearned revenue from prior periods	(1,798)	(4,526)	**(5,600)**
Other current liabilities	208	1,050	**(445)**
Accounts receivable	(520)	(687)	**(944)**
Other current assets	(88)	(235)	**(775)**
Net cash from operations	8,433	13,137	**13,961**
Financing			
Common stock issued	959	1,350	**2,245**
Common stock repurchased	(2,468)	(2,950)	**(4,896)**
Put warrant proceeds	538	766	**472**
Preferred stock dividends	(28)	(28)	**(13)**
Net cash used for financing	(999)	(862)	**(2,192)**
Investing			
Additions to property and equipment	(656)	(583)	**(879)**
Cash portion of WebTV purchase price	(190)	–	**–**
Cash proceeds from sale of Softimage, Inc.	–	79	**–**
Purchases of investments	(19,114)	(36,441)	**(43,158)**
Maturities of investments	1,890	4,674	**4,025**
Sales of investments	10,798	21,080	**28,085**
Net cash used for investing	(7,272)	(11,191)	**(11,927)**
Net change in cash and equivalents	162	1,084	**(158)**
Effect of exchange rates on cash and equivalents	(29)	52	**29**
Cash and equivalents, beginning of year	3,706	3,839	**4,975**
Cash and equivalents, end of year	$ 3,839	$ 4,975	**$ 4,846**

See accompanying notes.

Balance Sheets

In millions

June 30	1999	2000
Assets		
Current assets:		
Cash and equivalents	$ 4,975	**$ 4,846**
Short-term investments	12,261	**18,952**
Total cash and short-term investments	17,236	**23,798**
Accounts receivable	2,245	**3,250**
Deferred income taxes	1,469	**1,708**
Other	752	**1,552**
Total current assets	21,702	**30,308**
Property and equipment, net	1,611	**1,903**
Equity and other investments	14,372	**17,726**
Other assets	940	**2,213**
Total assets	$ 38,625	**$ 52,150**
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 874	**$ 1,083**
Accrued compensation	396	**557**
Income taxes	1,691	**585**
Unearned revenue	4,239	**4,816**
Other	1,602	**2,714**
Total current liabilities	8,802	**9,755**
Deferred income taxes	1,385	**1,027**
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock – shares authorized 100; shares issued and outstanding 13 and 0	980	**–**
Common stock and paid-in capital – shares authorized 12,000; shares issued and outstanding 5,109 and 5,283	13,844	**23,195**
Retained earnings, including other comprehensive income of $1,787 and $1,527	13,614	**18,173**
Total stockholders' equity	28,438	**41,368**
Total liabilities and stockholders' equity	$ 38,625	**$ 52,150**

See accompanying notes.

Stockholders' Equity Statements

In millions

Year Ended June 30	1998	1999	**2000**
Convertible preferred stock			
Balance, beginning of year	$ 980	$ 980	**$ 980**
Conversion of preferred to common stock	–	–	**(980)**
Balance, end of year	980	980	**–**
Common stock and paid-in capital			
Balance, beginning of year	4,509	8,025	**13,844**
Common stock issued	1,262	2,338	**3,554**
Common stock repurchased	(165)	(64)	**(210)**
Structured repurchases price differential	328	(328)	**–**
Proceeds from sale of put warrants	538	766	**472**
Stock option income tax benefits	1,553	3,107	**5,535**
Balance, end of year	8,025	13,844	**23,195**
Retained earnings			
Balance, beginning of year	5,288	7,622	**13,614**
Net income	4,490	7,785	**9,421**
Other comprehensive income:			
Net unrealized investment gains/(losses)	627	1,052	**(283)**
Translation adjustments and other	(124)	69	**23**
Comprehensive income	4,993	8,906	**9,161**
Preferred stock dividends	(28)	(28)	**(13)**
Immaterial pooling of interests	–	–	**97**
Common stock repurchased	(2,631)	(2,886)	**(4,686)**
Balance, end of year	7,622	13,614	**18,173**
Total stockholders' equity	$ 16,627	$ 28,438	**$ 41,368**

See accompanying notes.

Notes to Financial Statements

Accounting Policies

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

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

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

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

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

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

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

Advertising Costs
Advertising costs are expensed as incurred. Advertising expense was $732 million in 1998, $804 million in 1999, and $1.1 billion in 2000.

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

Notes to Financial Statements continued

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.

SFAS 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended by SFAS 137, *Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement No. 133,* and SFAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* is effective for the Company as of July 1, 2000. SFAS 133 requires that an entity recognize all derivatives as either assets or liabilities measured at fair value. The accounting for changes in the fair value of a derivative depends on the use of the derivative. Adoption of these new accounting standards will result in cumulative after-tax reductions in net income of approximately $350 million and other comprehensive income of approximately $50 million in the first quarter of fiscal 2001. The adoption will also impact assets and liabilities recorded on the balance sheet.

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 15 years. As required by SOP 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use,* Microsoft began capitalizing certain computer software developed or obtained for internal use in fiscal 2000. Capitalized computer software is depreciated using the straight-line method over the shorter of the estimated life of the software or three years.

Reclassifications

As required by Emerging Issues Task Force (EITF) Issue 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option,* stock option income tax benefits are classified as cash from operations in the cash flows statement. Prior period cash flows statements have been restated to conform with this presentation. Certain other reclassifications have been made for consistent presentation.

Unearned Revenue

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

End users receive certain elements of the Company's products over a period of time. These elements include items such as browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. Upon adoption of SOP 98-9 during the fourth quarter of fiscal 1999, the Company was required to change the methodology of attributing the fair value to undelivered elements. The percentages of undelivered elements in relation to the total arrangement decreased, reducing the amount of Windows and Office revenue treated as unearned, and increasing the amount of revenue recognized upon shipment. The percentage of revenue recognized ratably decreased from a range of 20% to 35% to a range of approximately 15% to 25% of Windows desktop operating systems. For desktop applications, the percentage decreased from approximately 20% to a range of approximately 10% to 20%. The ranges depend on the terms and conditions of the license and prices of the elements. In addition, in the fourth quarter of fiscal 1999, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. Product life cycles are currently estimated at 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organizational license agreements. At June 30, 1999 and 2000, Windows Platforms products unearned revenue was $2.17 billion and $2.61 billion and unearned revenue associated with Productivity Applications and Developer products totaled $1.96 billion and $1.99 billion. Unearned revenue for other miscellaneous programs totaled $116 million and $210 million at June 30, 1999 and 2000.

Notes to Financial Statements continued

Financial Risks

The Company's cash and short-term investment portfolio is diversified and consists primarily of investment grade securities. Investments are held with high-quality financial institutions, government and government agencies, and corporations, thereby reducing credit risk concentrations. Interest rate fluctuations impact the carrying value of the portfolio. The Company routinely hedges the portfolio with options in the event of a catastrophic increase in interest rates. The notional amount of the options outstanding was $4.0 billion and $3.6 billion at June 30, 1999 and 2000. The fair value and premiums paid for the options were not material. Much of the Company's equity security portfolio is highly volatile, so certain positions are hedged.

Finished goods sales to international customers in Europe, Japan, Canada, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. Certain international manufacturing and operational costs are incurred in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Although foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses, the Company hedges a portion of accounts receivable balances denominated in local currencies, primarily with purchased options. The notional amount of options outstanding was $662 million and $1.46 billion at June 30, 1999 and 2000. The fair value and premiums paid for the options were not material.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a portion of planned international revenue with purchased options. The notional amount of the options outstanding was $2.25 billion and $2.08 billion at June 30, 1999 and 2000. The fair value and premiums paid for the options were not material.

At June 30, 1999 and 2000, approximately 50% and 42% of accounts receivable represented amounts due from 10 customers. A single customer accounted for approximately 8%, 11%, and 9% of revenue in 1998, 1999, and 2000.

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

Notes to Financial Statements continued (in millions)

Cash and Short-Term Investments

June 30	1999	2000
Cash and equivalents:		
Cash	$ 635	**$ 849**
Commercial paper	3,805	**1,986**
Certificates of deposit	522	**1,017**
U.S. government and agency securities	–	**729**
Corporate notes and bonds	–	**265**
Money market preferreds	13	**–**
Cash and equivalents	4,975	**4,846**
Short-term investments:		
Commercial paper	1,026	**612**
U.S. government and agency securities	3,592	**7,104**
Corporate notes and bonds	6,996	**9,473**
Municipal securities	247	**1,113**
Certificates of deposit	400	**650**
Short-term investments	12,261	**18,952**
Cash and short-term investments	$ 17,236	**$ 23,798**

Property and Equipment

June 30	1999	2000
Land	$ 158	**$ 176**
Buildings	1,347	**1,387**
Computer equipment and software	1,433	**1,909**
Other	578	**842**
Property and equipment – at cost	3,516	**4,314**
Accumulated depreciation	(1,905)	**(2,411)**
Property and equipment – net	$ 1,611	**$ 1,903**

During 1998, 1999, and 2000, depreciation expense, of which the majority related to computer equipment, was $528 million, $483 million, and $668 million; disposals were not material.

Notes to Financial Statements continued (in millions)

Equity and Other Investments

June 30, 1999	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
Debt securities recorded at market, maturing:				
Within one year	$ 682	$ 8	$ –	$ 690
Between 10 and 15 years	533	30	(33)	530
Beyond 15 years	4,731	347	–	5,078
Debt securities recorded at market	5,946	385	(33)	6,298
Common stock and warrants	3,029	3,598	(799)	5,828
Preferred stock	2,179	–	–	2,179
Other investments	67	–	–	67
Equity and other investments	$ 11,221	$ 3,983	$ (832)	$ 14,372

June 30, 2000	**Cost Basis**	**Unrealized Gains**	**Unrealized Losses**	**Recorded Basis**
Debt securities recorded at market, maturing:				
Within one year	**$ 498**	**$ 27**	**$ –**	**$ 525**
Between 2 and 10 years	**388**	**11**	**(3)**	**396**
Between 10 and 15 years	**775**	**14**	**(93)**	**696**
Beyond 15 years	**4,745**	**–**	**(933)**	**3,812**
Debt securities recorded at market	**6,406**	**52**	**(1,029)**	**5,429**
Common stock and warrants	**5,815**	**5,655**	**(1,697)**	**9,773**
Preferred stock	**2,319**	**–**	**–**	**2,319**
Other investments	**205**	**–**	**–**	**205**
Equity and other investments	**$ 14,745**	**$ 5,707**	**$ (2,726)**	**$ 17,726**

Debt securities include corporate and government notes and bonds and derivative securities. Debt securities maturing beyond 15 years are composed entirely of AT&T 5% convertible preferred debt with a contractual maturity of 30 years. The debt is convertible into AT&T common stock on or after December 1, 2000, or may be redeemed by AT&T upon satisfaction of certain conditions on or after June 1, 2002. Equity securities that are restricted for more than one year or not publicly traded are recorded at cost. At June 30, 1999 and 2000, the estimated fair value of these investments in excess of their recorded basis was $2.3 billion and $2.7 billion, based on publicly available market information or other estimates determined by management. The Company hedges the risk of significant market declines on certain highly volatile equity securities with options. The options are recorded at market, consistent with the underlying equity securities. At June 30, 1999 and 2000, the notional amount of the options outstanding was $2.1 billion and $4.0 billion; the fair value represents obligations of $1.0 billion and $1.7 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1998 were not material; realized gains were $623 million and $1.7 billion in 1999 and 2000 and losses were not material in 1999 and 2000.

Notes to Financial Statements continued (in millions)

Income Taxes

The provision for income taxes consisted of:

Year Ended June 30	1998	1999	**2000**
Current taxes:			
U.S. and state	$ 2,518	$ 4,027	**$ 4,744**
International	526	281	**535**
Current taxes	3,044	4,308	**5,279**
Deferred taxes	(417)	(202)	**(425)**
Provision for income taxes	$ 2,627	$ 4,106	**$ 4,854**

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

Year Ended June 30	1998	1999	**2000**
U.S.	$ 5,072	$ 10,649	**$ 11,860**
International	2,045	1,242	**2,415**
Income before income taxes	$ 7,117	$ 11,891	**$ 14,275**

The effective income tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies. In 1999, the effective tax rate was 35.0%, excluding the impact of the gain on the sale of Softimage, Inc. In 2000, the effective tax rate was 34.0%, and included the effect of a 2.5% reduction from the U.S. statutory rate for tax credits and a 1.5% increase for other items. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate in 1998 and 1999 were not significant.

Deferred income taxes as of June 30 were:

	1999	**2000**
Deferred income tax assets:		
Revenue items	$ 1,145	**$ 1,320**
Expense items	648	**2,122**
Deferred income tax assets	1,793	**3,442**
Deferred income tax liabilities:		
Unrealized gain on investments	(1,046)	**(874)**
International earnings	(647)	**(1,766)**
Other	(16)	**(121)**
Deferred income tax liabilities	$ (1,709)	**$ (2,761)**

Notes to Financial Statements continued (in millions)

The Internal Revenue Service (IRS) has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. Tax Court. Income taxes, except for taxes related to the 1990 and 1991 assessments, have been settled with the IRS for all years through 1994. The IRS is examining the Company's U.S. income tax returns for 1995 and 1996. Management believes any related adjustments that might be required will not be material to the financial statements. Income taxes paid were $1.1 billion in 1998, $874 million in 1999, and $800 million in 2000.

Convertible Preferred Stock

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Net proceeds of $980 million were used to repurchase common shares. The Company's convertible preferred stock matured on December 15, 1999. Each preferred share was converted into 1.1273 common shares.

Common Stock

Shares of common stock outstanding were as follows:

Year Ended June 30	1998	1999	**2000**
Balance, beginning of year	4,816	4,940	**5,109**
Issued	202	213	**229**
Repurchased	(78)	(44)	**(55)**
Balance, end of year	4,940	5,109	**5,283**

Repurchase Program

In January 2000, the Company terminated its stock buyback program. Prior to this termination, the Company periodically repurchased its common shares in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During 1998, the Company executed two forward settlement structured repurchase agreements with an independent third party totaling 42 million shares of stock and paid cash for a portion of the purchase price. In 1999, the Company settled the agreements by returning 28 million shares of stock, based upon the stock price on the date of settlement. The timing and method of settlement were at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the date of the agreement was originally reflected in common stock and paid-in capital.

Put Warrants

Prior to the termination of the stock buyback program, Microsoft enhanced the program by selling put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 2000, warrants to put 157 million shares were outstanding with strike prices ranging from $70 to $78 per share. The put warrants expire between September 2000 and December 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

Notes to Financial Statements continued (in millions)

Other Comprehensive Income

The changes in the components of other comprehensive income are as follows:

Year Ended June 30	1998	1999	**2000**
Net unrealized investment gains/(losses):			
Unrealized holding gains, net of tax effect of $355 in 1998, $772 in 1999, and $248 in 2000	$ 660	$ 1,432	**$ 531**
Reclassification adjustment for gains included in net income, net of tax effect of $(18) in 1998, $(205) in 1999, and $(420) in 2000	(33)	(380)	**(814)**
Net unrealized investment gains/(losses)	627	1,052	**(283)**
Translation adjustments and other	(124)	69	**23**
Other comprehensive income/(loss)	$ 503	$ 1,121	**$ (260)**

Employee Stock and Savings Plans

Employee Stock Purchase Plan

The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1998, 1999, and 2000, employees purchased 4.4 million, 2.7 million, and 2.5 million shares at average prices of $27.21, $52.59, and $72.38 per share. At June 30, 2000, 68.4 million shares were reserved for future issuance.

Savings Plan

The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may contribute up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were $39 million, $49 million, and $65 million in 1998, 1999, and 2000.

Stock Option Plans

The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire after 10 years. At June 30, 2000, options for 341 million shares were vested and 734 million shares were available for future grants under the plans.

Notes to Financial Statements continued (in millions, except per share amounts)

Stock options outstanding were as follows:

		Price per Share	
	Shares	Range	Weighted Average
Balance, June 30, 1997	956	$ 0.56 – $ 29.80	$ 7.86
Granted	138	16.56 – 43.63	31.28
Exercised	(176)	0.56 – 31.24	4.64
Canceled	(25)	4.25 – 41.94	14.69
Balance, June 30, 1998	893	0.56 – 43.63	11.94
Granted	78	45.59 – 83.28	54.62
Exercised	(175)	0.56 – 53.63	6.29
Canceled	(30)	4.25 – 74.28	21.06
Balance, June 30, 1999	766	0.56 – 83.28	23.87
Granted	**304**	**65.56 – 119.13**	**79.87**
Exercised	**(198)**	**0.56 – 82.94**	**9.54**
Canceled	**(40)**	**4.63 – 116.56**	**36.50**
Balance, June 30, 2000	**832**	**0.56 – 119.13**	**41.23**

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 2000 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	**133**	**2.1**	**$ 4.57**	**127**	**$ 4.53**
5.98 – 13.62	**104**	**3.0**	**10.89**	**84**	**10.83**
13.63 – 29.80	**135**	**3.7**	**14.99**	**77**	**14.83**
29.81 – 43.62	**96**	**4.5**	**32.08**	**39**	**31.98**
43.63 – 83.28	**198**	**7.3**	**63.19**	**14**	**54.64**
83.29 – 119.13	**166**	**8.6**	**89.91**	**–**	**–**

Notes to Financial Statements 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. An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation.* Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and this compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined as prescribed by SFAS 123, pro forma income statements for 1998, 1999, and 2000 would have been as follows:

Year Ended June 30	1998		1999		**2000**	
	Reported	Pro Forma	Reported	Pro Forma	**Reported**	**Pro Forma**
Revenue	$ 15,262	$ 15,262	$ 19,747	$ 19,747	**$ 22,956**	**$ 22,956**
Operating expenses:						
Cost of revenue	2,460	2,603	2,814	3,013	**3,002**	**3,277**
Research and development	2,601	2,963	2,970	3,479	**3,775**	**4,817**
Acquired in-process technology	296	296	–	–	–	–
Sales and marketing	2,828	2,977	3,231	3,438	**4,141**	**4,483**
General and administrative	433	508	689	815	**1,009**	**1,243**
Other expenses	230	230	115	115	**92**	**92**
Total operating expenses	8,848	9,577	9,819	10,860	**12,019**	**13,912**
Operating income	6,414	5,685	9,928	8,887	**10,937**	**9,044**
Investment income	703	703	1,803	1,803	**3,182**	**3,182**
Gain on sales	–	–	160	160	**156**	**156**
Income before income taxes	7,117	6,388	11,891	10,850	**14,275**	**12,382**
Provision for income taxes	2,627	2,369	4,106	3,741	**4,854**	**4,210**
Net income	$ 4,490	$ 4,019	$ 7,785	$ 7,109	**$ 9,421**	**$ 8,172**
Diluted earnings per share	$ 0.84	$ 0.75	$ 1.42	$ 1.30	**$ 1.70**	**$ 1.48**

The weighted average Black-Scholes value of options granted under the stock option plans during 1998, 1999, and 2000 was $11.81, $20.90, and $36.67. Value was estimated using a weighted average expected life of 5.3 years in 1998, 5.0 years in 1999, and 6.2 years in 2000, no dividends, volatility of .32 in 1998 and 1999 and .33 in 2000, and risk-free interest rates of 5.7%, 4.9%, and 6.2% in 1998, 1999, and 2000.

Notes to Financial Statements continued (in millions, except per share amounts)

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	1998	1999	**2000**
Net income	$ 4,490	$ 7,785	**$ 9,421**
Preferred stock dividends	28	28	**13**
Net income available for common shareholders	$ 4,462	$ 7,757	**$ 9,408**
Weighted average outstanding shares of common stock	4,864	5,028	**5,189**
Dilutive effect of:			
Common stock under structured repurchases	6	13	**–**
Put warrants	–	–	**2**
Preferred stock	34	16	**7**
Employee stock options	458	425	**338**
Common stock and common stock equivalents	5,362	5,482	**5,536**
Earnings per share:			
Basic	$ 0.92	$ 1.54	**$ 1.81**
Diluted	$ 0.84	$ 1.42	**$ 1.70**

Operational Transactions

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

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

In November 1998, Microsoft acquired LinkExchange, Inc., a leading provider of online marketing services to Web site owners and small and medium-sized businesses. Microsoft paid $265 million in stock.

In September 1999, the Company sold the entertainment city guide portion of MSN Sidewalk to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of TMCS stock and warrants with a value of $223 million. The transaction also included a distribution agreement. Microsoft recognized a gain of $156 million on the sale and will recognize revenue amounts related to the distribution arrangement over the term of the agreement.

In November 1999, Expedia, Inc. completed an initial public offering of its common stock. Expedia, which is majority-owned by Microsoft, is a leading provider of branded online travel services for leisure and small business travelers. Expedia's financial results and financial condition are consolidated with the operations of Microsoft.

In January 2000, the Company merged with Visio Corporation in a transaction that was accounted for as a pooling of interests. Microsoft issued 14 million shares in the exchange for the outstanding stock of Visio. Visio's assets and liabilities, which were nominal, are included with those of Microsoft as of the merger. Operating results for Visio from periods prior to the merger were not material to the combined results of the two companies. Accordingly, the financial statements for such periods have not been restated.

During fiscal 1999 and 2000, Microsoft also acquired several other entities primarily providing online technologies and services. The Company did not record significant in-process technology write-offs in connection with these transactions.

Notes to Financial Statements continued

Commitments

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $95 million, $135 million, and $201 million in 1998, 1999, and 2000. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2001, $178; 2002, $172; 2003, $160; 2004, $151; 2005, $139; and thereafter, $437.

Microsoft has committed $299 million for constructing new buildings and $200 million for the manufacturing of products. During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay $220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

Contingencies

On October 7, 1997, Sun Microsystems, Inc. (“Sun”) brought suit against Microsoft in the U.S. District Court for the Northern District of California. Sun’s complaint alleges several claims against Microsoft, all related to the parties’ relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology.

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

On November 17, 1998, the Court entered an order granting Sun’s request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims, because Microsoft’s use of Sun’s technology in its products was beyond the scope of the parties’ license agreement. The Court ordered Microsoft to make certain changes in its products that include Sun’s Java technology and to make certain changes in its Java software development tools. The Court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft’s Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit Court of Appeals on December 16, 1998.

On August 23, 1999 the 9th Circuit Court of Appeals vacated the November 1998 preliminary injunction and remanded the case to the District Court for further proceedings. Sun immediately filed two motions to reinstate and expand the scope of the earlier injunction on the basis of copyright infringement and unfair competition. On January 25, 2000, the Court issued rulings on the two motions, denying Sun’s motion to reinstate the preliminary injunction on the basis of copyright infringement and granting, in part, Sun’s motion to reinstate the preliminary injunction based on unfair competition. Microsoft is in compliance with the terms of the partially reinstated preliminary injunction and will not need to undertake any further action to comply with the terms of the injunction. No other hearing or trial dates have been set.

The parties have filed multiple summary judgment motions on the interpretation of the Agreement and on Sun’s copyright and trademark infringement claims. On February 25, 2000, the Court entered an order denying both parties’ motions for summary judgment as to whether the Agreement authorizes Microsoft to distribute independently developed Java Technology. On April 5, 2000, the Trial Court entered an order denying Sun’s motion for summary judgment regarding the interpretation of Section 2.7(a), which sets forth certain requirements that Sun must meet when they deliver Java Technology to Microsoft. On May 9, 2000, the Court entered an order granting Microsoft’s motion to dismiss Sun’s copyright infringement claim and on May 25, 2000, the Court issued a tentative order granting Microsoft’s motion to dismiss Sun’s claim that it is entitled to liquidated damages based on the alleged improper posting of its source code by Microsoft. The Court has indicated its intention to set a hearing on the remaining motions in September 2000.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-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.

Notes to Financial Statements continued

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted Microsoft's motion for summary judgment as to the states' monopoly leverage claim and permitted the remaining claims to proceed to trial. Trial began on October 19, 1998 and ended with closing arguments on September 21, 1999. On November 5, 1999, Judge Jackson issued his Findings of Fact. On April 3, 2000 the Court entered its Conclusions of Law, determining that Microsoft "tied" Internet Explorer and Windows 95/98 in violation of Section 1 of the Sherman Act, that Microsoft violated Section 2 of the Sherman Act by taking actions to maintain its monopoly in the desktop-PC operating system market, and that Microsoft attempted to monopolize the Internet browser market in violation of Section 2 of the Sherman Act. The Court also held that Microsoft did not violate Section 1 of the Sherman Act by entering into a number of contracts challenged by the government. The Court established a schedule for consideration of the remedy to be imposed in a final judgment. On April 28, 2000, the plaintiffs submitted a joint proposed remedy that included a proposed break-up of Microsoft into two companies, an operating systems company, and a company that would own all of Microsoft's other products and businesses. Microsoft submitted its proposed remedy and its proposal for further remedy proceedings on May 10, 2000. On June 7, 2000, Judge Jackson entered the government's proposed order nearly verbatim as his final judgment in the case. That judgment orders a divestiture that will create two separate companies, an "Operating Systems Business" and an "Applications Business," to be implemented one year following a final decision on appeal. It also provides for a broad range of "conduct" remedies that would have gone into effect in 90 days, absent a stay. On June 13, 2000, Microsoft appealed to the United States Court of Appeals. The Court of Appeals immediately entered an order notifying the parties that the Court would hear all matters related to this appeal *en banc*. The government then asked Judge Jackson to enter an order certifying the case for direct appeal to the Supreme Court. On June 20, 2000, Judge Jackson certified the case for direct appeal to the Supreme Court and simultaneously granted Microsoft's request to stay the entire remedy pending final appeal. The certification divests the Court of Appeals of jurisdiction over the case until the Supreme Court decides whether or not to accept jurisdiction of the case, which is entirely discretionary. The parties have agreed to a briefing schedule on this issue, according to which Microsoft filed its Jurisdictional Statement on July 26, 2000, the government responded on August 15, 2000, and Microsoft replied on August 22, 2000. If the Supreme Court declines to accept jurisdiction, the appeal will return to the Court of Appeals. If the Supreme Court accepts jurisdiction, a schedule will be established for briefing and oral argument on the merits of our appeal.

In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues. In addition, the European Commission has instituted proceedings in which it alleges that Microsoft has failed to disclose information that Sun claims it needs to interoperate fully with Windows 2000 clients and has engaged in discriminatory licensing of such technology. The remedies sought, though not fully defined, include mandatory disclosure of Microsoft intellectual property concerning Windows operating systems and imposition of fines. Microsoft denies the Commission's allegations and intends to contest the proceedings vigorously.

A large number of antitrust class action lawsuits have been initiated against Microsoft. These cases allege that Microsoft has competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications and seek to recover alleged overcharges that the complaints contend Microsoft charged for these products. Microsoft believes the claims are without merit and is vigorously defending the cases.

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

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.

Notes to Financial Statements continued (in millions)

Segment Information

Year Ended June 30	Windows Platforms	Productivity Applications and Developer	Consumer and Other	Reconciling Amounts	Consolidated
1998					
Revenue	$ 6,236	$ 7,458	$ 1,765	$ (197)	$ 15,262
Operating income	3,661	4,824	(1,050)	(1,021)	6,414
1999					
Revenue	$ 8,570	$ 8,636	$ 1,854	$ 687	$ 19,747
Operating income	5,476	4,950	(1,241)	743	9,928
2000					
Revenue	**$ 9,265**	**$ 10,089**	**$ 2,718**	**$ 884**	**$ 22,956**
Operating income	**5,813**	**4,935**	**(1,455)**	**1,644**	**10,937**

The Company's organizational structure and fundamental approach to business reflect the needs of its customers. As such, Microsoft has three major segments: Windows Platforms; Productivity Applications and Developer; and Consumer and Other. Windows Platforms includes the Windows Division, which is primarily responsible for developing and marketing Windows NT Workstation, Windows 2000 Professional, Windows 98, Windows 95, Windows NT Server, and Windows 2000 Server. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and vertical properties. Assets of the segment groups are not relevant for management of the businesses nor for disclosure.

Segment information is presented in accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information.* This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The Company's financial reporting systems present various data for management to run the business, including internal profit and loss statements (P&Ls) prepared on a basis not consistent with generally accepted accounting principles. Reconciling items include certain elements of unearned revenue, the treatment of certain channel inventory amounts and estimates, and the classification of revenue from product support and consulting. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization. In fiscal 2000, the Company's internal P&Ls included the Black-Scholes value of employee stock option grants, amortized over the remaining months of the fiscal year of the grant, as well as minor changes to the segments' composition due to various internal reorganizations during the year. Fiscal 1999 disclosures have been restated for consistent presentation. It is not practicable to restate fiscal 1998 for these changes.

Revenue attributable to U.S. operations includes shipments to customers in the United States, licensing to OEMs and certain multinational organizations, and exports of finished goods, primarily to Asia, Latin America, and Canada. Revenue from U.S operations totaled $10.1 billion, $13.7 billion, and $15.7 billion in 1998, 1999, and 2000. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled $5.2 billion, $6.0 billion, and $7.3 billion in 1998, 1999, and 2000.

Long-lived assets totaled $1.5 billion and $1.8 billion in the United States in 1999 and 2000 and $154 million and $126 million in other countries in 1999 and 2000.

Quarterly Information Unaudited (in millions, except per share amounts)

	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
1998					
Revenue	$ 3,334	$ 3,792	$ 3,984	$ 4,152	$ 15,262
Gross profit	2,800	3,179	3,344	3,479	12,802
Net income	663	1,133	1,337	1,357	4,490
Basic earnings per share	0.14	0.24	0.27	0.27	0.92
Diluted earnings per share	0.13	0.21	0.25	0.25	0.84
Common stock price per share:					
High	37.69	36.66	45.47	54.28	54.28
Low	30.82	29.50	31.10	40.94	29.50
1999					
Revenue	$ 4,193	$ 5,195	$ 4,595	$ 5,764	$ 19,747
Gross profit	3,544	4,407	3,887	5,095	16,933
Net income	1,683	1,983	1,917	2,202	7,785
Basic earnings per share	0.34	0.40	0.38	0.43	1.54
Diluted earnings per share	0.31	0.36	0.35	0.40	1.42
Common stock price per share:					
High	59.81	72.00	94.63	95.63	95.63
Low	47.25	43.88	68.00	75.50	43.88
2000					
Revenue	**$ 5,384**	**$ 6,112**	**$ 5,656**	**$ 5,804**	**$ 22,956**
Gross profit	**4,672**	**5,356**	**4,904**	**5,022**	**19,954**
Net income	**2,191**	**2,436**	**2,385**	**2,409**	**9,421**
Basic earnings per share	**0.43**	**0.47**	**0.46**	**0.46**	**1.81**
Diluted earnings per share	**0.40**	**0.44**	**0.43**	**0.44**	**1.70**
Common stock price per share:					
High	**100.75**	**119.94**	**118.63**	**96.50**	**119.94**
Low	**81.63**	**84.38**	**88.13**	**60.38**	**60.38**

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 2000, there were 107,824 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

Report of Management

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.

John G. Connors
Senior Vice President, Finance and Administration;
Chief Financial Officer

Report of Independent Auditors

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1999 and 2000, and the related consolidated statements of income, cash flows, and stockholders' equity for each of the three years in the period ended June 30, 2000, appearing on page 11 and pages 19 through 36. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1999 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2000 in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Seattle, Washington
July 18, 2000

Directors and Officers

Directors

William H. Gates, III
Chairman of the Board;
Chief Software Architect,
Microsoft Corporation

Steven A. Ballmer
President;
Chief Executive Officer,
Microsoft Corporation

Paul G. Allen
Chairman of the Board,
Vulcan Northwest Inc.

Richard A. Hackborn
Chairman of the Board;
Executive Vice
President (retired),
Hewlett-Packard Company

David F. Marquardt
General Partner,
August Capital

Ann McLaughlin
Chairman Emeritus,
The Aspen Institute;
Senior Advisor,
Benedetto and
Gartland & Company, Inc.

Wm. G. Reed, Jr.
Chairman, Simpson
Investment Company
(retired)

Jon A. Shirley
President and Chief
Operating Officer,
Microsoft Corporation
(retired)

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Chief Software Architect

Steven A. Ballmer
President;
Chief Executive Officer

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Executive Vice President;
Chief Operating Officer

William H. Neukom
Executive Vice President,
Law and Corporate Affairs;
Secretary

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Group Vice President,
Platforms

Orlando Ayala Lozano
Group Vice President,
Sales, Marketing and
Services

Richard E. Belluzzo
Group Vice President,
Personal Services
and Devices

Paul A. Maritz
Group Vice President,
Platforms Strategy &
Developer

Robert L. Muglia
Group Vice President,
.NET Services

Jeffrey S. Raikes
Group Vice President,
Productivity and
Business Services

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Senior Vice President,
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Senior Vice President,
MSN.com

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Personal Services Platform

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Senior Vice President,
Finance and Administration;
Chief Financial Officer

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Senior Vice President;
President, Microsoft Europe,
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Collaboration & Mobility

Joachim Kempin
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Senior Vice President;
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Consumer Strategy

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Brian Valentine
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Chairman Emeritus,
Microsoft Europe, Middle
East, and Africa

Worldwide Marketing Locations*

www.microsoft.com/worldwide/

South Pacific and Americas Region

Argentina	www.microsoft.com/argentina/
Australia	www.microsoft.com/australia/
Bolivia	www.microsoft.com/bolivia/
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/costarica/
Dominican Republic	www.microsoft.com/dominicana/
Ecuador	www.microsoft.com/ecuador/
El Salvador	www.microsoft.com/elsalvador
Guatemala	www.microsoft.com/guatemala/
Jamaica	www.microsoft.com/latam/
México	www.microsoft.com/mexico/
New Zealand	www.microsoft.com/nz/
Panama	www.microsoft.com/panama/
Perú	www.microsoft.com/peru/
Puerto Rico	www.microsoft.com/puertorico/
Trinidad & Tobago	www.microsoft.com/latam/
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/bulgaria/
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/
Nigeria	www.microsoft.com/northafrica/
Norway	www.microsoft.com/norge/
Pakistan	www.microsoft.com/middleeast/
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/
Tunisia	www.microsoft.com/northafrica/
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 http://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 Thursday, November 9, 2000 from 8 to 9 A.M. at the Washington State Convention & Trade Center, 800 Convention Place, Seattle, 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

Freedom to Innovate Network

You are encouraged to make your voice heard in the important public policy debates that will shape the future of the technology industry by joining the Freedom to Innovate Network (FIN). The FIN is a free service that will allow you to share your views, send a letter directly to your elected officials, and receive regular issue updates on important legislation facing Microsoft. Join today by contacting the FIN at:
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