Microsoft

Microsoft Corporation

Annual Report 2007

To our shareholders, customers, partners and employees:

Fiscal 2007 was an important and very successful year for Microsoft. Fueled by the launches of new versions of our flagship Microsoft® Windows® and Office products, the rollout of the biggest wave of business software in company history, and excellent momentum across a broad range of markets, we reached a significant milestone in 2007 when we surpassed $50 billion in revenue. For the year, revenue reached $51.12 billion, a 15 percent increase over fiscal 2006. Operating income totaled $18.52 billion, a jump of $2.05 billion compared with the previous year. During 2007, we returned $31 billion in cash to shareholders through stock buybacks and dividends.

Results such as these cap a remarkable run that has seen profit double and revenue nearly double over the past five years. During that time, we have also returned more than $100 billion to shareholders.

Fiscal 2007 saw many successful product launches, led by the release of Windows Vista®, the newest version of our desktop operating system. In fiscal 2007, we sold more than 55 million Windows Vista licenses. The 2007 Microsoft Office system also enjoyed an extremely successful launch, enabling us to sell more than 71 million Microsoft Office licenses in fiscal 2007.

Other important launches included the business security product Microsoft Forefront™, the Microsoft System Center family of IT management solutions, and new versions of many of our Microsoft Dynamics™ business solutions. We also launched Zune™, our digital and music entertainment device; released Microsoft Windows Mobile® 6; and introduced Microsoft Silverlight, which enables developers to create rich, interactive media experiences and applications for the Web.

During 2007, we acquired the global digital marketing company aQuantive. Valued at approximately $6 billion, it marks the largest acquisition in Microsoft's history. aQuantive's market-leading technology and its decade-long relationships with publishers and advertisers combined with our adCenter advertising platform will enable us to offer a world-class Internet-wide advertising platform along with tools, sales, support, and syndication to agencies, advertisers, and publishers. We also made a number of strategic acquisitions, including Tellme Networks, a leading provider of voice services for directory assistance, enterprise customer service and mobile search; ScreenTonic, a pioneer in mobile advertising and Medstory, which develops Web search technology for health information.

Long-Term Success Built on Broad Innovation and Global Talent

In 2007, we continued our 30-year commitment to innovation by investing $7.12 billion in research and development. The value of our investment in research and development can be seen in new products such as Microsoft Surface™, which provides a groundbreaking tabletop computing experience that lets people interact with digital content through natural gestures and touch, and Microsoft Robotics Studio, our revolutionary software development kit for the robotics industry. It also is evident in more established products such as the 2007 Microsoft Office system, where the new Office Ribbon interface is transforming the way people use productivity software.

The foundation for innovation at Microsoft is a work force that consists of the top talent from around the world. In a time of intense competition for talent in our industry, 2007 was one of the best recruiting years in company history. Around the globe, we hired great people for technical, sales, marketing, and support roles, and added new research and development facilities so we can continue to attract the world's best and brightest. Equally important, we are making industry-leading investments in career development and workplace enhancements so our employees have the right tools and incentives to drive the company forward.

Building New Competencies in Consumer Technology and the Services Transformation

One essential difference between Microsoft and any other company in this industry is our willingness to enter new markets and embrace disruptive business trends. Seventeen years ago, we began to diversify our company by expanding beyond the desktop and entering the enterprise server software market. Today, server software is a $11.18 billion business for Microsoft.

This kind of long-term commitment and vision has enabled Microsoft to create an impressive portfolio of desktop and enterprise products that have seen strong growth during the past five years. Since fiscal 2002, for example, Microsoft SQL Server™ revenue has grown by an annual average of 28 percent, Microsoft Dynamics—which became a $1 billion business in 2007—has grown 27 percent, and Microsoft Office SharePoint® Server has grown by 67 percent.

Now we are focused on diversifying once again as we pursue opportunities in consumer technology. To build on the strength we have in the consumer marketplace with Windows Vista, the 2007 Microsoft Office system, Xbox 360™, Microsoft Windows Live™, Windows Mobile, and Zune, we are focused on delivering products that are compelling and cutting edge in terms of design as well as features and functionality. As part of our emphasis on success in consumer technologies, we are also working to define the next era of consumer electronics. In the past, consumer electronics was a hardware-centric business; today, the real innovation in consumer electronics devices lies in the software that powers them. This is creating new opportunities for us to deliver end-to-end experiences that no other company can match.

Underlying our opportunities in consumer technologies, and in all of our businesses, is a companywide commitment to fully embrace software plus services. Software plus services enables us to combine the advantages of Internet-based services—software that resides on the Internet, is downloaded quickly for each use, and is accessed through a Web browser—with the power of desktop and server software. Software plus services represents the single biggest opportunity across every one of our businesses. Our software-plus-services approach will enable us to deliver new experiences to end users and new value to businesses as we combine the richness of our desktop software with the breadth of our online assets, and the control and security of our enterprise software with the flexibility and mobility of our consumer devices.

In fiscal 2007, we made important progress in software plus services with the introduction of Windows Live Spaces and Windows Live for Mobile, and the release from beta of Windows Live Search, Windows Live.com, Windows Live Local Search and Office Live. We also introduced new developer tools such as Silverlight, Popfly and the Microsoft .NET 3.0 Framework. In the coming year as we continue to build out our services platform, we will bring a broad range of new products and service offerings to market that target the needs of large enterprises, small and medium-sized businesses, and consumers.

Delivering More Value Around the World on the Desktop and the Server

Although we enjoyed strong success in 2007 with the launches of Windows Vista and the 2007 Microsoft Office system, we see strong opportunities for growth by delivering more value per customer. With the planned releases in fiscal 2008 of Windows Server® 2008, SQL Server 2008, and Visual Studio® 2008, and the opportunity to provide additional value in security, messaging, systems management and collaboration, we are well-positioned to build on our strength with businesses of all sizes. We will also continue to pursue new opportunities in high-performance computing, unified communications, healthcare and business intelligence.

Around the world, we're seeing excellent growth in many emerging markets as more and more people begin to participate in the global knowledge economy. For example, in Russia and Vietnam our revenue grew in excess of 70 percent in 2007. Other emerging markets that saw impressive growth included India, China, and Brazil which all delivered revenue growth that topped 40 percent. Growth was strong in many developed markets as well, with Ireland, the Netherlands, Spain, and Australia each exceeding revenue growth of 25 percent. All told, revenue jumped 25 percent or more in 46 countries in 2007.

Investing in Communities, Fostering Diversity

Using the power of technology to help people around the world achieve their potential is central to our mission, and we continue to work to foster social and economic advancement for communities through partnerships with public- and private-sector organizations.

In April, we announced the expansion of Unlimited Potential and unveiled a new commitment to help close the digital divide by creating new products and programs that will help bring social and economic opportunity to the estimated 5 billion people who are not yet realizing the benefits of technology. Unlimited Potential is focused on delivering relevant, accessible and affordable solutions that will help transform education, foster local innovation, and help create jobs and opportunities. We believe Microsoft can have the greatest impact in these three areas, creating a continuous cycle of sustained social and economic opportunity.

During fiscal 2007, community technology skills centers supported by Unlimited Potential reached more than 46 million people. Through our Partners in Learning program, we have helped provide information and communications technology curriculum and skills training to more than 71 million primary and secondary teachers and students in 101 countries.

At Microsoft, diversity and inclusion are also core values and we strive to be the industry leader in helping women and minorities realize their potential. Within the company, we promote diversity at every level of the organization, and in 2007, the number of women in senior executive positions increased more than 20 percent. We're also working to encourage more women and minorities to enter the technology industry through programs such as DigiGirlz, which provides high school girls with opportunities to learn about careers in technology and take advantage of hands-on technology workshops. And we're committed to working in partnership with minority- and women-focused organizations to help bring technology to diverse communities. One example is a $5 million technology grant to the National Urban League.

A New Era of Innovation and Change

Microsoft was founded with the dream of putting a computer on every desk and in every home, and for more than 30 years our software has played a vital role in the positive cycle of innovation and progress that has given rise to incredible new ways to communicate, share ideas, manage our businesses, and much more.

It's amazing to look back and see how much progress we have made in the past three decades. But it's even more inspiring to look ahead and imagine a world where that dream embraces every country in every part of the globe, empowering billions more people to participate in the knowledge economy. As this happens, new ideas will emerge, new businesses will be launched, and important new advances will be made in science and medicine. The result will be a wave of new innovations that will continue to make our lives richer, more productive and more fulfilling. Because software is the foundation for the profound changes that lie ahead, Microsoft is in an ideal position to take advantage of the incredible opportunities that lie before us.

It is your continued support that enables us to pursue these opportunities. Thank you.

William H. Gates III
Chairman of the Board

Steven A. Ballmer
Chief Executive Officer

SELECTED FINANCIAL DATA, QUARTERLY STOCK PRICE INFORMATION, ISSUER PURCHASES OF EQUITY SECURITIES, AND STOCK PERFORMANCE

FINANCIAL HIGHLIGHTS

(In millions, except per share data)

Fiscal Year Ended June 30	2007	2006	2005	2004	2003
Revenue	**$51,122**	$44,282	$39,788	$36,835	$32,187
Operating income	**18,524**	16,472	14,561	9,034	9,545
Net income	**14,065**	12,599	12,254	8,168	7,531
Diluted earnings per share	**$ 1.42**	$ 1.20	$ 1.12	$ 0.75	$ 0.69
Cash dividends declared per share	**$ 0.40**	$ 0.35	$ 3.40	$ 0.16	$ 0.08
Cash and short-term investments	**23,411**	34,161	37,751	60,592	49,048
Total assets	**63,171**	69,597	70,815	94,368	81,732
Long-term obligations	**8,320**	7,051	5,823	4,574	2,846
Stockholders' equity	**31,097**	40,104	48,115	74,825	64,912

Our common stock is traded on The NASDAQ Stock Market under the symbol MSFT. On August 1, 2007, there were 148,344 registered holders of record of our common stock. The high and low common stock prices per share were as follows:

Quarter Ended	Sep. 30	Dec. 31	Mar. 31	June 30	Year
Fiscal year 2007					
Common stock price per share:					
High	**$27.52**	**$30.26**	**$31.48**	**$31.16**	**$31.48**
Low	**22.23**	**27.15**	**26.60**	**27.56**	**22.23**
Fiscal year 2006					
Common stock price per share:					
High	$27.94	$28.25	$28.38	$27.94	$28.38
Low	24.50	24.25	26.10	21.46	21.46

See Note 12 – Stockholders' Equity of the Notes to Financial Statements for information regarding dividends approved by our Board of Directors in fiscal years 2007 and 2006.

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.00 billion tender offer which was completed on August 17, 2006; and authorization for up to an additional $20.00 billion ongoing share repurchase program that expires on June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.84 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.00 billion ongoing share repurchase program had been increased by approximately $16.16 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.16 billion through June 30, 2011. The repurchase program may be suspended or discontinued at any time without prior notice. The transactions occurred in open market purchases and pursuant to a trading plan under Rule 10b5-1. We repurchased common stock in each quarter of fiscal year 2007 using available cash resources as follows:

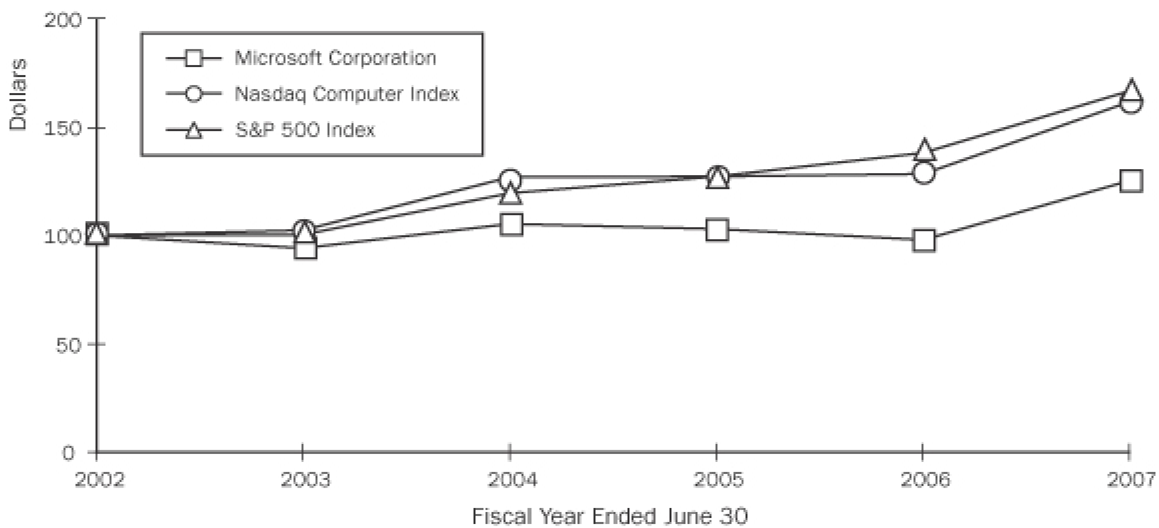
Period	Total number of shares purchased	Average price paid per share
July 1, 2006 – September 30, 2006	285,126,354	$24.43
October 1, 2006 – December 31, 2006	205,416,571	$29.39
January 1, 2007 – March 31, 2007	237,497,727	$28.40
April 1, 2007 – June 30, 2007	242,715,913	$30.35

SELECTED FINANCIAL DATA, QUARTERLY STOCK PRICE INFORMATION, ISSUER PURCHASES OF EQUITY SECURITIES, AND STOCK PERFORMANCE
(CONTINUED)

Common stock repurchases in the fourth quarter of fiscal year 2007 were as follows:

Period	(a) Total number of shares purchased	(b) Average price paid per share	(c) Total number of shares purchased as part of publicly announced plans or programs	(d) Approximate dollar value of shares that may yet be purchased under the plans or programs (in millions)
April 1, 2007 – April 30, 2007	10,816,647	$28.17	10,816,647	$22,200
May 1, 2007 – May 31, 2007	133,980,027	$30.71	133,980,027	$18,086
June 1, 2007 – June 30, 2007	97,919,239	$30.11	97,919,239	$15,138
	242,715,913		242,715,913	

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
Among Microsoft Corporation, The S&P 500 Index
And The NASDAQ Computer Index



	Cumulative Total Return*					
	2002	2003	2004	2005	2006	2007
Microsoft Corporation	100.00	94.05	105.34	102.86	97.75	125.35
S&P 500	100.00	100.25	119.41	126.96	137.92	166.32
NASDAQ Computer	100.00	102.34	126.67	126.95	128.29	161.47

* $100 invested on June 30, 2002, in stock or index, including reinvestment of dividends.

Special Note About Forward-Looking Statements

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "plan," "may," "should," "will," "would," "will be," "will continue," "will likely result," and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section entitled "Risk Factors" in our fiscal year 2007 Form 10-K. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

BUSINESS DESCRIPTION

GENERAL

Our mission is to enable people and businesses throughout the world to realize their full potential. Since our founding in 1975, we have worked to achieve our mission by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, and solutions that we believe deliver new opportunities, greater convenience, and enhanced value to people's lives. We do business throughout the world and have offices in more than 100 countries.

We generate revenue by developing, manufacturing, licensing, and supporting a wide range of software products for many computing devices. Our software products include operating systems for servers, personal computers, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solution applications; high-performance computing applications, and software development tools. We provide consulting and product support services, and we train and certify computer system integrators and developers. We sell the Xbox 360 video game console and games, the Zune digital music and entertainment device, PC games, and peripherals. Online offerings and information are delivered through our Windows Live, Office Live, and MSN portals and channels. We enable the delivery of online advertising through our proprietary adCenter® platform.

We also research and develop advanced technologies for future software products. We believe that delivering breakthrough innovation and high-value solutions through our integrated software platform is the key to meeting our customers' needs and to our future growth. We believe that we continue to lay the foundation for long-term growth by delivering new products, creating opportunities for partners, improving customer satisfaction, and improving our internal processes. Our focus is to build on this foundation through ongoing innovation in our integrated software platforms; by delivering compelling value propositions to customers; by responding effectively to customer and partner needs; and by continuing to emphasize the importance of product excellence, business efficacy, and accountability.

OPERATING SEGMENTS

Our segments provide management with a comprehensive financial view of our key businesses. The segments provide a framework for the alignment of strategies and objectives across the development, sales, marketing, and services organizations, and for the timely and rational allocation of development, sales, marketing, and services resources within businesses. The segments also help focus strategic planning efforts on key objectives and initiatives across our businesses.

Due to our integrated business structure, operating costs included in one segment may benefit other segments. Therefore, these segments are not designed to measure operating income or loss that is directly related to the products included in each segment. Inter-segment cost commissions are estimated by management and used to compensate or charge each segment for such shared costs and to motivate shared effort. Segments should not be viewed as discrete or easily separable businesses.

In July 2006, we announced a change in our operating segments reflecting previously announced reorganizations. We have five operating segments: Client, Server and Tools, the Online Services Business, the Microsoft Business Division, and the Entertainment and Devices Division. Prior fiscal year information has been recast to conform to the way we internally managed and monitored performance at the business group level in fiscal year 2007. See Note 18 – Segment Information of the Notes to Financial Statements for financial information regarding segment reporting.

Client. Client has overall responsibility for the technical architecture, engineering, and product delivery of our Windows product family, and is responsible for our relationships with personal computer manufacturers, including multinational and regional original equipment manufacturers ("OEMs"). The segment includes sales and marketing expenses for the Windows client operating system and product development efforts for the Windows platform. Client revenue growth is correlated with the growth of purchases of personal computers from OEMs that pre-install versions of Windows operating systems as the OEM channel accounts for over 80% of total Client revenue.

We released Windows Vista, the latest generation of the Windows operating system, in fiscal year 2007. This release concluded a major development phase that we believe resulted in a significantly more manageable and powerful PC operating system compared to prior releases. Windows Vista includes advances in security, digital media, user interfaces, and other areas that enhance the user and developer experience.

Products. Windows Vista, including Home, Home Premium, Ultimate, Business, and Enterprise Starter Edition; Windows XP Professional and Home; Media Center Edition; Tablet PC Edition; and other standard Windows operating systems.

Competition. Client faces strong competition from well-established companies with differing approaches to the PC market. Competing commercial software products, including variants of Unix, are supplied by competitors such as Apple Computer, Hewlett-Packard, IBM, and Sun Microsystems. The Linux operating system, which is also derived from Unix and is available without payment under a General Public License, has gained some acceptance as competitive pressures lead PC OEMs to reduce costs. The Windows operating system also faces competition from alternative platforms and new devices that may reduce consumer demand for traditional personal computers. Competitors such as Mozilla offer software that competes with the Internet Explorer Web browsing capabilities of Windows products. Apple Computer, Real Networks, and others compete with Windows Media Player. Our operating system products compete effectively by delivering innovative software, a familiar, easy-to-use interface, compatibility with a broad range of hardware and software applications, and the largest support network for any operating system.

Server and Tools. Server and Tools develops and markets software server products, services, and solutions. Windows Server products are integrated server infrastructure and middleware software designed to support software applications and tools built on the Windows Server operating system. Windows Server products include the server platform, database, storage, management and operations, service-oriented architecture platform, and security software. The segment also builds standalone and software development lifecycle tools for software architects, developers, testers, and project managers. Server products can be run on premise or in a hosting environment.

We offer a broad range of consulting services and provide product support services and customer industry solutions. The segment also provides training and certification to developers and information technology professionals about our Server and Client platform products. Server and Tools also includes the Enterprise Partner Group, which is responsible for sales, partner management, and partner programs for medium and large organizations, and the Public Sector sales and marketing organization.

Approximately 45% of Server revenue comes from multi-year licensing agreements, approximately 30% is purchased through fully packaged product and transactional volume licensing programs, and approximately 10% comes from licenses sold to OEMs. The remainder of our revenue comes from consulting and product support services.

Products and Services. Windows Server operating system; Microsoft SQL Server; Microsoft Enterprise Services; product support services; Visual Studio; System Center products; Forefront Security products; Biz Talk Server; MSDN; and TechNet, among others.

Competition. Our server operating system products face intense competition from a wide variety of server operating systems and server applications, offered by companies with a variety of market approaches. Vertically integrated computer manufacturers such as Hewlett-Packard, IBM, and Sun Microsystems offer their own variant of Unix preinstalled on server hardware. Nearly all computer manufacturers offer server hardware for the Linux operating system. Linux's competitive position has also benefited from the large number of compatible applications now produced by many leading commercial software developers and non-commercial software developers. A number of companies supply versions of Linux, including Novell and Red Hat. Server virtualization platform providers based on Linux, such as VMWare, represent another means by which Linux competes with the Windows server operating system.

We have entered into business and technical collaboration agreements with Novell and other Linux providers to build, market, and support a series of solutions to make our products work better with their solutions, and to provide each other's customers with patent coverage for respective products.

We compete in the business of providing enterprise-wide computing solutions with several companies that provide solutions and middleware technology platforms. IBM and Sun Microsystems lead a group of companies focused on the Java 2 Platform Enterprise Edition (J2EE). Commercial software developers that provide competing server applications for PC-based distributed client/server environments include Computer Associates, IBM, and Oracle.

Numerous commercial software vendors offer competing commercial software applications for connectivity (both Internet and intranet), security, hosting, and e-business servers. System Center competes with BMC, Computer Associates, and IBM in the management of information technology ("IT") infrastructures, while Forefront Security competes with McAfee, Symantec, and Trend Micro in protecting both client and server applications. Non-commercial software products, including the widely-deployed Apache Web Server, also compete with our solutions. Our products for software developers compete against offerings from Adobe, BEA Systems, Borland, IBM, Oracle, Sun Microsystems, and other companies. We believe that our server products provide customers with advantages in innovation, performance, total costs of ownership, and productivity, by delivering superior applications development tools and development environment, compatibility with a broad base of hardware and software applications, security, and manageability.

Online Services Business. The Online Services Business ("OSB") provides personal communications services, such as e-mail and instant messaging, and online information offerings such as Live Search and MSN portals and channels around the world. OSB also provides a variety of online services such as MSN Internet Access, MSN Premium Web Services, and OneCare. OSB manages many of its own properties, including home page, health, auto and shopping. In addition, OSB creates alliances with third parties, such as CareerBuilder.com, Expedia.com, Foxsports.com, Match.com, and MSNBC.com. OSB generates revenue primarily from online advertising, subscriptions and transactions of online paid services, as well as MSN narrowband Internet access subscriptions. In fiscal year 2006, OSB launched adCenter, our proprietary advertising platform, and has since transitioned the advertising business in the U.S. and certain international markets to adCenter. In fiscal year 2007, we launched new online initiatives, including Windows Live Search™ and Live.com in 54 international markets, Live Local Search in the U.S. and U.K., beta versions of MSN Soapbox (expansion of the MSN Video experience), Virtual Earth™ 3D, Windows Live Hotmail, and others.

Products. MSN Search; MapPoint; MSN Internet Access; MSN Premium Web Services (consisting of MSN Internet Software Subscription, MSN Hotmail Plus, MSN Bill Pay, and MSN Radio Plus); Windows Live; and MSN Mobile Services.

Competition. OSB competes with AOL, Google, Yahoo!, and a wide array of Web sites and portals that provide content and online offerings of all types to end users. We compete with these organizations to provide advertising opportunities for merchants. OSB also competes for narrowband Internet access users with AOL, Earthlink, and other ISPs for dial-up internet access in the United States. Due to the continuing trend of consumers migrating from narrowband to broadband Internet access, we expect our narrowband Internet access subscriber base to continue to decline as we de-emphasize this portion of our business. The Internet advertising industry has grown significantly over the past several years, and we anticipate that this trend will continue. Competitors are aggressively developing Internet offerings that seek to provide more effective ways of connecting advertisers with audiences through enhanced functionality in communication services, improvements in information services such as Internet search, and improved advertising infrastructure and support services. We have developed our own algorithmic search engine to provide end users with more relevant search results, a broader selection of content, and expanded search services. To support the growth of our advertising business, we also are investing in our communication services, technology, operations, and sales efforts. We will continue to introduce new products and services, including the Windows Live set of services that are aimed at attracting additional users through improvements in the user online experience. We believe that we can compete effectively across the breadth of our Internet services by providing users with software innovation in the form of information and communication services that help them find, discover, and experience what they want online and by providing merchants with effective advertising results through improved systems and sales support.

Microsoft Business Division. Microsoft Business Division ("MBD") offerings consist of the Microsoft Office system and Microsoft Dynamics business solutions. Microsoft Office system products are designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions. Growth of revenue from the Microsoft Office system offerings, which generate over 90% of MBD revenue, depends on our ability to add value to the core Office product set and to continue to expand our product offerings in other information worker areas such as enterprise content management, collaboration, unified communications and business intelligence. Microsoft Dynamics products provide business solutions for financial management, customer relationship management, supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises.

We evaluate our results based upon the nature of the end user in two primary parts – business revenue which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue, and consumer revenue which includes revenue from retail packaged product sales, OEM revenue, and sales of pre-installed versions of Office in Japan. Approximately 75% of MBD revenue is generated from sales to businesses. Revenue from this category generally depends upon the number of information workers in a licensed enterprise and is therefore relatively independent of the number of PCs sold in a given year. Approximately 25% of MBD revenue is derived from sales to consumers. Most of this revenue is generated from new licenses acquired through fully packaged products and licenses sold through OEMs for new PCs and are generally affected by the level of PC shipments and product launches.

Products. Microsoft Office; Microsoft Project; Microsoft Visio; Microsoft Office SharePoint Server; Microsoft Exchange Server; Microsoft Exchange Hosted Services; Microsoft Office Live Meeting; Microsoft Office Communication Server; Microsoft Office Communicator; Microsoft Tellme Service, Microsoft Dynamics AX; Microsoft Dynamics CRM; Microsoft Dynamics GP; Microsoft Dynamics NAV; Microsoft Dynamics SL; Microsoft Dynamics Retail Management System; Microsoft Partner Program; and Microsoft Office Accounting.

Competition. Competitors to the Microsoft Office system include many software application vendors such as Apple, Corel, Google, IBM, Novell, Oracle, Red Hat, Sun Microsystems, and local application developers in Europe and Asia. IBM (Smartsuite) and Corel (WordPerfect Suite) have measurable installed bases with their office productivity products. Apple may distribute certain of its application software products with various models of its PCs. The OpenOffice.org project provides a freely downloadable cross-platform application that also has been adapted by various commercial software vendors to sell under their brands, including IBM, Novell, Red Hat, and Sun. Corel's suite and many local software suites around the world are aggressively priced for OEMs to preinstall on low-priced PCs. Google has launched Google Apps, a hosted messaging and productivity suite, and also provides an enterprise search offering that competes with Microsoft Office SharePoint Server for Search, our new enterprise search product. Web-based offerings such as AjaxWrite, gOffice, iNetOffice, SimDesk, ThinkFree, wikiCalc, or other small projects competing with individual applications, can also provide an alternative to Microsoft Office system products. IBM has many different points of competition with Office system products with its Notes and Workplace offerings.

Our Microsoft Dynamics products compete with well-known vendors such as Intuit and Sage in the market focused on providing solutions for small and mid-sized businesses. The market for large organizations and divisions of global enterprises is intensely competitive with a small number of primary vendors including Oracle and SAP. These vendors are positioning many of their business applications to focus more intensely on small and mid-sized businesses. Additionally Salesforce.com's on-demand customer relationship management offerings compete directly with Microsoft Dynamics CRM Live and Microsoft Dynamic CRM's on-premise offerings. We believe our products compete effectively with these vendors based on our strategy of providing interoperable, adaptable solutions that work well with technologies our customers already have.

As we continue to respond to market demand for additional functionality and products, we will compete with additional vendors, most notably in enterprise content management, collaboration tools, unified communications, and business intelligence. These competitors include SAP; IBM; Cisco, with their acquisition of WebEx; Oracle, with the acquisition of Hyperion; and other business intelligence vendors such as Business Objects and Cognos.

Entertainment and Devices Division. The Entertainment and Devices Division ("EDD") is responsible for developing, producing, and marketing the Xbox video game system, including consoles and accessories, third-party games, games published under the Microsoft brand, and Xbox Live operations, as well as research, sales, and support of those products. In addition to Xbox, we offer the Zune digital music and entertainment device; PC software games; online games; Mediaroom, our Internet protocol television ("IPTV") software; and other devices.

EDD also leads the development efforts of our line of consumer software and hardware products including application software for Macintosh computers and Microsoft PC hardware products, and is responsible for all retail sales and marketing for Microsoft Office and the Windows operating systems. EDD also includes the mobile and embedded devices platform and is responsible for managing our company-wide sales and customer relations with device manufacturers and other communication-sector customers including network service providers and media and entertainment companies.

Products. Xbox 360 console and games; Xbox Live; Zune; Mediaroom; numerous consumer software and hardware products (such as mice and keyboards); Windows Mobile software platform; Windows Embedded device operating system; and Windows Automotive.

Competition. Entertainment and devices businesses are highly competitive, characterized by rapid product life cycles, frequent introductions of new products and titles, and the development of new technologies. The markets for our products are characterized by significant price competition. We anticipate continued pricing pressure from our competitors. From time to time, we have responded to this pressure by reducing prices on certain products. Our competitors vary in size from very small companies with limited resources to very large, diversified corporations with substantial financial and marketing resources. We compete primarily on the basis of product innovation, quality and variety, timing of product releases, and effectiveness of distribution and marketing.

Our Xbox hardware business competes with console platforms from Nintendo and Sony, both of which have a large, established base of customers. The lifecycle for video game consoles averages five to seven years. We released Xbox 360, our second generation console, in November 2005. Nintendo and Sony released new versions of their game consoles in late 2006. We believe the success of video game consoles is determined by the availability of games for the console, providing exclusive game content that gamers seek, the computational power and reliability of the console, and the ability to create new revenue sources such as advertising and downloadable content. We think the Xbox 360 is positioned well against competitive console products based on significant innovation in hardware architecture, new developer tools, expanded revenue sources, and continued strong exclusive content from our own game franchises such as Halo.

In addition to competing against software published for non-Xbox platforms, our games business also competes with numerous companies that we have licensed to develop and publish software for the Xbox consoles. Zune competes with the Apple iPod as well as other digital music and entertainment devices. Our PC hardware products face aggressive competition from computer and other hardware manufacturers, many of which are also current or potential partners. Mediaroom faces competition primarily from a variety of competitors that provide elements of an IPTV delivery platform, but that do not provide end-to-end solutions for the network operator. Windows Mobile software faces substantial competition from Nokia, Openwave Systems, Palm, QUALCOMM, Research In Motion, and Symbian. The embedded operating system business is highly fragmented with many competitive offerings. Key competitors include IBM, Wind River, and versions of embeddable Linux from commercial Linux vendors such as Metrowerks and MontaVista Software.

OPERATIONS

To serve the needs of customers around the world and to improve the quality and usability of products in international markets, we “localize” many of our products to reflect local languages and conventions. Localizing a product may require modifying the user interface, altering dialog boxes, and translating text.

Our operational centers support all operations in their regions, including customer contract and order processing, credit and collections, information processing and vendor management and logistics. The regional center in Ireland supports the European, Middle Eastern, and African region; the center in Singapore supports the Japan, Greater China and Asia-Pacific region; and the centers in Fargo, Puerto Rico, Redmond, and Reno support Latin America and North America.

We contract most of our manufacturing activities to third parties who produce the Xbox 360, Zune, various retail software packaged products, and Microsoft hardware. Our products may include some components that are available from only one or limited sources. Our Xbox 360 console includes certain key components that are supplied by a single source. The central processing unit is purchased from IBM and the graphics chips and embedded dynamic random access memory chips for the graphics processing unit are purchased from Taiwan Semiconductor Manufacturing Company and NEC Corporation, respectively. Although we have chosen to initially source these key Xbox 360 components from a single supplier, we are under no obligation to exclusively source components from these vendors in the future. Beyond the exceptions noted, we generally have the ability to use other custom manufacturers if the current vendor becomes unavailable. We generally have multiple sources for raw materials, supplies, and components, and are often able to acquire component parts and materials on a volume discount basis.

PRODUCT DEVELOPMENT

During fiscal years 2007, 2006, and 2005, research and development expense was $7.12 billion, $6.58 billion, and $6.10 billion, respectively. These amounts represented 14%, 15%, and 15%, respectively, of revenue in each of those years. We plan to continue to make significant investments in a broad range of research and product development efforts.

While most of our software products are developed internally, we also purchase technology, license intellectual property rights, and oversee third-party development and localization of certain products. We believe we are not materially dependent upon licenses and other agreements with third parties relating to the development of our products. Internal development allows us to maintain closer technical control over our products. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. Generally, we also create product documentation internally. We strive to obtain information at the earliest possible time about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing.

Business and Product Development Strategy. Innovation is a key factor affecting Microsoft's growth. Our model for growth is based on broad adoption of innovation, willingness to enter new markets, and embracing and acting on disruptive trends. We continue our long-term commitment to research and development, including advanced work aimed at innovations, in a wide spectrum of technologies, tools, and platforms; communication and collaboration; information access and organization; entertainment; business and e-commerce; and devices. Increasingly, we are taking a global approach to innovation. While our main research and development facilities are located in Redmond, Washington, we also operate research facilities in other parts of the United States and around the world, including China, Canada, Denmark, England, India, Ireland, and Israel. This global approach will help us remain competitive in local markets and attract top talent wherever it resides.

Based on our broad focus on innovation and long-term approach to new markets, we see the following key opportunities for growth:

- **Consumer technology.** To build on our strength in the consumer marketplace with Windows Vista, the 2007 Microsoft Office System, Xbox 360, Microsoft Windows Live, Windows Mobile, and Zune, we are focused on delivering products that we believe are compelling and cutting edge in terms of design as well as features and functionality. To succeed in consumer technologies, we also are working to define the next era of consumer electronics. In the past, consumer electronics was a hardware-centric business; today, the innovation in consumer electronics devices lies in the software that powers them. This is creating new opportunities for us to deliver end-to-end experiences.

- **Software plus services.** Underlying our opportunities in consumer technologies, and in all of our businesses, is a company-wide commitment to fully embrace software plus services. The ability to combine the power of desktop and server software with the reach of the Internet represents an opportunity across every one of our businesses. As we continue to build out our services platform, we will bring a broad range of new products and service offerings to market that target the needs of large enterprises, small and medium-sized businesses, and consumers.

- **Expanding our presence on the desktop and server.** While we enjoyed success in fiscal year 2007 with the launches of Windows Vista and the 2007 Microsoft Office System, we see potential for growth by delivering more value per customer. With the planned releases in fiscal year 2008 of Windows Server 2008, SQL Server 2008, and Visual Studio 2008, and the possibility to provide additional value in security, messaging, systems management, and collaboration, we believe we are well-positioned to build on our strength with businesses of all sizes. We will continue to pursue new opportunities in high performance computing, unified communications, healthcare, and business intelligence. Emerging markets are also an important opportunity for us. In fiscal year 2007, we announced the expansion of our Unlimited Potential program as the foundation for our efforts to reach the five billion people around the globe who do not have access to PCs and digital technology today.

DISTRIBUTION, SALES AND MARKETING

We distribute our products primarily through the following channels: OEM; distributors and resellers; and online.

OEM. Our operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to build computing devices based on our operating systems, principally PCs. Under similar arrangements, we also market and license certain server operating systems, desktop applications, hardware devices, and consumer software products to OEMs. We have OEM agreements covering one or more of our products with virtually all of the major PC OEMs, including Acer, Dell, Fujitsu, Fujitsu Siemens Computers, Gateway, Hewlett-Packard, Lenovo, NEC, Samsung, Sony, and Toshiba. A substantial amount of OEM business is also conducted with system builders, which are low-volume customized PC vendors operating in local markets.

Distributors and Resellers. We license software to organizations under arrangements that allow the end-user customer to acquire multiple licenses of products. Organizations license our products primarily through large account resellers (“LARs”), direct market resellers, and value-added resellers (“VARs”). Many organizations that license products through enterprise agreements (“EAs”) transact directly with us, with sales support from our Enterprise Software Advisor channel partners. These Enterprise Software Advisors typically are also authorized as LARs and operate as resellers for our other licensing programs. Although each type of reselling partner reaches organizations of all sizes, LARs are primarily engaged with large organizations and VARs typically reach the breadth of small- and medium-sized organizations. Some of our distributors include Ingram Micro and Tech Data, and some of our largest resellers include CDW, Dell, Insight Enterprises, Software House International, and Software Spectrum. Our Dynamics software offerings are licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services. We distribute our finished goods products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets. Individual consumers obtain our products primarily through retail outlets, including Best Buy, Target, and Wal-Mart. We have a network of field sales representatives and field support personnel that solicits orders from distributors and resellers and provides product training and sales support.

Our arrangements for organizations to acquire multiple licenses of products are designed to provide them with a means of doing so without having to acquire separate packaged product through retail channels. In delivering organizational licensing arrangements to the market, we use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include:

Open. Designed primarily for small-to-medium organizations (5 to over 250 licenses), this program allows customers to acquire perpetual licenses and, at the customer’s election, rights to future versions of software products over a specified time period (generally two years). The offering that conveys rights to future versions of certain software product over the contract period is called Software Assurance. Software Assurance also provides support, tools, and training to help customers deploy and use software efficiently. Under the Open program, customers can acquire licenses only, or licenses with Software Assurance. They can also renew Software Assurance upon the expiration of existing volume licensing agreements.

Select. Designed primarily for medium-to-large organizations (greater than 250 licenses), this program allows customers to acquire perpetual licenses and, at the customer’s election, Software Assurance, which consists of rights to future versions of certain software products, support, tools, and training over a specified time period (generally three years). Similar to the Open program, customers can acquire licenses only, acquire licenses with Software Assurance, or renew Software Assurance upon the expiration of existing volume licensing agreements.

Enterprise Agreement. The Enterprise Agreement is targeted at medium and large organizations that want to acquire perpetual licenses to software products for all or substantial parts of their enterprise, along with rights to future versions of certain software products, support, tools, and training over a specified time period (generally three years).

Online. We distribute online content and services through MSN and other online channels. OSB delivers Internet access and various premium services and tools to consumers. OSB also delivers online e-mail and messaging communication services and information services such as online search, advertising, and premium content. EDD operates the Xbox Live service which allows customers to participate in the gaming experience with other subscribers online. We operate and deliver the Microsoft Small Business Center portal. This portal provides tools and expertise for small-business owners to build, market, and manage their businesses online.

Other services delivered online include Microsoft Developer Networks subscription content and updates, periodic product updates, and online technical and practice readiness resources to support our partners in developing and selling our products and solutions.

CUSTOMERS

Our customers include individual consumers, small and medium-sized organizations, enterprises, governmental institutions, educational institutions, Internet Service Providers, application developers, and OEMs. Consumers and small- and medium-sized organizations obtain our products primarily through resellers and OEMs. No sales to an individual customer accounted for more than 10% of fiscal year 2007 revenue. Sales to Dell and its subsidiaries accounted for approximately 11% and 10% of fiscal year 2006 and 2005 revenue, respectively. These sales were made primarily through our OEM and volume licensing channels and cover a broad array of products including Windows PC operating systems, Microsoft Office, and server products. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

EMPLOYEES

As of June 30, 2007, we employed approximately 79,000 people on a full-time basis, 48,000 in the United States and 31,000 internationally. Of the total, 31,000 were in product research and development, 24,000 in sales and marketing, 13,000 in product support and consulting services, 3,000 in manufacturing and distribution, and 8,000 in general and administration. Our success is highly dependent on our ability to attract and retain qualified employees. None of our employees are subject to collective bargaining agreements.

AVAILABLE INFORMATION

Our Internet address is www.microsoft.com. There we make available, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with or furnish it to the Securities and Exchange Commission ("SEC"). Our SEC reports can be accessed through the investor relations section of our Web site. The information found on our Web site is not part of this or any other report we file with or furnish to the SEC.

RESULTS OF OPERATIONS FOR FISCAL YEARS 2007, 2006, AND 2005

OVERVIEW

The following Management's Discussion and Analysis ("MD&A") is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying notes to the financial statements ("Notes").

We develop, manufacture, license, and support a wide range of software products for many computing devices. Our software products include operating systems for servers, PCs, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solutions applications; and software development tools. We provide consulting and product support services, and we train and certify system integrators and developers. We sell the Xbox video game console and games, the Zune digital music and entertainment device, PC games, and PC peripherals. Online communication and information services are delivered through our MSN portals, channels around the world, and through our search products.

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. In fiscal year 2007, our revenue was highest in the third quarter due to the recognition of $1.67 billion of revenue previously deferred from the Express Upgrade to Windows Vista and Microsoft Office Technology Guarantee programs and pre-shipments of Windows Vista and the 2007 Microsoft Office system. The technology guarantee programs provided customers who purchased current products with free or discounted rights to Windows Vista and the 2007 Microsoft Office system when those products became available to consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated over 40% of its yearly segment revenues in our second fiscal quarter. With the exception of fiscal year 2007, we believe the seasonality of revenue is likely to continue in the future.

We intend to sustain the long-term growth of our businesses through technological innovation, engineering excellence, and a commitment to delivering high-quality products and services to customers and partners. Recognizing that one of our primary challenges is to help accelerate worldwide PC adoption and software upgrades, we continue to advance the functionality, security, and value of Windows operating systems and to develop operating system versions targeted at emerging markets. We also are increasing our focus on selling our products in emerging markets and reducing the amount of unlicensed software used in those markets. In addition, we continue to develop innovative software applications and solutions that we believe will enhance the productivity of information workers, improve communication and collaboration in work groups, aid business intelligence, and streamline processes for small and mid-sized businesses. To sustain the growth of our Server and Tools business amid competition from other vendors of both proprietary and open source software, our goal is to deliver products that provide the best platform for network computing – software that is easiest to deploy and manage, and that is most secure – with the lowest total cost of ownership.

We continue to invest in research and development in existing and new lines of business, including business solutions, mobile computing, communication, entertainment, and other areas that we believe may contribute to our long-term growth. We also invest in research and development of advanced technologies for future software products. We believe that delivering innovative and high-value solutions through our integrated platform is the key to meeting customer needs and to our future growth.

We believe that over the last few years we have laid a foundation for long-term growth by delivering innovative products, creating opportunities for partners, improving customer satisfaction with key audiences, and improving our internal business processes. Our focus in fiscal year 2008 is building on this foundation and executing well in key areas, including continuing to innovate on our integrated software platform, responding effectively to customer and partner needs, and continuing to focus internally on product excellence, business efficacy, and accountability across the company.

Key market opportunities include:

- **Consumer technology.** We are focused on delivering consumer software products that we believe are compelling in terms of design and features. We are also working to define the next era of consumer electronics through innovating software that powers today's consumer devices.

- **Software plus services.** The ability to combine the power of desktop and server software with the reach of the Internet represents an opportunity across every one of our businesses. We believe our software plus services approach will enable us to deliver new experiences to end users and new value to businesses.

- **Expanding our presence on the desktop and server.** Through our ability to deliver additional value in security, messaging, systems management, and collaboration, and new technology for high performance computing, unified communications, healthcare, and business intelligence, we believe we are well-positioned to build on our strength with businesses of all sizes. The expansion of our Unlimited Potential program provides the foundation for our efforts to reach the five billion people around the globe who do not have access to PCs and digital technology today.

Summary of Results for Fiscal Years 2007, 2006, and 2005

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Revenue	**$51,122**	$44,282	$39,788	15%	11%
Operating income	**$18,524**	$16,472	$14,561	12%	13%

Fiscal year 2007 compared to fiscal year 2006

Revenue growth was driven primarily by licensing of the 2007 Microsoft Office system and Windows Vista, increased revenue associated with SQL Server, Windows Server, and Visual Studio, and increased Xbox 360 console sales. Foreign currency exchange rates did not have a significant impact on consolidated revenue during the year.

Operating income growth was driven primarily by the increased revenue and decreased costs for legal settlements and legal contingencies, partially offset by increased cost of revenue associated with Xbox 360 and Windows Vista, increased OSB data centers costs, and increased sales and marketing expenses. In July 2007, we expanded our global Xbox 360 warranty coverage to three years from the date of purchase for a general hardware failure indicated by three flashing red lights. As a result, we recorded a $1.06 billion charge for anticipated costs under the warranty policy, inventory write-downs, and product returns. The increase in sales and marketing expenses was primarily driven by increased headcount-related costs and marketing costs related to recent product launches. Headcount-related costs increased 15%, driven by a 10% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount.

Fiscal year 2006 compared to fiscal year 2005

Revenue growth was driven primarily by growth in SQL Server following the launch of SQL Server 2005 in the second quarter of fiscal year 2006, Windows Server and other server applications, increased Xbox revenue resulting from the Xbox 360 launch in November 2005, growth in licensing of Windows PC operating systems through OEMs, and increased licensing of Office and other MBD software. Foreign currency exchange rates did not have a significant impact on consolidated or operating segment revenue during the fiscal year.

Operating income increased primarily reflecting the revenue increase and a decrease in costs for legal settlements and legal contingencies. These changes were partially offset by an increase in cost of revenue primarily related to Xbox 360 and an increase in sales and marketing expenses primarily as a result of increased investments in partner marketing and product launch-related spending. Headcount-related costs increased 7%, driven by an increase in salaries and benefits for existing headcount and a 16% growth in headcount.

Fiscal Year 2008 Outlook

Worldwide macroeconomic factors have a strong correlation to business and consumer demand for our software, services, games, and Internet service offerings. We expect a broad continuation in the economic conditions and demand in fiscal year 2008. We also expect continued double digit revenue growth. Given our product launches in the second half of fiscal year 2007, we expect revenue growth to be higher in the first half of fiscal year 2008 than in the second half. We estimate worldwide PC shipments will grow between 9% and 11%. We do not expect a significant impact from changes in year-over-year foreign currency exchange rates in fiscal year 2008. We expect our operating income growth rate to exceed our revenue growth rate.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

In July 2006, we announced a change in our operating segments reflecting previously announced reorganizations. We have five operating segments: Client, Server and Tools, the Online Services Business, the Microsoft Business Division, and the Entertainment and Devices Division. Prior fiscal year information has been recast to conform to the way we internally managed and monitored performance at the business group level in fiscal year 2007.

The revenue and operating income/(loss) amounts in this section are presented on a basis consistent with U.S. Generally Accepted Accounting Principles ("GAAP") and include certain reconciling items attributable to each of the segments. The segment information appearing in Note 18 – Segment Information of the Notes to Financial Statements is presented on a basis consistent with the Company's internal management reporting, in accordance with Statement of Financial Accounting Standards ("SFAS") No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Certain corporate-level activity has been excluded from our segment operating results and is analyzed separately.

Client

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Revenue	**$14,972**	$13,089	$12,042	14%	9%
Operating income	**$11,603**	$10,297	$ 9,442	13%	9%

Client offerings consist of premium edition and standard Windows operating systems. Premium offerings are those that include additional functionality and are sold at a price above our standard versions. Premium offerings include Windows XP Professional, XP Media Center Edition, XP Tablet PC Edition, Vista Business, Vista Home Premium, and Vista Ultimate. Standard Windows operating systems include Windows XP Home and Windows Vista Home Basic. Client revenue growth correlates with the growth of purchases of PCs from OEMs that pre-install versions of Windows operating systems because the OEM channel accounts for approximately 80% of total Client revenue. The differences between unit growth rates and revenue growth rates from year to year are affected by changes in the mix of OEM Windows operating systems licensed with premium edition operating systems as a percentage of total OEM Windows operating systems licensed ("OEM premium mix"), changes in the geographical mix, and changes in the channel mix of products sold by large, multi-national OEMs versus those sold by local and regional system builders.

Fiscal year 2007 compared to fiscal year 2006

Client revenue increased primarily reflecting licensing of Windows Vista. OEM revenue increased $1.46 billion or 13% driven by 13% growth in OEM license units while revenue from commercial and retail licensing of Windows operating systems increased $422 million or 21%. During the year, the OEM Premium Mix increased 16 percentage points to 68%. Based on our estimates, total worldwide PC shipments from all sources grew 10% to 12% driven by demand in both emerging and mature markets.

Client operating income increased reflecting the increased revenue and decreased research and development costs, partially offset by increased Windows Vista product costs and increased sales and marketing expenses for launch-related programs. The decrease in research and development costs reflects the capitalization of certain Windows Vista software development costs and completion of product development on Windows Vista. Headcount-related costs decreased 3%, driven by a 1% decrease in headcount and a decrease in stock-based compensation expense.

Fiscal year 2006 compared to fiscal year 2005

Client revenue increased reflecting $1.18 billion or 12% growth in OEM revenue driven by 17% growth in OEM license units from increased PC unit shipments, partially offset by a $118 million or 6% decrease in revenue from commercial and retail licensing of Windows operating systems. During the year, the OEM premium mix increased two percentage points to 52%. OEM revenue growth included an increase to revenue of $89 million resulting from the alignment of our billings associated with OEM distributors in our system builder channel with both industry standards and other Microsoft channels.

Client operating income increased reflecting the increase in OEM revenue partially offset by a $224 million increase in sales and marketing expenses, excluding headcount-related costs, mainly driven by increased investments in partner marketing and Windows Vista pre-launch programs. Headcount-related costs increased 6%, driven by a 13% increase in headcount primarily associated with Windows Vista and further investments in our sales and marketing organization, and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

Server and Tools

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Revenue	**$11,175**	$9,652	$8,367	16%	15%
Operating income	**$ 3,900**	$3,035	$2,072	29%	46%

Server and Tools offerings consist of server software licenses and client access licenses ("CAL") for Windows Server, Microsoft SQL Server, and other server products. It also includes developer tools, training, certification, Microsoft Press, Premier and Professional product support services, and Microsoft Consulting Services. Server and Tools concentrates on licensing products, applications, tools, content, and services that make information technology professionals and developers more productive and efficient. The segment uses multiple channels for licensing including pre-installed OEM versions, licenses through partners, and licenses directly to end customers. We sell licenses both as one-time licenses and as multi-year volume licenses.

Fiscal year 2007 compared to fiscal year 2006

Server and server application revenue (including CAL revenue) and developer tools, training, and certification revenue increased $1.12 billion or 14%. This increase was primarily driven by increased revenue associated with SQL Server, Windows Server, and Visual Studio. The results reflect broad adoption of Windows Server products, especially SQL Server which grew over 20%. Consulting, Premier, and Professional product support services revenue increased $404 million or 24% primarily due to higher demand for Premier services in corporate enterprises. Foreign currency exchange rates accounted for a $165 million or a two percentage point increase in revenue.

Server and Tools operating income increased reflecting the increased revenue, partially offset by growth in headcount-related costs and cost of revenue for services. Headcount-related costs increased 12%, driven by an 11% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense. Cost of revenue increased $243 million or 13% reflecting growth in services provided.

Fiscal year 2006 compared to fiscal year 2005

Server and Tools revenue increased mainly driven by growth in SQL Server, Windows Server, and Visual Studio. SQL Server 2005 and Visual Studio 2005 were launched in the second quarter of fiscal year 2006 and produced revenue growth in these product lines. Server and Server applications revenue (including CAL revenue) and developer tools, training and certification revenue increased $1.07 billion or 16% during fiscal year 2006. The results reflect broad adoption of Windows Server products, especially SQL Server, which grew over 30% for the year. Consulting, Premier and Professional product support services revenue increased $217 million or 15% primarily due to higher demand for services.

Server and Tools operating income increased primarily reflecting the increased revenue, partially offset by increased sales and marketing expenses related to supporting long-term strategies and the launches of SQL Server 2005 and Visual Studio 2005. Headcount-related costs increased 5%, driven by an 11% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

Online Services Business

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Revenue	**$2,474**	$2,299	$2,344	8%	(2)%
Operating income (loss)	**$ (732)**	$ (74)	$ 402	*	*

* *Not meaningful*

The Online Services Business ("OSB") provides personal communications services, such as e-mail and instant messaging, online information offerings, such as Live Search, and the MSN portals and channels around the world. OSB also provides a variety of online services such as MSN Internet Access, MSN Premium Web Services and OneCare. We earn revenue primarily from online advertising, from consumers and partners through subscriptions and transactions generated from online paid services, and from MSN narrowband Internet access subscribers. We have transitioned to adCenter, our own platform, for online delivery of advertising in the U.S. and certain international markets. We continue to launch new online initiatives and expect to do so in the future. In fiscal year 2007, we launched Windows Live Search and Live.com in 54 international markets, Live Local Search in the U.S. and U.K., beta versions of MSN Soapbox (our expansion of the MSN Video experience), Virtual Earth™ 3D, Windows Live Hotmail, and other offerings.

Fiscal year 2007 compared to fiscal year 2006

OSB revenue increased driven primarily by advertising revenue which grew $314 million or 21% to $1.84 billion. This increase was primarily due to growth in advertising for search, home page, email, and messaging services. The increase in advertising revenue was partially offset by a $156 million or 31% decrease in access revenue. At June 30, 2007, we estimate that OSB had over 310 million active Hotmail accounts and over 280 million Messenger accounts.

OSB operating loss increased driven primarily by increased cost of revenue which grew $352 million or 45% and increased headcount-related costs as a result of continued search and advertising platform investments. The increase in cost of revenue was primarily driven by increased data center costs, online content expenses, and royalties. Headcount-related costs increased 30%, driven by a 12% increase in headcount and an increase in salaries and benefits for existing headcount.

Fiscal year 2006 compared to fiscal year 2005

OSB revenue decreased primarily reflecting a $195 million or 28% decline in access revenue, partially offset by a $126 million or 9% increase in advertising revenue and a $23 million or 9% increase in revenue from subscription and transaction services other than access. Advertising revenue for fiscal year 2006 was $1.52 billion. The increase in advertising revenue reflects growth in display advertising for portals, channels, email, and messaging services, which was partially offset by a decline in search revenue due to the transition to adCenter. As of June 30, 2006, OSB had 2.1 million access subscribers compared with 2.7 million at June 30, 2005. In addition, OSB had over 261 million active Hotmail accounts and over 243 million active Messenger accounts as of June 30, 2006.

OSB operating income decreased due to a $230 million or 39% increase in research and development costs, a $126 million or 22% increase in sales and marketing expenses, and a $67 million or 9% increase in cost of revenue as we continued to invest in adCenter, Windows Live, and other new platforms. Headcount-related costs increased 25%, reflecting a 44% increase in headcount and increased salaries and benefits for existing employees, partially offset by a decrease in stock-based compensation.

Microsoft Business Division

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Revenue	**$16,396**	$14,486	$13,520	13%	7%
Operating income	**$10,838**	$ 9,620	$ 9,116	13%	6%

MBD offerings consist of the Microsoft Office system and Microsoft Dynamics business solutions. Microsoft Office system products are designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions. Growth of revenue from the Microsoft Office system offerings, which generate over 90% of MBD revenue, depends on our ability to add value to the core Office product set and to continue to expand our product offerings in other information worker areas such as enterprise content management, collaboration, unified communications, and business intelligence. Microsoft Dynamics products provide business solutions for financial management, customer relationship management, supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises. We evaluate our results based upon the nature of the end user in two primary parts – business revenue which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue, and consumer revenue which includes revenue from retail packaged product sales, OEM revenue, and sales of pre-installed versions of Office in Japan.

Fiscal year 2007 compared to fiscal year 2006

MBD revenue increased primarily reflecting licensing of the 2007 Microsoft Office system. Revenue from consumer sales increased $371 million or 11% while revenue from business sales increased $1.54 billion or 14%. The increase in business revenue includes a 21% increase in Microsoft Dynamics customer billings. Foreign currency exchange rates accounted for a $248 million or a two percentage point increase in revenue.

MBD operating income increased reflecting the increased revenue, partially offset by increased sales and marketing expenses and cost of revenue primarily associated with the 2007 Microsoft Office system. The increase in sales and marketing expenses reflects increased headcount-related expenses, increased sales support costs from our Enterprise Software Advisor channel partners, and increased launch-related marketing expenses. Headcount-related costs increased 10%, driven by a 6% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

Fiscal year 2006 compared to fiscal year 2005

MBD revenue increased reflecting an increase in business sales of $1.01 billion or 10%, partially offset by a decrease in consumer sales of $44 million or 1%. The increase in business sales reflects a 16% increase in Microsoft Dynamics customer billings.

MBD operating income increased reflecting the increased revenue partially offset by increased sales and marketing expenses related to supporting field sales efforts and increased research and development expenses. Headcount-related costs increased 8%, driven by a 14% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

Entertainment and Devices Division

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Revenue	**$ 6,083**	$ 4,756	$3,515	28%	35%
Operating loss	**$(1,892)**	$(1,284)	$ (539)	(47)%	(138)%

The Entertainment and Devices Division ("EDD") products include the Xbox video game system; PC games; consumer software and hardware products; the Zune digital music and entertainment device; Mediaroom, our Internet protocol television software; and Mobile and Embedded devices (Windows Mobile software platform, Windows Embedded device operating system and Windows Automotive). The success of video game consoles is determined by console innovation and quality, the portfolio of video game content for the console, online offerings, and the market share of the console. We believe that the functionality of the Xbox 360 console, games portfolio, and online offerings are well-positioned relative to recently launched competitive consoles.

Fiscal year 2007 compared to fiscal year 2006

EDD revenue increased primarily due to increased Xbox 360 console sales, Zune sales, and increased Xbox accessories and video game sales. We shipped 6.6 million Xbox 360 consoles during fiscal year 2007 as compared to 5.0 million consoles during fiscal year 2006. Xbox and PC game revenue increased $650 million or 19% as a result of increased Xbox 360 platform sales, partially offset by decreased sales of the first generation Xbox console and related accessories and video games. Zune, which was launched in November 2006, consumer hardware and software, and TV platforms revenue increased $539 million or 65%. Mobile and Embedded Devices revenue increased $138 million or 28% driven by sales growth in Windows Mobile software and Windows Embedded operating systems.

EDD operating loss increased primarily due to the $1.06 billion Xbox 360 charge recognized in the fourth quarter of fiscal year 2007 and Zune launch-related expenses. The increase in operating loss was partially offset by increased Xbox 360 platform sales and decreased Xbox 360 console manufacturing costs. Headcount-related costs increased 15%, driven by a 9% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

Fiscal year 2006 compared to fiscal year 2005

EDD revenue increased primarily due to the launch of the Xbox 360 console in November 2005, partially offset by a decline in first party Xbox game sales primarily resulting from the significant impact of Halo 2 in fiscal year 2005. The revenue growth was also attributable to $140 million or 15% growth from our other product lines, primarily as a result of an increase in PC games sales due to significant new game releases, especially “Age of Empires III”, and an increase in TV platform revenue due to deployments in fiscal year 2006. Mobile and Embedded Devices revenue increased $115 million or 44% driven by unit volume increases in major product lines, especially Windows Mobile software sales and Windows Embedded operating systems.

EDD operating loss increased primarily as a result of a $1.64 billion increase in cost of revenue resulting from the number of Xbox 360 consoles sold and higher Xbox 360 unit costs, partially offset by the revenue growth. The significant impact of Halo 2 in fiscal year 2005 also contributed to the increase in fiscal year 2006 operating loss. Headcount-related costs increased 8%, driven by a 21% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

Corporate-Level Activity

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Corporate-level activity	**$(5,193)**	$(5,122)	$(5,932)	(1)%	14%

Certain corporate-level results are not allocated to our segments. Those results include expenses related to corporate operations associated with broad-based sales and marketing, product support services, human resources, legal, finance, information technology, corporate development and procurement activities, research and development and other costs, and legal settlements and contingencies.

Fiscal year 2007 compared to fiscal year 2006

Corporate-level expenses increased primarily driven by increased headcount-related costs offset by decreased costs for legal settlements and legal contingencies. Headcount-related costs increased 25%, driven by a 19% increase in headcount and an increase in salaries and benefits for existing headcount. We incurred $511 million in legal charges during the twelve months ended June 30, 2007, primarily related to antitrust and unfair competition consumer class actions, intellectual property claims, and an extension payment to Sun Microsystems, Inc. under our Limited Patent Covenant and Standstill Agreement. We incurred $1.32 billion in legal charges during fiscal year 2006 which included settlement expense of $361 million related to our settlement with RealNetworks, Inc. as well as other intellectual property and antitrust matters, a € 281 million ($351 million) fine imposed by the European Commission in July 2006 related to its 2004 decision in its competition law investigation of Microsoft, and an extension payment to Sun Microsystems, Inc.

Fiscal year 2006 compared to fiscal year 2005

Corporate-level expenses decreased primarily reflecting decreased costs for legal settlements and legal contingencies partially offset by increased headcount-related costs. We incurred $1.32 billion in legal charges during fiscal year 2006 as compared to $2.31 billion in legal charges incurred during fiscal year 2005 primarily related to settlements with Novell, Inc., Gateway, IBM, and other antitrust and competition law matters. Headcount-related costs increased 5%, driven by a 23% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation.

Outlook

Our outlook for fiscal year 2008 is as follows:

Client We expect revenue to grow reflecting improvement in the commercial and retail portion of the business due to increased acceptance of Windows Vista. We expect PC shipments to grow 9% to 11% for fiscal year 2008. We believe that PC unit growth rates will be higher in the consumer segment than in the business segment and higher in emerging markets than in mature markets.

Server and Tools We expect continued momentum from recent product launches and to benefit from the upcoming launches of the new versions of SQL Server, Windows Server, and Visual Studio in the second half of fiscal year 2008.

Online Services Business We expect increased growth in online advertising revenue as the portals, channels, and communications services continue to expand globally and the overall Internet advertising industry continues to expand. In May 2007, we agreed to acquire aQuantive, Inc., a digital marketing company, for approximately $6 billion in cash. We expect to complete this transaction in August 2007. This acquisition will enable us to strengthen relationships with advertisers, agencies and publishers by enhancing our advertising platforms and services. The acquisition also provides us with increased depth in building and supporting next generation advertising solutions and environments such as cross media planning and video-on-demand.

Microsoft Business Division We expect revenue to continue to increase in fiscal year 2008 due to increased customer acceptance of the 2007 Microsoft Office system. We continue to develop plans to grow revenue in new areas such as unified communications, enterprise content management, collaboration tools, business intelligence, and through our existing portfolio of Microsoft Dynamics products.

Entertainment and Devices Division We expect revenue to increase due to the increased installed base of the Xbox 360 console and from the release of Halo 3, a new Xbox 360 game. Revenue from existing mobility and embedded devices is expected to increase due to unit volume increases of Windows Mobile software driven by increased market demand for phone-enabled devices and Windows Embedded operating systems.

Operating Expenses

Cost of Revenue

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Cost of revenue	**$10,693**	$7,650	$6,031	40%	27%
As a percent of revenue	**21%**	17%	15%	4ppt	2ppt

Cost of revenue includes manufacturing and distribution costs for products sold and programs licensed, operating costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, warranty costs, inventory write-downs, and costs associated with the delivery of consulting services. Cost of revenue increased in fiscal year 2007 primarily driven by the Xbox 360 charge, increased Windows Vista product costs, increased OSB data center costs, and costs associated with the growth in consulting services. Cost of revenue increased in fiscal year 2006 mainly due to a $1.64 billion increase in EDD as a result of an increase in the number of total Xbox consoles sold and higher Xbox 360 unit costs.

Research and Development

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Research and development	**$7,121**	$6,584	$6,097	8%	8%
As a percent of revenue	**14%**	15%	15%	(1)ppt	–

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related costs associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Research and development costs increased during fiscal year 2007 primarily due to increased headcount-related costs which grew 8%, reflecting a 9% growth in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense. Research and development costs increased during fiscal year 2006 primarily due to increased development costs associated with upcoming offerings and corporate research activities. Headcount-related costs increased 3% during fiscal year 2006, driven by a 17% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

Sales and Marketing

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
Sales and marketing	**$11,455**	$9,818	$8,563	17%	15%
As a percent of revenue	**22%**	22%	22%	–	–

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related costs associated with sales and marketing personnel and advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses increased during fiscal year 2007 primarily because of increased headcount-related costs and increased marketing costs related to recent product launches. Headcount-related costs increased 22% during fiscal year 2007, driven by an 11% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense. Sales and marketing expenses increased during fiscal year 2006 primarily because of increased headcount-related costs, investments in partner marketing and product launch-related spending. Headcount-related costs increased 13% during fiscal year 2006, driven by a 20% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

General and Administrative

(In millions, except percentages)	2007	2006	2005	Percent Change 2007 versus 2006	Percent Change 2006 versus 2005
General and administrative	**$3,329**	$3,758	$4,536	(11)%	(17)%
As a percent of revenue	**7%**	8%	11%	(1)ppt	(3)ppt

General and administrative costs include payroll, employee benefits, stock-based compensation expense and other headcount-related costs associated with finance, legal, facilities, certain human resources, other administrative headcount, and legal and other administrative fees. General and administrative costs decreased during fiscal year 2007 primarily reflecting decreased costs for legal settlements and legal contingencies, partially offset by increased headcount-related costs. During fiscal year 2007, we incurred $511 million of legal charges primarily related to antitrust and unfair competition consumer class actions, intellectual property claims, and extension payment to Sun Microsystems, Inc. as compared to $1.32 billion of legal charges in fiscal year 2006. Headcount-related costs increased 15% during fiscal year 2007, driven by a 12% increase in headcount and an increase in salaries and benefits for existing headcount. General and administrative costs decreased in fiscal year 2006 primarily reflecting decreased costs for legal settlements and legal contingencies. During fiscal year 2006, we incurred $1.32 billion of legal charges primarily related to antitrust and unfair competition consumer class actions, intellectual property claims, and an extension payment to Sun Microsystems, Inc. Legal charges in fiscal year 2006 also included settlement expense of $361 million related to our settlement with RealNetworks, Inc. and the €281 million ($351 million) European Commission fine. Headcount-related costs increased 7% during fiscal year 2006, driven by an 18% increase in headcount and an increase in salaries for existing headcount. We incurred $2.31 billion in legal charges during fiscal year 2005.

Investment Income and Other

The components of investment income and other were as follows:

(In millions)	2007	2006	2005
Dividends and interest	**$1,319**	$1,510	$1,460
Net gains on investments	**650**	161	856
Net losses on derivatives	**(358)**	(99)	(262)
Other, net	**(34)**	218	13
Investment income and other	**$1,577**	$1,790	$2,067

For fiscal year 2007, dividends and interest income declined, reflecting a decline in the average balance of dividend and interest-bearing investments, partly offset by higher interest rates received on our fixed-income investments. For fiscal year 2006, dividends and interest income increased due to higher interest rates received on our fixed-income investments, partially offset by a decline in the average balance of dividend and interest-bearing investments as a result of the $32.64 billion special dividend paid on December 2, 2004, and stock repurchases made throughout fiscal year 2006.

For fiscal year 2007, net gains on investments increased primarily due to lower other-than-temporary impairments and gains on sales of fixed-income investments in the current period as compared to losses in fiscal year 2006, partly offset by fewer gains on the sale of equity investments. Other-than-temporary impairments in fiscal year 2007 were not material and were $408 million in fiscal year 2006. Net gains on investments decreased in fiscal year 2006 primarily due to increased net losses on sales of fixed-income investments, higher other-than-temporary impairments, and fewer net gains on equity investments in fiscal year 2006 as compared to fiscal year 2005. For fiscal year 2006, other-than-temporary impairments were $408 million, as compared to $152 million in fiscal year 2005. The increase in other-than-temporary impairments in fiscal year 2006 was driven by planned sales of certain investments in an unrealized loss position in order to raise funds for the $20 billion tender offer announced on July 20, 2006.

Investments are considered to be impaired when a decline in fair value is judged to be other than temporary. We employ a systematic methodology that considers available evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, among other factors, we evaluate general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, operational and financing cash flow factors, and rating agency actions. Once a decline in fair value is determined to be other than temporary, an impairment charge is recorded and a new cost basis in the investment is established.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Collateral and/or security interest is determined based upon the underlying security and the creditworthiness of the borrower. Cash collateral is recorded as an asset with a corresponding liability. We anticipate that the magnitude of securities lent under this program will remain relatively consistent during the fiscal year.

We use derivative instruments to manage exposures to interest rates, equity prices, and foreign currency markets and to facilitate portfolio diversification. Derivative losses during fiscal 2007 were primarily driven by net losses in time value on foreign currency contracts used to hedge anticipated foreign currency revenues. During fiscal year 2006, we experienced lower net losses on derivatives as compared to fiscal year 2005 primarily due to net gains on non-designated equity derivatives in fiscal 2006 as compared to net losses in fiscal 2005 and higher net gains on commodity positions in fiscal 2006 driven by increases in the related commodity indices. These gains were partially offset by higher net losses in time value on foreign exchange contracts used to hedge anticipated foreign currency revenues and higher net losses on interest rate derivative contracts in fiscal 2006. Net derivative losses in fiscal year 2005 were primarily related to losses on equity derivatives, interest rate derivatives, and foreign currency contracts, partly offset by gains related to commodity positions used to provide portfolio diversification. Gains and losses arising from derivatives not designated as accounting hedges are in large part economically offset by unrealized losses and gains, respectively, in the underlying securities which are recorded as a component of other comprehensive income. Commodity derivatives are held for the purpose of portfolio diversification.

Other, net in fiscal year 2006 includes $195 million of gains that resulted from the restructuring of joint venture relationships between Microsoft and NBC related to MSNBC Cable L.L.C. and MSNBC Interactive News, L.L.C.

Income Taxes

Our effective tax rate for fiscal years 2007, 2006, and 2005 was 30%, 31%, and 26%, respectively. The fiscal year 2007 rate reflects a recurring effective tax rate of 31% offset by a $195 million reduction resulting from various changes in tax positions taken in prior periods, related primarily to favorable developments in an IRS position and multiple foreign audit assessments. During fiscal year 2006, we recorded a tax benefit of $108 million from the resolution of state audits and recorded a charge of €281 million ($351 million) from the European Commission fine which was not tax deductible. The 2005 tax rate was lower from the reversal of previously accrued taxes and from an IRS settlement.

Financial Condition

Cash and equivalents and short-term investments totaled $23.41 billion and $34.16 billion as of June 30, 2007 and 2006, respectively. Equity and other investments were $10.12 billion and $9.23 billion as of June 30, 2007 and 2006, respectively. Our investments consist primarily of fixed-income securities, diversified among industries and individual issuers. Our investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S.-dollar-denominated securities, but also includes foreign-denominated securities in order to diversify financial risk. As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was $29.46 billion at June 30, 2007. Our retained deficit is not expected to impact our future ability to operate or pay dividends given our continuing profitability and strong cash and financial position.

Unearned Revenue

Unearned revenue from volume licensing programs represents customer billings, paid either upfront or annually at the beginning of each billing coverage period, that are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. For certain other licensing arrangements, revenue attributable to undelivered elements, including free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis for Windows XP and previous PC operating systems, is based on the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the life cycle of the related product. Other unearned revenue includes services, Microsoft Dynamics business solution products, Xbox Live subscriptions, advertising, and TV platform for which we have been paid upfront and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected recognition of unearned revenue as of June 30, 2007:

(In millions)	Recognition of Unearned Revenue
Three months ended:	
September 30, 2007	$4,021
December 31, 2007	3,245
March 31, 2008	2,264
June 30, 2008	1,249
Thereafter	1,867
Unearned revenue	$12,646

Cash Flows

Fiscal year 2007 compared to fiscal year 2006

Cash flow from operations increased $3.39 billion due to an increase in cash received from customers driven by 15% revenue growth, along with a $1.64 billion decrease in cash outflow for other current assets primarily reflecting changes in inventory. Cash used for financing increased $3.98 billion. Several events occurred during fiscal year 2007 that affected cash used for financing. We issued $6.78 billion of common stock, including $3.25 billion related to 113 million call options exercised by JPMorgan in December 2006. We also completed our tender offer on August 17, 2006, which was included in the $27.58 billion of common stock repurchases. Cash from investing decreased $1.91 billion due to a $3.49 billion decline in securities lending activity where cash collateral is received from the counterparty along with $1.19 billion spent on acquisitions of companies and additions to property and equipment. These impacts were partially offset by a $2.77 billion increase in net cash from combined investment purchases, sales, and maturities.

Fiscal year 2006 compared to fiscal year 2005

Cash flow from operations decreased $2.20 billion primarily due to increased payments to fund a $987 million increase in Xbox 360 inventory and product costs and increased payments to employees resulting from a 16% growth in headcount. These factors were partially offset by increased cash receipts from customers driven by our 11% revenue growth and a $1.74 billion increase in unearned revenue. Cash used in financing decreased $20.52 billion driven by a $32.57 billion reduction in cash dividend payments. This impact was partially offset by an $11.15 billion increase in common stock repurchases. Net cash from investing decreased $7.02 billion driven primarily by an $8.93 billion decrease in cash from combined purchase, sales, and maturities of investments and a $766 million increase in additions to property and equipment. These factors were partially offset by $3.12 billion of net cash proceeds from our securities lending program.

We have no material long-term debt. Stockholders' equity at June 30, 2007, was $31.10 billion. We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $821 million on June 30, 2007. We have operating leases for most U.S. and international sales and support offices and certain equipment under which we incurred rental expense totaling $326 million, $276 million, and $299 million in fiscal year 2007, 2006, and 2005, respectively. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of requirements for capital resources. In May 2007, we announced that we had entered into an agreement to purchase aQuantive, Inc. for approximately $6 billion in cash. We expect to complete this transaction in August 2007.

During fiscal years 2007 and 2006, our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
(Fiscal year 2007)				
September 13, 2006	$0.10	November 16, 2006	$980	December 14, 2006
December 20, 2006	$0.10	February 15, 2007	$978	March 8, 2007
March 26, 2007	$0.10	May 17, 2007	$952	June 14, 2007
June 27, 2007	$0.10	August 16, 2007	$938	September 13, 2007
(Fiscal year 2006)				
September 23, 2005	$0.08	November 17, 2005	$846	December 8, 2005
December 14, 2005	$0.09	February 17, 2006	$926	March 9, 2006
March 27, 2006	$0.09	May 17, 2006	$916	June 8, 2006
June 21, 2006	$0.09	August 17,2006	$897	September 14, 2006

On July 20, 2006, we announced the completion of the repurchase program initially approved by our Board of Directors on July 20, 2004 to buy back up to $30.00 billion in Microsoft common stock. During fiscal year 2006, we repurchased 754 million shares, or $19.75 billion, of our common stock under this plan. On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.00 billion tender offer, which was completed on August 17, 2006; and authorization for up to an additional $20.00 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.84 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.00 billion ongoing share repurchase program had been increased by approximately $16.16 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.16 billion through June 30, 2011. As of June 30, 2007, approximately $15.14 billion remained of the $36.16 billion approved repurchase amount.

We believe existing cash and equivalents and short-term investments, together with funds generated from operations, should be sufficient to meet operating requirements, regular quarterly dividends, and planned share repurchases. Our philosophy regarding the maintenance of a balance sheet with a large component of cash and short-term investments, as well as equity and other investments, reflects our views on potential future capital requirements relating to research and development, creation and expansion of sales distribution channels, investments and acquisitions, share dilution management, legal risks, and challenges to our business model. We regularly assess our investment management approach in view of our current and potential future needs.

Off-Balance Sheet Arrangements and Contractual Obligations

We provide indemnifications of varying scope and amount to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. We evaluate estimated losses for such indemnifications under SFAS No. 5, *Accounting for Contingencies*, as interpreted by Financial Accounting Standards Board (“FASB”) Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. We consider factors such as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any material liabilities related to such indemnifications in our financial statements.

Contractual Obligations

The following table summarizes our outstanding contractual obligations as of June 30, 2007:

(In millions)[(1)]

Fiscal Years	Payments due by period				
	2008	2009-2011	2012-2014	2015 and thereafter	Total
Long-term debt	$ –	$ –	$ –	$ –	$ –
Construction commitments[(2)(4)]	821	–	–	–	821
Lease obligations:					
Capital leases	–	–	–	–	–
Operating leases[(3)]	349	618	258	116	1,341
Purchase commitments[(4)]	1,824	19	–	–	1,843
Other long-term liabilities[(5)]	1	519	–	–	520
Total contractual obligations	$2,995	$1,156	$258	$116	$4,525

(1) We have excluded the $768 million long-term contingent liability related to the antitrust and unfair competition class action lawsuits referred to in Note 17 – Contingencies of the Notes to Financial Statements as the timing and amount to be resolved in cash versus vouchers is subject to uncertainty.

(2) We have certain commitments for the construction of buildings. We expect to fund these commitments with existing cash and cash flows from operations.

(3) Our future minimum rental commitments under noncancellable leases comprise the majority of the operating lease obligations presented above. We expect to fund these commitments with existing cash and cash flows from operations.

(4) The amount presented above as purchase and construction commitments includes all known open purchase orders and all known contracts that are take-or-pay contracts. We expect to fund these commitments with existing cash and our cash flows from operations.

(5) We have excluded other obligations of $5.86 billion from other long-term liabilities presented above as the amount that will be settled in cash is not known. We have also excluded non-cash items of $71 million and unearned revenue of $1.87 billion.

In May 2007, we entered into an Agreement and Plan of Merger with aQuantive, Inc. to acquire the company for approximately $6 billion in cash. As part of the Agreement and Plan of Merger, we are required to pay $500 million if certain events occur that result in the merger not being completed. Due to the nature of this obligation, this amount has not been accrued for or included in the above schedule. The acquisition is expected to be completed in August 2007.

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2006, the FASB issued Interpretation No. 48 ("FIN No. 48"), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. The Interpretation provides a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Under FIN No. 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for us beginning July 1, 2007. Based on our current assessment, the adoption of FIN No. 48 is expected to decrease beginning retained earnings by $200 million to $400 million upon adoption.

In June 2006, the FASB ratified the Emerging Issues Task Force ("EITF") consensus on EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43." EITF Issue

No. 06-2 requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. EITF Issue No. 06-2 is effective for us beginning July 1, 2007. The cumulative effect of the application of this consensus on prior period results should be recognized through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. Elective retrospective application is also permitted. We do not expect the application of this consensus to have a material impact on our financial statements.

In fiscal year 2007, we adopted Staff Accounting Bulletin ("SAB") No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements*. SAB No. 108 requires companies to quantify misstatements using both a balance sheet (iron curtain) and an income statement (rollover) approach to evaluate whether either approach results in an error that is material in light of relevant quantitative and qualitative factors, and provides for a one-time cumulative effect transition adjustment. The adoption of SAB No. 108 did not have an impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for us beginning July 1, 2008. We currently are assessing the potential impact that adoption of SFAS No. 157 would have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings. SFAS No. 159 is effective for us beginning July 1, 2008, although early adoption is permitted. We are currently assessing the potential impact that adoption of SFAS No. 159 will have on our financial statements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us include revenue recognition, impairment of investment securities, impairment of goodwill, accounting for research and development costs, accounting for legal contingencies, accounting for income taxes, and accounting for stock-based compensation.

We account for the licensing of software in accordance with American Institute of Certified Public Accountants Statement of Position ("SOP") 97-2, *Software Revenue Recognition*. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence ("VSOE") of fair value exists for those elements. For some of our products, customers receive certain elements of our products over a period of time. These elements include free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. The fair value of these elements is recognized over the estimated life cycle for the Windows XP and previous PC operating systems. For Windows Vista, there are no significant undelivered elements and accordingly, no license revenue is deferred for Windows Vista sales. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and SAB Topic 5M, *Accounting for Noncurrent Marketable Equity Securities*, provide guidance on determining when an investment is other-than-temporarily impaired. Investments are reviewed quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, operational and financing cash flow factors, and rating agency actions. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (July 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition or sale or disposition of a significant portion of a reporting unit. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This requires significant judgments including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit. We allocate goodwill to reporting units based on the reporting unit expected to benefit from the combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach.

We account for research and development costs in accordance with applicable accounting pronouncements, including SFAS No. 2, *Accounting for Research and Development Costs*, and SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. SFAS No. 86 specifies that costs incurred internally in researching and developing a computer software product should be charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all software costs should be capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through coding and testing. This is generally shortly before the products are released to manufacturing. We determined that technological feasibility was reached with Windows Vista and the 2007 Microsoft Office system during the second quarter of fiscal year 2007 and accordingly, we capitalized approximately $120 million of software development costs. The amortization of these costs will be included in cost of revenue over the estimated life of the products. Previously, costs incurred prior to technological feasibility were not material and were expensed as incurred.

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. SFAS No. 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency such as a legal proceeding or claim should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our results of operations, financial position, or our cash flows.

SFAS No. 109, *Accounting for Income Taxes*, establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, or cash flows. Accruals for tax contingencies are provided for in accordance with the requirements of SFAS No. 5.

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

We account for product warranties in accordance with SFAS No. 5, *Accounting for Contingencies*. We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include technical support, parts, and labor over a period generally ranging from 90 days to three years. For software, we estimate the costs to provide bug fixes, such as security patches, over the life of the software. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Statement of Management's Responsibility for Financial Statements

Management is responsible for the preparation of the consolidated financial statements and related information that are presented in this report. The consolidated financial statements, which include amounts based on management's estimates and judgments, have been prepared in conformity with accounting principles generally accepted in the United States of America.

The Company maintains accounting and internal control systems to provide reasonable assurance at reasonable cost that assets are safeguarded against loss from unauthorized use or disposition, and that the financial records are reliable for preparing financial statements and maintaining accountability for assets. These systems are augmented by written policies, an organizational structure providing division of responsibilities, careful selection and training of qualified personnel, and a program of internal audits.

The Company engaged Deloitte & Touche LLP, independent auditors, to audit and render an opinion on the consolidated financial statements and management's report on its assessment and the effectiveness of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States).

The Board of Directors, through its Audit Committee, consisting solely of independent directors of the Company, meets periodically with management, internal auditors and our independent auditors to ensure that each is meeting its responsibilities and to discuss matters concerning internal controls and financial reporting. Deloitte & Touche LLP and the internal auditors each have full and free access to the Audit Committee.

Steven A. Ballmer
Chief Executive Officer

Christopher P. Liddell
Senior Vice President, Finance and
Administration; Chief Financial Officer

Frank H. Brod
Corporate Vice President, Finance and
Administration; Chief Accounting Officer

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to foreign currency, interest rate, fixed-income, equity, and commodity price risks. A portion of these risks is hedged, but fluctuations could impact our results of operations, financial position, and cash flows. We hedge a portion of anticipated revenue and accounts receivable exposure to foreign currency fluctuations, primarily with option contracts. We monitor our foreign currency exposures daily to maximize the overall effectiveness of our foreign currency hedge positions. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. Fixed-income securities and interest rate derivatives are subject primarily to interest rate risk. The portfolio is diversified and structured to minimize credit risk. Securities held in our equity and other investments portfolio and equity derivatives are subject to price risk, and are generally not hedged. However, we use put-call collars to hedge our price risk on certain equity securities that are held primarily for strategic purposes. Commodity derivatives held for the purpose of portfolio diversification are subject to commodity price risk.

We use a value-at-risk ("VaR") model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. The model used for currencies, equities, and commodities is geometric Brownian motion, which allows incorporation of optionality with regard to these risk exposures. For interest rate risk, exposures such as key rate durations and spread durations are used in calculations that reflect the principle that fixed-income security prices revert to maturity value over time.

VaR is calculated by computing the exposures of each holding's market value to a range of over 1,000 equity, fixed-income, foreign exchange, and commodity risk factors. The exposures are then used to compute the parameters of a distribution of potential changes in the total market value of all holdings, taking into account the weighted historical volatilities of the different rates and prices and the weighted historical correlations among the different rates and prices. The VaR is then calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, credit risk, and legal risk.

Certain securities in our equity portfolio are held for strategic purposes. We hedge the value of a portion of these securities through the use of derivative contracts such as put-call collars. In these arrangements, we hedge a security's equity price risk below the purchased put strike and forgo most or all of the benefits of the security's appreciation above the sold call strike. We also hold equity securities for general investment return purposes. We have incurred material impairment charges related to these securities in previous periods.

The VaR amounts disclosed below are used as a risk management tool and reflect an estimate of potential reductions in fair value of our portfolio. Losses in fair value over the specified holding period can exceed the reported VaR by significant amounts and can also accumulate over a longer time horizon than the specified holding period used in the VaR analysis. VaR amounts are not necessarily reflective of potential accounting losses, including determinations of other-than-temporary losses in fair value in accordance with U.S. GAAP.

VaR numbers are shown separately for interest rate, currency rate, equity price, and commodity price risks. These VaR numbers include the underlying portfolio positions and related hedges. We use historical data to estimate VaR. Given the reliance on historical data, VaR is most effective in estimating risk exposures in markets in which there are no fundamental changes or shifts in market conditions. An inherent limitation in VaR is that the distribution of past changes in market risk factors may not produce accurate predictions of future market risk.

The following table sets forth the one-day VaR for substantially all of our positions as of and for the years ended June 30, 2007 and 2006:

(In millions)

			Year ended June 30, 2007		
Risk Categories	**June 30, 2007**	**June 30, 2006**	**Average**	**High**	**Low**
Interest rates	**$34**	$66	**$43**	**$ 67**	**$32**
Currency rates	**55**	91	**52**	**101**	**15**
Equity prices	**60**	88	**59**	**89**	**49**
Commodity prices	**7**	12	**7**	**12**	**4**

Total one-day VaR for the combined risk categories was $95 million at June 30, 2007 and $158 million at June 30, 2006. The total VaR is 39% less at June 30, 2007, and 38% less at June 30, 2006, than the sum of the separate risk categories in the above table due to the diversification benefit of the overall portfolio.

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30	2007	2006	2005
Revenue	**$51,122**	$44,282	$39,788
Operating expenses:			
Cost of revenue	**10,693**	7,650	6,031
Research and development	**7,121**	6,584	6,097
Sales and marketing	**11,455**	9,818	8,563
General and administrative	**3,329**	3,758	4,536
Total operating expenses	**32,598**	27,810	25,227
Operating income	**18,524**	16,472	14,561
Investment income and other	**1,577**	1,790	2,067
Income before income taxes	**20,101**	18,262	16,628
Provision for income taxes	**6,036**	5,663	4,374
Net income	**$14,065**	$12,599	$12,254
Earnings per share:			
Basic	**$ 1.44**	$ 1.21	$ 1.13
Diluted	**$ 1.42**	$ 1.20	$ 1.12
Weighted average shares outstanding:			
Basic	**9,742**	10,438	10,839
Diluted	**9,886**	10,531	10,906
Cash dividends declared per common share	**$ 0.40**	$ 0.35	$ 3.40

See accompanying notes.

BALANCE SHEETS

(In millions)

June 30	**2007**	**2006**
Assets		
Current assets:		
Cash and equivalents	**$ 6,111**	$ 6,714
Short-term investments (including securities pledged as collateral of $2,356 and $3,065)	**17,300**	27,447
Total cash and short-term investments	**23,411**	34,161
Accounts receivable, net of allowance for doubtful accounts of $117 and $142	**11,338**	9,316
Inventories	**1,127**	1,478
Deferred income taxes	**1,899**	1,940
Other	**2,393**	2,115
Total current assets	**40,168**	49,010
Property and equipment, net	**4,350**	3,044
Equity and other investments	**10,117**	9,232
Goodwill	**4,760**	3,866
Intangible assets, net	**878**	539
Deferred income taxes	**1,389**	2,611
Other long-term assets	**1,509**	1,295
Total assets	**$63,171**	$69,597
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	**$ 3,247**	$ 2,909
Accrued compensation	**2,325**	1,938
Income taxes	**1,040**	1,557
Short-term unearned revenue	**10,779**	9,138
Securities lending payable	**2,741**	3,117
Other	**3,622**	3,783
Total current liabilities	**23,754**	22,442
Long-term unearned revenue	**1,867**	1,764
Other long-term liabilities	**6,453**	5,287
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 9,380 and 10,062	**60,557**	59,005
Retained deficit, including accumulated other comprehensive income of $1,654 and $1,229	**(29,460)**	(18,901)
Total stockholders' equity	**31,097**	40,104
Total liabilities and stockholders' equity	**$63,171**	$69,597

See accompanying notes.

CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30	2007	2006	2005
Operations			
Net income	**$ 14,065**	$ 12,599	$ 12,254
Depreciation, amortization, and other noncash items	**1,440**	903	855
Stock-based compensation	**1,550**	1,715	2,448
Net recognized gains on investments	**(292)**	(270)	(527)
Stock option income tax benefits	**–**	–	668
Excess tax benefits from stock-based payment arrangements	**(77)**	(89)	–
Deferred income taxes	**421**	219	(179)
Unearned revenue	**21,032**	16,453	13,831
Recognition of unearned revenue	**(19,382)**	(14,729)	(12,919)
Accounts receivable	**(1,764)**	(2,071)	(1,243)
Other current assets	**232**	(1,405)	(245)
Other long-term assets	**(435)**	(49)	21
Other current liabilities	**(552)**	(145)	396
Other long-term liabilities	**1,558**	1,273	1,245
Net cash from operations	**17,796**	14,404	16,605
Financing			
Common stock issued	**6,782**	2,101	3,109
Common stock repurchased	**(27,575)**	(19,207)	(8,057)
Common stock cash dividends	**(3,805)**	(3,545)	(36,112)
Excess tax benefits from stock-based payment arrangements	**77**	89	–
Other	**(23)**	–	(18)
Net cash used in financing	**(24,544)**	(20,562)	(41,078)
Investing			
Additions to property and equipment	**(2,264)**	(1,578)	(812)
Acquisition of companies, net of cash acquired	**(1,150)**	(649)	(207)
Purchases of investments	**(36,308)**	(51,117)	(68,045)
Maturities of investments	**4,736**	3,877	29,153
Sales of investments	**41,451**	54,353	54,938
Securities lending payable	**(376)**	3,117	–
Net cash from investing	**6,089**	8,003	15,027
Net change in cash and equivalents	**(659)**	1,845	(9,446)
Effect of exchange rates on cash and equivalents	**56**	18	(7)
Cash and equivalents, beginning of period	**6,714**	4,851	14,304
Cash and equivalents, end of period	**$ 6,111**	$ 6,714	$ 4,851

See accompanying notes.

STOCKHOLDERS' EQUITY STATEMENTS

(In millions)

Year Ended June 30	**2007**	**2006**	**2005**
Common stock and paid-in capital			
Balance, beginning of period	**$ 59,005**	$60,413	$56,396
Common stock issued	**6,783**	1,939	3,223
Common stock repurchased	**(6,162)**	(4,447)	(1,737)
Stock-based compensation expense	**1,550**	1,715	2,448
Stock option income tax benefits/(deficiencies)	**(661)**	(617)	89
Other, net	**42**	2	(6)
Balance, end of period	**60,557**	59,005	60,413
Retained earnings (deficit)			
Balance, beginning of period	**(18,901)**	(12,298)	18,429
Net income	**14,065**	12,599	12,254
Other comprehensive income:			
Net unrealized gains/(losses) on derivative instruments	**14**	76	(58)
Net unrealized gains/(losses) on investments	**326**	(282)	371
Translation adjustments and other	**85**	9	(6)
Comprehensive income	**14,490**	12,402	12,561
Common stock cash dividends	**(3,837)**	(3,594)	(36,968)
Common stock repurchased	**(21,212)**	(15,411)	(6,320)
Balance, end of period	**(29,460)**	(18,901)	(12,298)
Total stockholders' equity	**$ 31,097**	$40,104	$48,115

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

NOTE 1 ACCOUNTING POLICIES

ACCOUNTING PRINCIPLES

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

PRINCIPLES OF CONSOLIDATION

The financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments in which we exercise significant influence but do not control and are not the primary beneficiary are accounted for using the equity method. Investments in which we are not able to exercise significant influence over the investee and which do not have readily determinable fair values are accounted for under the cost method.

ESTIMATES AND ASSUMPTIONS

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include estimates of loss contingencies, product warranties, product life cycles, product returns, and stock-based compensation forfeiture rates; assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our financial statements or tax returns; estimating the fair value and/or goodwill impairment for our reporting units; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

FOREIGN CURRENCIES

Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the year. Translation adjustments resulting from this process are charged or credited to Other Comprehensive Income ("OCI").

REVENUE RECOGNITION

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable. We enter into certain arrangements where we are obligated to deliver multiple products and/or services (multiple elements). In these arrangements, we generally allocate the total revenue among the elements based on the sales price of each element when sold separately (vendor-specific objective evidence).

Revenue for retail packaged products, products licensed to original equipment manufacturers ("OEM"), and perpetual licenses for current products under our Open and Select volume licensing programs generally is recognized as products are shipped. A portion of the revenue related to certain products, which include all Windows XP and previous PC operating systems, is recorded as unearned due to undelivered elements including, in some cases, free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. The amount of revenue allocated to undelivered elements is based on the vendor-specific objective evidence of fair value for those elements using the residual method. Under the residual method, the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is recorded as unearned, and the difference between the total arrangement fee and the amount recorded as unearned for the undelivered elements is recognized as revenue related to delivered elements. Unearned revenue due to undelivered elements is recognized ratably on a straight-line basis over the related product's life cycle. Revenue related to Windows Vista is not subject to a similar deferral because there are no significant undelivered elements.

Revenue from multi-year licensing arrangements are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the billing coverage period. Certain multi-year licensing arrangements include rights to receive future versions of software product on a when-and-if-available basis under Open and Select volume licensing programs (Software Assurance). In addition, other multi-year licensing arrangements include a perpetual license for current products combined with rights to receive future versions of software products on a when-and-if-available basis under Open, Select, and Enterprise Agreement volume licensing programs. Premier support services agreements, MSN Internet Access subscriptions, Xbox Live, and Microsoft Developer Network subscriptions are also accounted for as subscriptions.

Revenue related to our Xbox game console and other hardware components is recognized upon shipment of the product to retailers. Revenue related to games published by us is recognized when those games have been delivered to retailers. Revenue related to games published by third parties for use on the Xbox platform is recognized when manufactured for the game publishers. Online advertising revenue is recognized as advertisements are displayed. Search advertising revenue is recognized when the ad appears in the search results or when the action necessary to earn the revenue has been completed. Consulting services revenue is recognized as services are rendered, generally based on the negotiated hourly rate in the consulting arrangement and the number of hours worked during the period. Consulting revenue for fixed-price services arrangements is recognized based on percentage of completion.

Costs related to insignificant obligations, which include telephone support for developer tools software, PC games, computer hardware, and Xbox, are accrued when the related revenue is recognized. Provisions are recorded for estimated returns, concessions, warranties, and bad debts.

COST OF REVENUE

Cost of revenue includes manufacturing and distribution costs for products sold and programs licensed, operating costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, warranty costs, inventory write-downs, costs associated with the delivery of consulting services, and the amortization of capitalized research and development costs associated with software products that have reached technological feasibility.

RESEARCH AND DEVELOPMENT

Research and development expenses include payroll, employee benefits, stock-based compensation, and other headcount-related costs associated with product development. We have determined that technological feasibility for our software products is reached shortly before the products are released to manufacturing. The amortization of these costs is included in cost of revenue over the estimated life of the products. We determined that technological feasibility was reached with Windows Vista and the 2007 Microsoft Office system during the second quarter of fiscal year 2007 and accordingly, we capitalized approximately $120 million of software development costs. Previously, costs incurred prior to technological feasibility were not material and were expensed as incurred.

SALES AND MARKETING

Sales and marketing expenses include payroll, employee benefits, stock-based compensation, and other headcount-related costs associated with sales and marketing personnel and advertising, promotions, tradeshows, seminars, and other marketing-related programs. Advertising costs are expensed as incurred. Advertising expense was $1.33 billion, $1.23 billion, and $995 million in fiscal years 2007, 2006, and 2005, respectively.

INCOME TAXES

Income tax expense includes U.S. and international income taxes, plus the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes.

FINANCIAL INSTRUMENTS

We consider all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. The fair value of these investments approximates their carrying value. In general, investments with original maturities of greater than three months and remaining maturities of less than one year are classified as short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash equivalents and short-term investments are classified as available for sale and are recorded at market value using the specific identification method. Changes in market value are reflected in OCI (excluding other-than-temporary impairments).

Equity and other investments may include both 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. Changes in market value are reflected in OCI (excluding other-than-temporary impairments). All other investments, excluding those accounted for using the equity method, are recorded at cost.

We lend certain fixed-income and equity securities to enhance investment income. The loaned securities continue to be carried as investments on our balance sheet. Collateral and/or security interest is determined based upon the underlying security and the creditworthiness of the borrower. Cash collateral is recorded as an asset with a corresponding liability.

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. We employ a systematic methodology on a quarterly basis that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, operational and financing cash flow factors, and rating agency actions. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established.

We use derivative instruments to manage exposures to foreign currency, equity price, interest rate and credit risks, to enhance returns, and to facilitate portfolio diversification. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the economic impact of these exposures as effectively as possible. Derivative instruments are recognized as either assets or liabilities and are measured at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. For a derivative instrument designated as a fair-value hedge, the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributed to the risk being hedged. For a derivative instrument designated as a cash-flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of OCI and is subsequently recognized in earnings when the hedged exposure affects earnings. The ineffective portion of the gain or loss is recognized in earnings. For options designated either as fair-value or cash-flow hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings. Gains and losses from changes in fair values of derivatives that are not designated as hedges for accounting purposes are recognized in earnings.

Foreign Currency Risk. Certain assets, liabilities, and forecasted transactions are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the overall effectiveness of our foreign currency hedge positions. Options are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash-flow hedging instruments under Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. Certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair-value hedging instruments under SFAS No. 133. Certain options and forwards not designated as hedging instruments under SFAS No. 133 are also used to hedge the impact of the variability in exchange rates on accounts receivable and collections denominated in certain foreign currencies and to manage other foreign currency exposures.

Equities Price Risk. Equity investments are subject to market price risk. From time to time, we use and designate options to hedge fair values on certain equity securities. We determine the security, selected for hedging by evaluating market conditions, up-front costs, and other relevant factors. Certain options, futures and swap contracts, not designated as hedging instruments under SFAS No. 133, are also used to manage equity exposures.

Interest Rate Risk. Fixed-income securities are subject to interest rate risk. The fixed-income portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. We use exchange-traded option and futures contracts and over-the-counter swap contracts, not designated as hedging instruments under SFAS No. 133, to hedge interest rate risk.

Other Derivatives. Swap contracts, not designated as hedging instruments under SFAS No. 133, are used to manage exposures to credit risks, enhance returns, and to facilitate portfolio diversification. In addition, we may invest in warrants to purchase securities of other companies as a strategic investment. Warrants that can be net share settled are deemed derivative financial instruments and are not designated as hedging instruments. "To Be

Announced" forward purchase commitments of mortgage-backed assets are also considered derivatives in cases where physical delivery of the assets in not taken at the earliest available delivery date. All derivative instruments not designated as hedging instruments are recorded at fair value, with changes in value recognized in earnings during the period of change.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence. Activity in the allowance for doubtful accounts was as follows:

(In millions)

Year Ended June 30	Balance at beginning of year	Charged to costs and expenses	Write-offs and other	Balance at end of year
2005	166	48	(43)	$171
2006	171	40	(69)	142
2007	**142**	**64**	**(89)**	**$117**

INVENTORIES

Inventories are stated at the lower of cost or market, using the average cost method. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis.

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 15 years. Computer software developed or obtained for internal use is depreciated using the straight-line method over the estimated useful life of the software, generally three years or less.

GOODWILL

Goodwill is tested for impairment on an annual basis as of July 1, and between annual tests if indicators of potential impairment exist, using a fair-value-based approach. No impairment of goodwill has been identified during any of the periods presented.

INTANGIBLE ASSETS

Intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from one to ten years. We evaluate the recoverability of intangible assets periodically and take into account events or circumstances that warrant revised estimates of useful lives or that indicate that impairment exists. All of our intangible assets are subject to amortization. No material impairments of intangible assets have been identified during any of the periods presented.

PRODUCT WARRANTY

We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include technical support, parts, and labor over a period generally ranging from 90 days to three years. For software, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2006, the FASB issued Interpretation No. 48 (“FIN No. 48”), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. The Interpretation provides a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Under FIN No. 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for us beginning July 1, 2007. Based on our current assessment, the adoption of FIN No. 48 is expected to decrease beginning retained earnings by $200 million to $400 million upon adoption.

In June 2006, the FASB ratified the Emerging Issues Task Force (“EITF”) consensus on EITF Issue No. 06-2, “Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43.” EITF Issue No. 06-2 requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. EITF Issue No. 06-2 is effective for us beginning July 1, 2007. The cumulative effect of the application of this consensus on prior period results should be recognized through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. Elective retrospective application is also permitted. We do not expect the application of this consensus to have a material impact on our financial statements.

In fiscal year 2007, we adopted Staff Accounting Bulletin (“SAB”) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements*. SAB No. 108 requires companies to quantify misstatements using both a balance sheet (iron curtain) and an income statement (rollover) approach to evaluate whether either approach results in an error that is material in light of relevant quantitative and qualitative factors, and provides for a one-time cumulative effect transition adjustment. The adoption of SAB No. 108 did not have an impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for us beginning July 1, 2008. We currently are assessing the potential impact that adoption of SFAS No. 157 would have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings. SFAS No. 159 is effective for us beginning July 1, 2008, although early adoption is permitted. We are currently assessing the potential impact that adoption of SFAS No. 159 will have on our financial statements.

NOTE 2 UNEARNED REVENUE

Unearned revenue is comprised of the following items:

Volume licensing programs – Represents customer billings for multi-year licensing arrangements, paid either upfront or annually at the beginning of each billing coverage period, which are accounted for as subscriptions with revenue recognized ratably over the billing coverage period.

Undelivered elements – Represents free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. This revenue deferral is applicable for Windows XP and previous PC operating systems shipped as retail packaged products, products licensed to original equipment manufacturers (“OEM”), and perpetual licenses for current products under our Open and Select volume licensing programs. The amount recorded as unearned is based on the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the related product’s life cycle. The percentage of revenue recorded as unearned due to undelivered elements ranges from approximately 15% to 25% of the sales price for Windows XP Home and approximately 5% to 15% of the sales price for Windows XP Professional, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three and one-half years for Windows operating systems.

Other – Represents payments for post-delivery support and consulting services to be performed in the future, online advertising for which the advertisement has yet to be displayed, Microsoft Dynamics business solutions maintenance and enhancement billings, Xbox Live and other billings that are accounted for as subscriptions, and other agreements where Microsoft is committed to the delivery of future enhancements, products, or services.

The components of unearned revenue were as follows:

(In millions)

June 30	**2007**	**2006**
Volume licensing programs	**$ 9,334**	$ 7,661
Undelivered elements	**1,839**	2,066
Other	**1,473**	1,175
Unearned revenue	**$12,646**	$10,902

Unearned revenue by segment was as follows:

(In millions)

June 30	**2007**	**2006**
Client	**$2,875**	$2,850
Server and Tools	**3,652**	3,792
Microsoft Business Division	**5,771**	3,609
Other segments	**348**	651
Unearned revenue	**$12,646**	$10,902

NOTE 3 INVESTMENTS

The components of investments were as follows:

(In millions)	Cost basis	Unrealized gains	Unrealized losses	Recorded basis	Cash and equivalents	Short-term investments	Equity and other investments
June 30, 2007							
Cash	**$3,040**	**$ –**	**$ –**	**$ 3,040**	**$3,040**	**$ –**	**$ –**
Mutual funds	**398**	**4**	**(1)**	**401**	**132**	**205**	**64**
Commercial paper	**227**	**–**	**–**	**227**	**179**	**48**	**–**
Certificates of deposit	**98**	**–**	**–**	**98**	**–**	**98**	**–**
U.S. Government and Agency securities	**3,085**	**4**	**(12)**	**3,077**	**1**	**3,002**	**74**
Foreign government bonds	**3,845**	**2**	**(63)**	**3,784**	**–**	**3,784**	**–**
Mortgage backed securities	**3,236**	**4**	**(49)**	**3,191**	**–**	**3,191**	**–**
Corporate notes and bonds	**7,184**	**14**	**(18)**	**7,180**	**2,425**	**4,753**	**2**
Municipal securities	**2,639**	**3**	**(25)**	**2,617**	**334**	**2,283**	**–**
Common stock and equivalents	**7,290**	**2,309**	**(18)**	**9,581**	**–**	**–**	**9,581**
Preferred stock	**62**	**12**	**–**	**74**	**–**	**–**	**74**
Other investments	**258**	**–**	**–**	**258**	**–**	**(64)**	**322**
Total	**$31,362**	**$2,352**	**$(186)**	**$33,528**	**$6,111**	**$17,300**	**$10,117**

(In millions)	Cost basis	Unrealized gains	Unrealized losses	Recorded basis	Cash and equivalents	Short-term investments	Equity and other investments
June 30, 2006							
Cash	$3,248	$ –	$ –	$3,248	$3,248	$ –	$ –
Mutual funds	723	11	(1)	733	288	445	–
Commercial paper	3,242	–	–	3,242	3,150	92	–
Certificates of deposit	364	–	–	364	–	364	–
U.S. Government and Agency securities	4,904	4	(30)	4,878	14	4,790	74
Foreign government bonds	6,034	21	(73)	5,982	–	5,982	–
Mortgage backed securities	4,285	–	(42)	4,243	–	4,243	–
Corporate notes and bonds	7,605	15	(18)	7,602	–	7,475	127
Municipal securities	4,008	5	(45)	3,968	14	3,954	–
Common stock and equivalents	6,933	1,846	(34)	8,745	–	–	8,745
Preferred stock	41	5	–	46	–	–	46
Other investments	342	–	–	342	–	102	240
Total	$41,729	$1,907	$(243)	$43,393	$6,714	$27,447	$9,232

Investments with continuous unrealized losses for less than and greater than 12 months and their related fair values were as follows:

(In millions)	Less than 12 months Fair value	Less than 12 months unrealized losses	12 months or greater Fair value	12 months or greater unrealized losses	Fair value	Total unrealized losses
June 30, 2007						
Mutual funds	**$ 76**	**$ (1)**	**$ 3**	**$ –**	**$ 79**	**$ (1)**
U. S. Government and Agency securities	**1,219**	**(8)**	**238**	**(4)**	**1,457**	**(12)**
Foreign government bonds	**3,554**	**(63)**	**2**	**–**	**3,556**	**(63)**
Mortgage backed securities	**2,520**	**(43)**	**214**	**(6)**	**2,734**	**(49)**
Corporate notes and bonds	**526**	**(14)**	**74**	**(4)**	**600**	**(18)**
Municipal securities	**575**	**(9)**	**420**	**(16)**	**995**	**(25)**
Common stock and equivalents	**237**	**(17)**	**9**	**(1)**	**246**	**(18)**
Total	**$8,707**	**$(155)**	**$960**	**$(31)**	**$9,667**	**$(186)**

(In millions)	Less than 12 months Fair value	Less than 12 months unrealized losses	12 months or greater Fair value	12 months or greater unrealized losses	Fair value	Total unrealized losses
June 30, 2006						
Mutual funds	$ 14	$ (1)	$ 4	$ –	$ 18	$ (1)
U. S. Government and Agency securities	2,303	(24)	172	(6)	2,475	(30)
Foreign government bonds	2,523	(56)	1,749	(17)	4,272	(73)
Mortgage backed securities	2,692	(40)	102	(2)	2,794	(42)
Corporate notes and bonds	4,721	(13)	359	(5)	5,080	(18)
Municipal securities	1,323	(13)	1,192	(32)	2,515	(45)
Common stock and equivalents	266	(33)	29	(1)	295	(34)
Total	$13,842	$(180)	$3,607	$(63)	$17,449	$(243)

At June 30, 2007, unrealized losses of $186 million consisted of: $161 million related to investment grade fixed-income securities, $7 million related to investments in high yield and emerging market fixed-income securities, $7 million related to domestic equity securities, and $11 million related to international equity securities. At June 30, 2006, unrealized losses of $243 million consisted of: $196 million related to investment grade fixed-income securities, $12 million related to investments in high yield and emerging market fixed-income securities, $2 million related to domestic equity securities, and $33 million related to international equity securities. Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from domestic and international equities are due to market price movements. Management does not believe any unrealized losses represent an other-than-temporary impairment based on our evaluation of available evidence as of June 30, 2007.

Common and preferred stock and other investments that are restricted for more than one year or are not publicly traded are recorded at cost. At June 30, 2007, the recorded basis and estimated fair value of these investments was $38 million. At June 30, 2006, the recorded basis and estimated fair value of these investments was $41 million. The estimate of fair value is based on publicly available market information or other estimates determined by management.

The maturities of debt securities, including fixed-maturity securities, at June 30, 2007 were as follows:

(In millions)	Cost basis	Estimated fair value
Due in one year or less	$ 5,519	$ 5,518
Due after one year through five years	6,886	6,849
Due after five years through ten years	2,935	2,890
Due after ten years	4,910	4,853
Total	$20,250	$20,110

NOTE 4 INVESTMENT INCOME AND OTHER

The components of investment income and other were as follows:

(In millions) Year Ended June 30	2007	2006	2005
Dividends and interest	**$1,319**	$1,510	$1,460
Net gains on investments	**650**	161	856
Net losses on derivatives	**(358)**	(99)	(262)
Income/(losses) from equity investees and other	**(34)**	218	13
Investment income and other	**$1,577**	$1,790	$2,067

Net gains on investments include other-than-temporary impairments. These were not material in fiscal year 2007, were $408 million in fiscal year 2006, and were $152 million in fiscal year 2005. The decrease in other-than-temporary impairments in fiscal year 2007 and the increase in fiscal year 2006 were driven by planned sales of certain investments in an unrealized loss position in order to raise funds for the $20 billion tender offer announced on July 20, 2006. Realized gains and losses from sales of available-for-sale securities (excluding other-than-temporary impairments) were $851 million and $176 million, respectively, in fiscal year 2007, $1.11 billion and $531 million, respectively, in fiscal year 2006, and $1.38 billion and $376 million, respectively, in fiscal year 2005.

NOTE 5 DERIVATIVES

For derivative instruments designated as hedges, hedge ineffectiveness, determined in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* did not have a significant impact on earnings for fiscal years 2007, 2006, or 2005. During fiscal year 2007, $219 million in gains on fair value hedges from changes in time value and $361 million in losses on cash flow hedges from changes in time value were excluded from the assessment of hedge effectiveness and included in investment income and other. During fiscal year 2006, $217 million in gains on fair value hedges from changes in time value and $399 million in losses on cash flow hedges from changes in time value were excluded from the assessment of hedge effectiveness and included in investment income and other. During fiscal year 2005, $79 million in gains on fair value hedges from changes in time value and $116 million in losses on cash flow hedges from changes in time value were excluded from the assessment of hedge effectiveness and included in investment income and other.

Derivative gains and losses included in OCI are reclassified into earnings at the time forecasted revenue or the sale of an equity investment is recognized. During fiscal year 2007, $168 million of derivative gains were reclassified to revenue. During fiscal year 2006, $166 million of derivative gains were reclassified to revenue and $23 million in derivative gains were reclassified to investment income and other. During fiscal year 2005, $57 million of derivative gains were reclassified to revenue and $33 million in derivative gains were reclassified to investment income and other.

We estimate that $124 million of net derivative gains included in OCI will be reclassified into earnings within the next 12 months. No significant amounts of gains or losses were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur for fiscal years 2007, 2006, and 2005.

NOTE 6 INVENTORIES

(In millions)

June 30	2007	2006
Raw materials	**$ 435**	$ 465
Work in process	**148**	–
Finished goods	**544**	1,013
Inventories	**$1,127**	$1,478

NOTE 7 PROPERTY AND EQUIPMENT

(In millions)

June 30	2007	2006
Land	**$ 428**	$ 362
Buildings and improvements	**3,170**	2,228
Leasehold improvements	**1,077**	918
Computer equipment and software	**3,458**	2,682
Furniture and equipment	**1,233**	1,033
Property and equipment, at cost	**9,366**	7,223
Accumulated depreciation	**(5,016)**	(4,179)
Property and equipment, net	**$ 4,350**	$ 3,044

Property and equipment are stated at cost. Depreciation is computed principally on the straight-line method over the estimated useful lives of the assets. The useful lives for buildings range from five to 15 years, leasehold improvements generally range from two to ten years – representing the applicable lease terms plus reasonably assured extensions, computer equipment and software range from two to three years, and furniture and equipment range from one to five years. Land is not depreciated.

During fiscal years 2007, 2006, and 2005, depreciation expense was $1.17 billion, $863 million, and $723 million, respectively. The majority of depreciation expense in all years related to computer equipment.

NOTE 8 GOODWILL

Changes in the carrying amount of goodwill for fiscal years 2007 and 2006 by segment were as follows:

(In millions)

	Balance as of June 30, 2005	Acquisitions	Other	Balance as of June 30, 2006	Acquisitions	Other	Balance as of June 30, 2007
Client	$ 43	$ 31	$ –	$ 74	**$ 6**	**$ (3)**	**$ 77**
Server and Tools	241	29	(14)	256	**325**	**(1)**	**580**
Microsoft Business Division	2,435	246	–	2,681	**508**	**(57)**	**3,132**
Online Services Business	171	263	21	455	**123**	**(26)**	**552**
Entertainment and Devices Division	419	23	(42)	400	**21**	**(2)**	**419**
Total	$3,309	$592	$(35)	$3,866	**$983**	**$(89)**	**$4,760**

We test goodwill for impairment annually on July 1 at the reporting unit level using a fair value approach, in accordance with the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. Our annual testing resulted in no impairments of goodwill in fiscal years 2007 and 2006. If an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value, goodwill will be evaluated for impairment between annual tests.

During fiscal year 2007, we acquired the following entities for total consideration of $1.34 billion, which was primarily paid in cash:

- Softricity, Inc., a provider of application virtualization and dynamic streaming technologies;
- TellMe Networks, Inc., a company specializing in speech-recognition technology providing an outsourced, network-based, voice application platform; and
- 11 other entities specializing in areas such as application security, desktop, and data management.

As a result of these acquisitions, we recorded $983 million of goodwill, none of which is expected to be deductible for tax purposes. All of the entities were consolidated with Microsoft since their respective acquisition dates. The purchase price allocations for these acquisitions are preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available. Any change in the estimated fair value of the net assets of the acquired companies will change the amount of the purchase price allocable to goodwill. Pro forma results of operations have not been presented because the effects of these acquisitions, individually and in aggregate, were not material.

NOTE 9 INTANGIBLE ASSETS

The components of finite-lived intangible assets were as follows:

(In millions)

June 30	2007			2006		
	Gross carrying amount	**Accumulated amortization**	**Net carrying amount**	**Gross carrying amount**	**Accumulated amortization**	**Net carrying amount**
Contract-based	**$ 988**	**$ (727)**	**$261**	$ 954	$(661)	$293
Technology-based	**916**	**(407)**	**509**	458	(255)	203
Marketing-related	**57**	**(39)**	**18**	42	(32)	10
Customer-related	**122**	**(32)**	**90**	54	(21)	33
Total	**$2,083**	**$(1,205)**	**$878**	$1,508	$(969)	$539

During fiscal year 2007 and 2006, we recorded additions to intangible assets of $473 million and $189 million, respectively. We estimate that we have no significant residual value related to our intangible assets. The components of finite-lived intangible assets acquired during fiscal years 2007 and 2006 were as follows:

(In millions)

Year Ended June 30	2007		2006	
	Amount	**Weighted average life**	**Amount**	**Weighted average life**
Contract-based	**$ 57**	**5 years**	$ 36	4 years
Technology-based	**333**	**4 years**	140	4 years
Marketing-related	**14**	**4 years**	5	3 years
Customer-related	**69**	**5 years**	8	4 years
Total	**$473**		$189	

Intangible asset additions include $170 million of technology-based intangible assets with a weighted-average life of 4 years, and $84 million of other intangible assets with a weighted-average life of 4.9 years, related to the acquisitions of Softricity Inc., TellMe Networks, Inc., and the remaining 11 entities acquired.

Acquired intangibles are generally amortized on a straight-line basis over weighted average lives. Intangible assets amortization expense was $236 million for fiscal year 2007, $127 million for fiscal year 2006, and $161 million for fiscal year 2005. The estimated future amortization expense related to intangible assets as of June 30, 2007 is as follows:

(In millions)

Year Ended June 30	**Amount**
2008	$263
2009	229
2010	184
2011	111
2012 and thereafter	91
Total	$878

NOTE 10 INCOME TAXES

The components of the provision for income taxes were as follows:

(In millions)

Year Ended June 30	**2007**	**2006**	**2005**
Current taxes:			
U.S. Federal	**$4,593**	$4,471	$3,401
U.S. State and Local	**154**	101	152
International	**957**	882	911
Current taxes	**5,704**	5,454	4,464
Deferred taxes (benefits)	**332**	209	(90)
Provision for income taxes	**$6,036**	$5,663	$4,374

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

(In millions)

Year Ended June 30	**2007**	**2006**	**2005**
U.S.	**$12,902**	$11,404	$ 9,806
International	**7,199**	6,858	6,822
Income before income taxes	**$20,101**	$18,262	$16,628

The items accounting for the difference between income taxes computed at the federal statutory rate and the provision for income taxes were as follows:

Year Ended June 30	**2007**	**2006**	**2005**
Federal statutory rate	**35.0%**	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	**(5.1)%**	(4.6)%	(3.1)%
Examination settlements	**–**	(0.6)%	(4.7)%
Other reconciling items	**0.1%**	1.2%	(0.9)%
Effective rate	**30.0%**	31.0%	26.3%

The 2007 other reconciling items includes the impact of a $195 million reduction resulting from various changes in tax positions taken in prior periods, related primarily to favorable developments in an IRS position and multiple foreign audit assessments. The 2006 other reconciling item includes the impact of the $351 million non-deductible European Commission fine. The 2005 other reconciling items include a $179 million repatriation tax benefit under the American Jobs Creation Act of 2004.

The components of the deferred tax assets and liabilities were as follows:

(In millions)

June 30	**2007**	**2006**
Deferred income tax assets:		
Stock-based compensation expense	**$2,859**	$3,630
Other expense items	**1,735**	1,451
Unearned revenue	**842**	1,028
Impaired investments	**710**	989
Other revenue items	**58**	102
Deferred income tax assets	**$6,204**	$7,200
Deferred income tax liabilities:		
International earnings	**$(1,763)**	$(1,715)
Unrealized gain on investments	**(926)**	(801)
Other	**(227)**	(133)
Deferred income tax liabilities	**(2,916)**	(2,649)
Net deferred income tax assets	**$ 3,288**	$ 4,551
Reported as:		
Current deferred tax assets	**$1,899**	$1,940
Long-term deferred tax assets	**1,389**	2,611
Net deferred income tax assets	**$3,288**	$4,551

Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases and are stated at enacted tax rates expected to be in effect when taxes are actually paid or recovered.

We have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $6.10 billion resulting from earnings for certain non-U.S. subsidiaries which are permanently reinvested outside the United States. The amount of unrecognized deferred tax liability associated with these temporary differences is approximately $1.77 million.

The American Jobs Creation Act of 2004 (the "Act") was enacted in October 2004. The Act creates a temporary incentive for U.S. corporations to repatriate foreign subsidiary earnings by providing an elective 85% dividends received deduction for certain dividends from controlled foreign corporations. Under these provisions, we repatriated approximately $780 million in dividends subject to the elective 85% dividends received deduction and we recorded a corresponding tax provision benefit of $179 million from the reversal of previously provided U.S. deferred tax liabilities on these unremitted foreign subsidiary earnings in 2005. The dividend was paid in June 2006.

Income taxes paid were $5.24 billion in fiscal year 2007, $4.78 billion in fiscal year 2006, and $4.33 billion in fiscal year 2005.

Tax Contingencies. We are subject to income taxes in the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes and recording the related assets and liabilities. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities. Accruals for tax contingencies are provided for in accordance with the requirements of SFAS No. 5, *Accounting for Contingencies*.

Although we believe we have appropriate support for the positions taken on our tax returns, we have recorded a liability for our best estimate of the probable loss on certain of these positions, the non-current portion of which is included in other long-term liabilities. We believe that our accruals for tax liabilities are adequate for all open years, based on our assessment of many factors including past experience and interpretations of tax law applied to the facts of each matter, which matters result primarily from inter-company transfer pricing, restructuring of foreign operations, tax benefits from the Foreign Sales Corporation and Extra Territorial Income tax rules, the amount of research and experimentation tax credits claimed, state income taxes, and certain other matters. Although we believe our recorded assets and liabilities are reasonable, tax regulations are subject to interpretation and tax litigation is inherently uncertain; therefore our assessments can involve both a series of complex judgments about future events and rely heavily on estimates and assumptions. Although we believe that the estimates and assumptions supporting our assessments are reasonable, the final determination of tax audit settlements and any related litigation could be materially different than that which is reflected in historical income tax provisions and recorded assets and liabilities. If we were to settle an audit or a matter under litigation, it could have a material effect on our income tax provision, net income, or cash flows in the period or periods for which that determination is made. Due to the complexity involved we are not able to estimate the range of reasonably possible losses in excess of amounts recorded.

The Internal Revenue Service ("IRS") has completed and closed its audits of our consolidated federal income tax returns through 1999. The IRS is currently conducting audits of our consolidated federal income tax return for tax years 2000 through 2006.

NOTE 11 OTHER LONG-TERM LIABILITIES

(In millions)

June 30	**2007**	**2006**
Tax contingencies	**$5,071**	$4,194
Legal contingencies	**778**	1,022
Product warranty	**487**	–
Other	**117**	71
Other long-term liabilities	**$6,453**	$5,287

NOTE 12 STOCKHOLDERS' EQUITY

Shares of common stock outstanding were as follows:

(In millions)

Year Ended June 30	**2007**	**2006**	**2005**
Balance, beginning of year	**10,062**	10,710	10,862
Issued	**289**	106	160
Repurchased	**(971)**	(754)	(312)
Balance, end of year	**9,380**	10,062	10,710

On July 20, 2006, we announced the completion of the repurchase program initially approved by our Board of Directors on July 20, 2004 to buy back up to $30.00 billion in Microsoft common stock.

On July 20, 2006, we also announced that our Board of Directors authorized two new share repurchase programs: a $20.00 billion tender offer, which was completed on August 17, 2006; and authorization for up to an additional $20.00 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.84 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.00 billion ongoing share repurchase program had been increased by approximately $16.16 billion. As a result, we are authorized to repurchase additional shares in an amount up to

$36.16 billion through June 30, 2011. As of June 30, 2007, approximately $15.14 billion remained of the $36.16 billion approved repurchase amount. During fiscal year 2006, we repurchased 754 million shares, or $19.75 billion, of our common stock under a previously approved plan. Under these repurchase plans, we have made the following share repurchases:

(In millions)

Fiscal year	**2007(1)**		**2006(2)**		**2005(2)**	
	Shares	**Amount**	**Shares**	**Amount**	**Shares**	**Amount**
First quarter	**285**	**$ 6,965**	114	$ 3,029	23	$ 625
Second quarter	**205**	**6,037**	283	7,666	23	655
Third quarter	**238**	**6,744**	181	4,879	95	2,420
Fourth quarter	**243**	**7,367**	176	4,175	171	4,302
Total	**971**	**$27,113**	754	$19,749	312	$8,002

(1) Approximately 155 million shares of common stock for approximately $3.84 billion were repurchased under our tender offer in the first quarter of fiscal year 2007. All other amounts repurchased were repurchased under the repurchase plan approved by our Board of Directors on July 20, 2006.

(2) All amounts repurchased in fiscal years 2006 and 2005 were repurchased under the repurchase plan approved by our Board of Directors on July 20, 2004.

In fiscal year 2007, our Board of Directors declared the following dividends:

Declaration Date	**Dividend Per Share**	**Date of Record**	**Total Amount (in millions)**	**Payment Date**
September 13, 2006	$0.10	November 16, 2006	$980	December 14, 2006
December 20, 2006	$0.10	February 15, 2007	$978	March 8, 2007
March 26, 2007	$0.10	May 17, 2007	$952	June 14, 2007
June 27, 2007	$0.10	August 16, 2007	$938(1)	September 13, 2007

(1) The dividend declared on June 27, 2007 will be paid after the filing date of this report on Form 10-K and was included in other current liabilities as of June 30, 2007.

In fiscal year 2006, our Board of Directors declared the following dividends:

Declaration Date	**Dividend Per Share**	**Date of Record**	**Total Amount (in millions)**	**Payment Date**
September 23, 2005	$0.08	November 17, 2005	$846	December 8, 2005
December 14, 2005	$0.09	February 17, 2006	$926	March 9, 2006
March 27, 2006	$0.09	May 17, 2006	$916	June 8, 2006
June 21, 2006	$0.09	August 17, 2006	$897(1)	September 14, 2006

(1) The dividend declared on June 21, 2006 was included in other current liabilities as of June 30, 2006.

NOTE 13 OTHER COMPREHENSIVE INCOME

The activity in other comprehensive income and related tax effects were as follows:

(In millions)

Year Ended June 30	2007	2006	2005
Net unrealized gains/(losses) on derivative instruments:			
Unrealized gains, net of tax effect of $66 in 2007, $107 in 2006, and $0 in 2005	**$ 123**	$ 199	$ –
Reclassification adjustment for gains included in net income, net of tax effect of $(59) in 2007, $(66) in 2006, and $(31) in 2005	**(109)**	(123)	(58)
Net unrealized gains/(losses) on derivative instruments	**14**	76	(58)
Net unrealized gains/(losses) on investments:			
Unrealized gains/(losses), net of tax effect of $393 in 2007, $(105) in 2006, and $469 in 2005	**730**	(195)	870
Reclassification adjustment for gains included in net income, net of tax effect of $(217) in 2007, $(47) in 2006, and $(269) in 2005	**(404)**	(87)	(499)
Net unrealized gains/(losses) on investments	**326**	(282)	371
Translation adjustments and other	**85**	9	(6)
Other comprehensive income/(loss)	**$ 425**	$(197)	$ 307

Certain activity within the unrealized gains/(losses) and reclassification adjustment line items in 2006 and 2005 has been revised to correct the prior period presentation. These revisions did not affect other comprehensive income/(loss) nor any of the subtotals in the table above.

The components of accumulated other comprehensive income were as follows:

(In millions)

Year Ended June 30	2007	2006	2005
Net unrealized gains on derivative instruments	**$ 117**	$ 103	$ 27
Net unrealized gains on investments	**1,388**	1,062	1,344
Translation adjustments and other	**149**	64	55
Accumulated other comprehensive income	**$1,654**	$1,229	$1,426

NOTE 14 EMPLOYEE STOCK AND SAVINGS PLANS

Effective July 1, 2005, we adopted SFAS No. 123(R), *Share-Based Payment,* using the modified prospective application transition method. Because the fair value recognition provisions of SFAS No. 123, *Stock-Based Compensation,* and SFAS No. 123(R) were materially consistent under our equity plans, the adoption of SFAS No. 123(R) did not have a significant impact on our financial position or our results of operations. Prior to our adoption of SFAS No. 123(R), benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows. SFAS No. 123(R) requires excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid.

The stock-based compensation and related income tax benefits were as follows:

(In millions)	2007	2006	2005
Total stock-based compensation	**$1,550**	$1,715	$2,448
Income tax benefits related to stock-based compensation	**$ 542**	$ 600	$ 857

Employee Stock Purchase Plan. We have an employee stock purchase plan for all eligible employees. Compensation expense for the employee stock purchase plan is recognized in accordance with SFAS No. 123(R). Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value on the last day of each three-month period. Employees may purchase shares having a value not exceeding 15% of their gross compensation during an offering period. Employees purchased the following shares:

(Shares In millions)	2007	2006	2005
Shares purchased	**17**	17	16
Average price per share	**$25.36**	$23.02	$23.33

At June 30, 2007, 125 million shares were reserved for future issuance.

Savings Plan. We have a savings plan in the United States that qualifies under Section 401(k) of the Internal Revenue Code, and a number of savings plans in international locations. Participating U.S. employees may contribute up to 50% of their pretax salary, but not more than statutory limits. We contribute fifty cents for each dollar a participant contributes in this plan, with a maximum contribution of 3% of a participant's earnings. Matching contributions for all plans were $218 million, $178 million, and $154 million in fiscal years 2007, 2006, and 2005, respectively. Matching contributions are invested proportionate to each participant's voluntary contributions in the investment options provided under the plan. Investment options in the U.S. plan include Microsoft common stock, but neither participant nor our matching contributions are required to be invested in Microsoft common stock.

Stock Plans. We have stock plans for directors and for officers, employees, consultants, and advisors. At June 30, 2007, an aggregate of 819 million shares were authorized for future grant under our stock plans, which cover stock options, stock awards, and shared performance stock awards. Awards that expire or are canceled without delivery of shares generally become available for issuance under the plans. The options transferred to JPMorgan Chase Bank ("JPMorgan") (see below) in fiscal year 2004 have been removed from our plans; the options transferred to JPMorgan that expired without being exercised are not available for grant under any of our plans. We issue new shares to satisfy stock option exercises.

On November 9, 2004, our shareholders approved amendments to the stock plans that allowed our Board of Directors to adjust eligible options, unvested stock awards, and shared performance stock awards to maintain their pre-dividend value after the $3.00 special dividend. Additional awards were granted for options, stock awards, and shared performance stock awards by the ratio of post- and pre-special dividend stock price as of the ex-dividend date. Strike prices for options were decreased by the same ratio. Stock-based compensation was not affected by this adjustment. As a result of this approval and payment of the $3.00 special dividend on December 2, 2004, an adjustment to the prices and number of shares of existing awards was made resulting in a total of 96 million options and 7 million stock awards being issued to adjust the outstanding awards. In addition, the target shared performance stock awards were increased by 4 million shares.

Stock Awards and Shared Performance Stock Awards. Stock awards are grants that entitle the holder to shares of common stock as the award vests. Our stock awards generally vest over a five-year period.

Shared Performance Stock Awards ("SPSAs") are a form of stock award in which the number of shares ultimately received depends on our business performance against specified performance targets. The performance period for SPSAs issued in fiscal years 2004, 2005, and 2006 was July 1, 2003 through June 30, 2006 (January 1, 2004 through June 30, 2006 for certain executive officers). Following the end of the performance period, the Compensation Committee of the Board of Directors determined that the number of shares of stock awards to be issued was 37.0 million, based on the actual performance against metrics established for the performance period. One-third of the awards vested in fiscal year 2007. An additional one-third of the awards will vest over each of the following two years. Because the SPSAs covered a three-year period, SPSAs issued in fiscal year 2005 and 2006 were given only to newly hired and promoted employees eligible to receive SPSAs.

The Company granted SPSAs for fiscal year 2007 with a performance period of July 1, 2006 through June 30, 2007. At the end of the performance period, the number of shares of stock subject to the award is determined by multiplying the target award by a percentage ranging from 0% to 150%. The percentage is determined based on performance against metrics for the performance period, as determined by the Compensation Committee of the Board of Directors in its sole discretion. An additional 15% of the total stock and stock awards will be available as additional awards to participants based on individual performance. One-quarter of the shares of stock subject to each award will vest following the end of the performance period, and an additional one-quarter of the shares will vest over each of the following three years.

We measure the fair value of SAs and SPSAs based upon the market price of the underlying common stock as of the date of grant, reduced by the present value of estimated future dividends. SAs and SPSAs are amortized over their applicable vesting period (generally three to five years) using the straight-line method. The fair value of each award grant is estimated on the date of grant using the following assumptions:

(In millions)	2007	2006	2005
Dividend per share (quarterly amounts)	**\$0.09 - \$0.10**	\$0.08 - \$0.09	\$0.08
Interest rates range	**4.3% - 5.3%**	3.2% - 5.3%	1.3% - 4.3%

During fiscal year 2007, the following activity occurred under our existing plans:

	Shares (in millions)	Weighted Average Grant-Date Fair Value
Stock awards:		
Nonvested balance at June 30, 2006	98	\$24.25
Granted	57	25.15
Vested	(24)	24.15
Forfeited	(7)	24.44
Nonvested balance at June 30, 2007	**124**	**\$24.67**
Shared performance stock awards:		
Nonvested balance at June 30, 2006	37	\$23.57
Granted	11	25.18
Vested	(13)	23.74
Forfeited	(2)	23.92
Nonvested balance at June 30, 2007	**33**	**\$24.11**

As of June 30, 2007, there were \$2.22 billion and \$392 million of total unrecognized compensation costs related to SAs and SPSAs, respectively. These costs are expected to be recognized over a weighted average period of 3.4 years and 2.1 years, respectively.

SPSAs granted in fiscal year 2007 include adjustments for estimated performance against performance targets.

During the 12 months ended June 30, 2006 and June 30, 2005, the following activity occurred under our plans:

(In millions, except fair values)	Fiscal Year 2006	Fiscal Year 2005
Stock awards granted	47	41
Weighted average grant-date fair value	\$24.70	\$24.03
Shared performance stock awards granted	3	4
Weighted average grant-date fair value	\$24.80	\$24.35

Stock Options. In fiscal year 2004, we began granting employees stock awards rather than stock options as part of our equity compensation plans. Since then, stock options issued to employees have been issued primarily in conjunction with business acquisitions. Nonqualified stock options were granted to our directors under our non-employee director stock plan. Nonqualified and incentive stock options were granted to our officers and employees under our employee stock plans. Options granted between 1995 and 2001 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire ten years from the date of grant. Options granted after 2001 vest over four and one-half years and expire ten years from the date of grant. Approximately 3 million stock options were granted in conjunction with business acquisitions during fiscal years 2007 and 2006, respectively. No stock options were granted during the year ended June 30, 2005.

During fiscal year 2004, we completed an employee stock option transfer program whereby employees could elect to transfer all of their vested and unvested options with a strike price of $33.00 or higher to JPMorgan. The options transferred to JPMorgan were amended and restated upon transfer to contain terms and conditions typical of equity option transactions entered into between sophisticated financial counterparties at arm's length using standard terms and definitions for equity derivatives. As a result of this program, we recorded additional stock-based compensation expense of $2.21 billion ($1.48 billion after-tax or $0.14 per diluted share) which was recorded in the second quarter of fiscal year 2004. In December 2006, JP Morgan Chase Bank ("JPMorgan") exercised approximately 113 million call options for $3.25 billion at an average price per share of $28.80. The call options were among 345 million options acquired by JPMorgan in fiscal year 2004 through our employee stock option transfer program. The other approximately 232 million options expired unexercised.

Employee stock options outstanding were as follows:

	Shares (in millions)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in millions)
Balance, June 30, 2006	750	$27.92		
Granted	3	27.28		
Exercised	(134)	23.66		
Canceled	(92)	34.46		
Forfeited	(3)	21.51		
Balance, June 30, 2007	**524**	**$27.86**	**3.60**	**$1,877**
Exercisable, June 30, 2007	**511**	**$27.98**	**3.55**	**$1,773**

Included in the options outstanding balance are approximately 5 million options that were granted in conjunction with business acquisitions. While these options are included in the options outstanding balance, they are excluded from the weighted average exercise prices presented. These options have an exercise price range of $0 to $150.93 and a weighted average exercise price of $10.35.

During fiscal years 2007, 2006, and 2005 the following activity occurred under our plans:

(In millions)	2007	2006	2005
Total intrinsic value of stock options exercised	**$818**	$491	$940
Total fair value of stock awards vested	**618**	377	198
Total fair value of shared performance stock awards vested	**316**	–	–

Cash received and income tax benefits from stock option exercises were $6.35 billion and $286 million, respectively, for fiscal year 2007.

NOTE 15 EARNINGS PER SHARE

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options, stock awards, and shared performance stock awards. The components of basic and diluted earnings per share are as follows:

(In millions, except earnings per share)

Year Ended June 30	2007	2006	2005
Net income available for common shareholders (A)	**$14,065**	$12,599	$12,254
Weighted average outstanding shares of common stock (B)	**9,742**	10,438	10,839
Dilutive effect of employee stock options and awards	**144**	93	67
Common stock and common stock equivalents (C)	**9,886**	10,531	10,906
Earnings per share:			
Basic (A/B)	**$ 1.44**	$ 1.21	$ 1.13
Diluted (A/C)	**$ 1.42**	$ 1.20	$ 1.12

For the years ended June 30, 2007, 2006, and 2005, 199 million, 649 million, and 854 million shares, respectively, were attributable to outstanding stock options and were excluded from the calculation of diluted earnings per share because the exercise prices of the stock options were greater than or equal to the average price of the common shares, and therefore their inclusion would have been anti-dilutive. For the year ended June 30, 2007, 4 million shared performance stock awards, out of the 14 million targeted amount outstanding, have been excluded from the calculation of diluted earnings per share because the number of shares ultimately issued is contingent on our performance against metrics established for the performance period, as discussed in Note 14 – Employee Stock and Savings Plans.

NOTE 16 COMMITMENTS AND GUARANTEES

We have committed $821 million for constructing new buildings.

We have operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $326 million, $276 million, and $299 million, in fiscal years 2007, 2006, and 2005, respectively. Future minimum rental commitments under noncancellable leases are as follows:

(In millions)

Year Ended June 30	Amount
2008	$ 349
2009	242
2010	202
2011	174
2012 and thereafter	374
	$1,341

In connection with various operating leases, we issued residual value guarantees, which provide that if we do not purchase the leased property from the lessor at the end of the lease term, then we are liable to the lessor for an amount equal to the shortage (if any) between the proceeds from the sale of the property and an agreed value. As of June 30, 2006, the maximum amount of the residual value guarantees was approximately $271 million. During 2007, we exercised a provision in the operating lease agreements to purchase the outstanding portion of certain operating leases for approximately $41 million and are no longer subject to the residual value guarantees.

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. In addition, we also provide indemnification against credit risk in several geographical locations to our volume license resellers in case the resellers fail to collect from the end user. Due to the nature of the indemnification provided to our resellers, we cannot estimate the fair value, nor determine the total nominal amount of the indemnification. We evaluate estimated losses for such indemnifications under SFAS No. 5, *Accounting for Contingencies*, as interpreted by FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others*. We consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnifications in our financial statements. We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include technical support, parts, and labor over a period generally ranging from 90 days to three years. For software warranty, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

In July 2007, we expanded our global Xbox 360 warranty coverage to three years from the date of purchase for a general hardware failure indicated by three flashing red lights. The basic Xbox 360 console warranty remains in place with a warranty period of one year from the date of purchase in most geographies.

The changes in our aggregate product warranty liabilities, which are included in other current liabilities and other long term-liabilities on our balance sheets, were as follows:

(In millions)	Amount
Balance at July 1, 2005	$ 14
Accruals for warranties issued	45
Adjustments to pre-existing warranties	(7)
Settlements of warranty claims	(42)
Balance at June 30, 2006	10
Accruals for warranties issued(1)	974
Adjustments to pre-existing warranties	92
Settlements of warranty claims	(226)
Balance at June 30, 2007	**$850**

(1) Includes warranty expense incurred as a result of the expansion of our Xbox 360 warranty coverage as discussed above.

NOTE 17 CONTINGENCIES

Government competition law matters. In March 2004, the European Commission issued a decision in its competition law investigation of us. The Commission concluded that we infringed European competition law by refusing to license to our competitors certain protocol technology in the Windows server operating systems and by including streaming media playback features in Windows desktop operating systems. The Commission ordered us to license the protocol technology to our competitors and to develop and make available a version of the Windows desktop operating system that does not include specified media playback software. The Commission also fined us €497 million ($605 million). We appealed the decision to the Court of First Instance. In July 2006, the European Commission determined that we had not complied with the technical documentation requirements of the 2004 Decision, and fined us €281 million ($351 million). We have appealed this fine to the Court of First Instance. We have expensed and paid both fines, pending resolution of the appeals. In March 2007, the European Commission announced a new statement of objections. The new statement of objections claims that the pricing terms we proposed for licensing certain server protocol technology as required by the March 2004 decision are "not reasonable." The statement of objections threatens to impose new fines of up to €500,000

($675,000) per day from December 2005 to June 2006, up to €2 million ($3 million) per day from June to July 2006, and up to €3 million ($4 million) per day beginning August 2006. The maximum amount of the potential fine as of June 30, 2007 is $1.58 billion. We have submitted a written response to the statement of objections and are seeking to determine a reasonable royalty rate with the Commission.

In December 2005, the Korean Fair Trade Commission ("KFTC") ruled that we abused a market dominant position and engaged in unfair trade practices under the Korean Fair Trade Act. The KFTC stated we violated the Act by building instant messaging and media player features into the Windows PC operating system and streaming media technologies into the Windows server operating system. The KFTC imposed a fine of approximately $34 million which we have expensed and paid. The KFTC's order issued in February 2006 held that our integration of these media and messaging features into the Windows PC and server operating systems was an abuse of monopoly power and unlawful tying in violation of the Korean Fair Trade Act. The order required us to develop and distribute in Korea versions of Windows XP and its successors that do not include Windows Media Player or Windows Messenger functionality. We also may distribute a second modified version of Windows that contains the media and messenger features, as long as it includes promotional links to certain competing media players and instant messengers. We have appealed the KFTC's decision to the Seoul High Court. In May 2006, the KFTC denied our motion for reconsideration of its ruling, but also dropped the element of its ruling that prohibited us from including media player or instant messaging functionality in any product other than the Windows client operating system for which we have a 50% or greater market share. In other ongoing investigations, various foreign governments and several state attorneys general have requested information from us concerning competition, privacy, and security issues.

Antitrust, unfair competition, and overcharge class actions. A large number of antitrust and unfair competition class action lawsuits have been filed against us in various state and federal courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals of damages claims of indirect purchasers under federal law and in 15 states. Courts refused to certify classes in two additional states. We have reached agreements to settle all claims in 20 states.

Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers.

The settlements in all states but Iowa have received final court approval. Settlements in Arkansas and Wisconsin received final court approval in March 2007. The Iowa case settled in February 2007 and the court gave its preliminary approval of the settlement in April 2007. The cases in Mississippi have not been settled. We estimate the total cost to resolve all of these cases will range between $1.7 billion and $1.9 billion. The actual cost depends on factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims. At June 30, 2007, we have recorded a liability related to these claims of approximately $1.2 billion, which reflects our estimated exposure of $1.7 billion less payments made to date of approximately $500 million, mostly for administrative expenses and legal fees.

Other antitrust litigation and claims. In November 2004, Novell, Inc. filed a complaint in U.S. District Court in Utah, now consolidated with other cases in Maryland, asserting antitrust and unfair competition claims against us related to Novell's ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. An appeal of that ruling is now pending and the case is effectively stayed during the appeal.

Patent and intellectual property claims. We are vigorously defending more than 45 patent infringement cases. In the case of *Eolas Technologies, Inc. and University of California v. Microsoft*, filed in U.S. District Court in Illinois in 1999, the plaintiffs alleged infringement by the browser functionality of Windows. In January 2004, the trial court entered final judgment of $565 million, and entered an injunction against distribution of any new infringing products, but stayed execution of the judgment and the injunction pending our appeal. We appealed and in March 2005 the U.S. Court of Appeals for the Federal Circuit reversed the decision and vacated the judgment, based on certain evidentiary rulings of the trial court. The appellate court also reversed the trial court's decision that the inventors had not engaged in inequitable conduct. Trial has been postponed indefinitely while the parties seek to settle the matter. A settlement is not expected to have a material effect on our financial position, results of operations, or cash flows.

Microsoft and Alcatel-Lucent Matters. Microsoft and Alcatel-Lucent are parties to a number of legal proceedings relating to certain patents of each of the companies. Some of these actions began before the merger of Alcatel and Lucent in 2006. For simplicity, we refer to the post-merger entity of Alcatel-Lucent throughout the following discussion.

- In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents. Alcatel-Lucent has asserted claims under these patents against computer manufacturers that sell computers with our operating system and application software pre-installed. In February 2007, the jury returned a verdict in Alcatel-Lucent's favor in the first of a series of patent trials, and awarded $1.5 billion in damages. The trial court has dismissed Alcatel-Lucent's claims with respect to a second group of patents and two patents in a third grouping. Trial on a newly-consolidated group of all remaining patents is scheduled to begin in February 2008.
- In March 2006, Alcatel-Lucent filed a lawsuit against us in U.S. District Court in California, claiming the Xbox 360 violates one of its patents. In response, we asserted counterclaims that Alcatel-Lucent infringes 10 Microsoft patents by its sales of various products. That case has been set for trial in April 2008.
- In November 2006, Alcatel-Lucent filed two patent infringement cases against us in U.S. District Court in Texas, asserting IPTV and various networking functionalities violate seven of its patents. In April 2007, we asserted infringement counterclaims based on four of our patents relating to functionality similar to that accused by Alcatel-Lucent. The trial on all of the patents is set for January 2009.
- In February 2007, we filed a complaint against Alcatel-Lucent with the International Trade Commission claiming Alcatel-Lucent is infringing four Microsoft patents related to our unified communications technology and seeking to prevent the import of certain Alcatel-Lucent unified communications products into the U.S. This matter has been set for trial in October 2007.
- In April 2007, the Multimedia Patent Trust filed a complaint against Microsoft, Dell, and Gateway in San Diego, California accusing the parties of infringing three video-related patents that originally belonged to Alcatel-Lucent. Alcatel-Lucent created the Multimedia Patent Trust prior to the companies' merger and transferred the patents at issue to the trust. Motions challenging the validity of the trust and Alcatel-Lucent's transfer of these patents to it will be heard in September 2007.

The actual costs to resolve these cases will depend upon many factors such as the outcome of post-trial motions, any appeals, and the results of the remaining trials.

In *Z4 Technologies, Inc. v. Microsoft,* filed in U.S. District Court in Texas in September 2004, the plaintiff alleged that Microsoft Windows and Office product activation functionality violates its patent rights. In April 2006, the jury rendered a $115 million verdict against us. In August 2006, the trial court increased damages by $25 million pursuant to the jury's finding of willful infringement and awarded Z4 $2 million in attorneys' fees. We have appealed the verdict.

In *Veritas Operating Corporation v. Microsoft*, filed in U.S. District Court in Washington in May 2006, a subsidiary of Symantec filed an action asserting trade secret misappropriation, breach of contract, and patent infringement relating to certain storage technologies.

Adverse outcomes in some or all of the matters described in this section may result in significant monetary damages or injunctive relief against us that would adversely affect distribution of our operating system or application products. We may enter into material settlements because of these risks.

Other. We are also subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

As of June 30, 2007, we had accrued aggregate liabilities of approximately $800 million in other current liabilities and approximately $800 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could be up to $4.15 billion in aggregate beyond recorded amounts. Were an unfavorable final outcome to occur, there exists the possibility of a material adverse impact on the Company's financial position and on the results of operations for the period in which the effect becomes reasonably estimable

NOTE 18 SEGMENT INFORMATION

Segment revenue and operating income/(loss) was as follows:

(In millions)

Year Ended June 30	**2007**	**2006**	**2005**
Revenue:			
Client	**$14,812**	$13,040	$11,901
Server and Tools	**11,182**	9,680	8,314
Online Services Business	**2,474**	2,306	2,353
Microsoft Business Division	**16,381**	14,516	13,298
Entertainment and Devices Division	**6,132**	4,808	3,485
Unallocated and other	**141**	(68)	437
Consolidated	**$51,122**	$44,282	$39,788

Year Ended June 30	**2007**	**2006**	**2005**
Operating Income/(Loss):			
Client	**$11,544**	$10,245	$9,435
Server and Tools	**3,837**	3,171	2,381
Online Services Business	**(745)**	115	470
Microsoft Business Division	**10,724**	9,687	9,146
Entertainment and Devices Division	**(2,066)**	(1,284)	(464)
Reconciling amounts	**(4,770)**	(5,462)	(6,407)
Consolidated	**$18,524**	$16,472	$14,561

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. This standard requires segmentation based on our internal organization and reporting of revenue and operating income based upon internal accounting methods. Our financial reporting systems present various data for management to operate the business, including internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. In July 2006 we announced a change in our operating segments from seven to five reflecting previously announced reorganizations. Amounts for fiscal years 2006 and 2005 have been recast to conform to the current management view. The segments are designed to allocate resources internally and provide a framework to determine management responsibility. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our Chief Executive Officer. Our five segments are Client; Server and Tools; Online Services Business; Microsoft Business Division; and Entertainment and Devices Division.

The types of products and services provided by each segment are summarized below:

Client – Windows Vista, including Home, Home Premium, Ultimate, Business, and Enterprise Starter Edition; Windows XP Professional and Home; Media Center Edition; Tablet PC Edition; and other standard Windows operating systems.

Server and Tools – Windows Server operating system; Microsoft SQL Server; Microsoft Enterprise Services; product support services; Visual Studio; System Center products; Forefront Security products; Biz Talk Server; MSDN; and TechNet, among others.

Online Services Business – MSN Search; MapPoint; MSN Internet Access; MSN Premium Web Services (consisting of MSN Internet Software Subscription, MSN Hotmail Plus, MSN Bill Pay, and MSN Radio Plus); Windows Live; and MSN Mobile Services.

Microsoft Business Division – Microsoft Office; Microsoft Project; Microsoft Visio; Microsoft Office SharePoint Server; Microsoft Exchange Server; Microsoft Exchange Hosted Services; Microsoft Office Live Meeting; Microsoft Office Communication Server; Microsoft Office Communicator; Microsoft Tellme Service; Microsoft Dynamics AX; Microsoft Dynamics CRM; Microsoft Dynamics GP; Microsoft Dynamics NAV; Microsoft Dynamics SL; Microsoft Dynamics Retail Management System; Microsoft Partner Program; and Microsoft Office Accounting.

Entertainment and Devices Division – Xbox 360 console and games; Xbox Live; Zune; Mediaroom; numerous consumer software and hardware products; Windows Mobile software platform; Windows Embedded device operating system; and Windows Automotive.

Because of our integrated business structure, operating costs included in one segment may benefit other segments, and therefore these segments are not designed to measure operating income or loss directly related to the products included in each segment. Inter-segment cost commissions are estimated by management and used to compensate or charge each segment for such shared costs and to incent shared efforts. Management will continually evaluate the alignment of product development organizations, sales organizations, and inter-segment commissions for segment reporting purposes, which may result in changes to segment allocations in future periods.

Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each segment and it is impracticable for us to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

Reconciling amounts include adjustments to conform with U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, period-end cut-off timing, and accelerated amortization for depreciation, stock awards, and performance-based stock awards. In addition, certain revenue and expenses are excluded from segments or included in corporate-level activity including certain legal settlements and accruals for legal contingencies.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Significant reconciling items were as follows:

(In millions) Year Ended June 30	2007	2006	2005
Summary of reconciling amounts:			
Corporate-level activity[(1)]	**$(5,193)**	$(5,122)	$(5,932)
Stock-based compensation expense	**124**	(174)	(1,042)
Revenue reconciling amounts	**119**	(68)	437
Other	**180**	(98)	130
Total	**$(4,770)**	$(5,462)	$(6,407)

(1) Corporate-level activity excludes stock-based compensation expense and revenue reconciling amounts presented separately in those line items.

No sales to an individual customer accounted for more than 10% of fiscal year 2007 revenue. Sales to Dell and its subsidiaries accounted for approximately 11% and 10% of fiscal year 2006 and 2005 revenue, respectively. These sales were made primarily through our OEM and volume licensing channels and cover a broad array of products including Windows PC operating systems, Microsoft Office, and server products.

Revenue, classified by the major geographic areas in which our customers are located, were as follows:

(In millions) Year Ended June 30	2007	2006	2005
United States[(1)]	**$31,346**	$27,957	$25,427
Other countries	**19,776**	16,325	14,361
Total	**$51,122**	$44,282	$39,788

(1) Includes shipments to customers in the United States and licensing to certain OEMs and multinational organizations. In fiscal year 2007, the Company refined its revenue allocation methodology and has revised prior year amounts accordingly.

Long-lived assets, classified by the geographic location of the controlling statutory company in which that company operates, were as follows:

(In millions) Year Ended June 30	2007	2006
United States	**$9,121**	$6,661
Other countries	**866**	788
Total	**$9,987**	$7,449

QUARTERLY INFORMATION

(In millions, except per share amounts) (Unaudited)

Quarter Ended	Sep. 30	Dec. 31	Mar. 31	June 30	Total
Fiscal year 2007					
Revenue	**$10,811**	**$12,542**[(1)]	**$14,398**[(2)]	**$13,371**	**$51,122**
Gross profit	**9,115**	**8,922**	**12,258**	**10,134**	**40,429**
Net income	**3,478**	**2,626**	**4,926**	**3,035**[(3)]	**14,065**
Basic earnings per share	**0.35**	**0.27**	**0.51**	**0.32**	**1.44**
Diluted earnings per share	**0.35**	**0.26**	**0.50**	**0.31**	**1.42**
Fiscal year 2006					
Revenue	$ 9,741	$11,837	$10,900	$11,804	$44,282
Gross profit	8,488	9,598	8,872	9,674	36,632
Net income	3,141[(4)]	3,653	2,977[(5)]	2,828[(6)]	12,599
Basic earnings per share	0.29	0.35	0.29	0.28	1.21
Diluted earnings per share	0.29	0.34	0.29	0.28	1.20
Fiscal year 2005					
Revenue	$ 9,189	$10,818	$ 9,620	$10,161	$39,788
Gross profit	7,784	8,943	8,257	8,773	33,757
Net income	2,528[(7)]	3,463	2,563[(8)]	3,700[(9)]	12,254
Basic earnings per share	0.23	0.32	0.24	0.34	1.13
Diluted earnings per share	0.23	0.32	0.23	0.34	1.12

(1) Reflects $1.64 billion of revenue deferred to the third quarter of fiscal year 2007 for the Express Upgrade to Windows Vista and Microsoft Office Technology guarantee programs and pre-shipments of Windows Vista and the 2007 Microsoft Office system.
(2) Includes $1.64 billion of revenue discussed above and charges totaling $296 million (pre-tax) related to various legal matters.
(3) Includes $1.06 billion charge related to the Xbox 360 warranty policy, inventory write-downs, and product returns.
(4) Includes charge of $361 million (pre-tax) related to the settlement with RealNetworks, Inc.
(5) Includes charges of $397 million (pre-tax) related to various legal matters.
(6) Includes charge of €281 million ($351 million) as a result of the fine imposed by the European Commission in July 2006.
(7) Includes charges totaling $536 million (pre-tax) related to the settlement of certain litigation with Novell, Inc.
(8) Includes charges totaling $768 million (pre-tax) related to the Gateway, Inc. and Burst.com settlements, Sun Microsystems, Inc., and additional charges related to anti-trust and certain other matters.
(9) Includes charges totaling $756 million (pre-tax) related to IBM and other matters.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2007 and 2006, and the related consolidated statements of income, cash flows, and stockholders' equity for each of the three years in the period ended June 30, 2007. 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 the standards of the Public Company Accounting Oversight Board (United States). 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, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2007, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of June 30, 2007, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 3, 2007, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
August 3, 2007

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective.

REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the company. Internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of our financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes maintaining records that in reasonable detail accurately and fairly reflect our transactions; providing reasonable assurance that transactions are recorded as necessary for preparation of our financial statements; providing reasonable assurance that receipts and expenditures of company assets are made in accordance with management authorization; and providing reasonable assurance that unauthorized acquisition, use or disposition of company assets that could have a material effect on our financial statements would be prevented or detected on a timely basis. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected.

Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of June 30, 2007. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Deloitte & Touche LLP has audited this assessment of our internal control over financial reporting; their report follows.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited management's assessment, included in the accompanying Report of Management on Internal Control over Financial Reporting, that Microsoft Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of June 30, 2007, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of June 30, 2007, is fairly stated, in all material respects, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2007, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended June 30, 2007 of the Company and our report dated August 3, 2007 expressed an unqualified opinion on those financial statements.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
August 3, 2007

DIRECTORS AND EXECUTIVE OFFICERS OF MICROSOFT CORPORATION

DIRECTORS

William H. Gates III
Chairman of the Board,
Microsoft Corporation

Steven A. Ballmer
Chief Executive Officer,
Microsoft Corporation

James I. Cash Jr., PhD. [1,2,5]
Former James E. Robison
Professor,
Harvard Business School

Dina Dublon [1,2,3]
Former Chief Financial Officer,
JPMorgan Chase

Raymond V. Gilmartin [4,5]
Former Chairman, President, Chief
Executive Officer, Merck & Co., Inc.

Reed Hastings [3]
Founder, Chairman and Chief
Executive Officer, Netflix, Inc.

David F. Marquardt [3,4]
General Partner, August Capital

Charles H. Noski [1,3]
Former Vice Chairman,
AT&T Corporation

Dr. Helmut Panke [2,5]
Former Chairman of the Board of
Management, BMW AG

Jon A. Shirley [3]
Former President, Chief Operating
Officer,
Microsoft Corporation

Board Committees
1. Audit Committee
2. Compensation Committee
3. Finance Committee
4. Governance and Nominating Committee
5. Antitrust Compliance Committee

EXECUTIVE OFFICERS

William H. Gates III
Chairman of the Board

Steven A. Ballmer
Chief Executive Officer

Robert J. (Robbie) Bach
President, Entertainment and Devices
Division

Lisa E. Brummel
Senior Vice President, Human
Resources

Kevin R. Johnson
President, Platforms and Services
Division

Christopher P. Liddell
Senior Vice President and Chief
Financial Officer

Jeffrey S. Raikes
President, Microsoft Business
Division

Bradford L. Smith
Senior Vice President, General
Counsel and Secretary

B. Kevin Turner
Chief Operating Officer

www.microsoft.com/msft

Investor Relations

You can contact the Microsoft Investor Relations group at any time to order financial documents such as annual reports and Form 10-Ks free of charge.

Call us toll-free at (800) 285-7772 or outside the United States, call (425) 706-4400. We can be contacted between the hours of 8:30 a.m. to 5:30 p.m. Pacific Time to answer investment oriented questions about Microsoft.

For access to additional financial information, visit the Investor Relations website online at:
www.microsoft.com/msft

You may also contact us by fax at (425) 706-8000.

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One Microsoft Way
Redmond, Washington 98052-6399

Annual Meeting

8:00 a.m. Pacific Time November 13, 2007
Washington State Convention & Trade Center
800 Convention Place
Seattle, Washington 98101

Registered Shareholder Services

Mellon Investor Services, 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

Mellon Investor Services also administers a direct stock purchase plan and a dividend reinvestment program for us.

To find out more about these services and programs you may contact Mellon Investor Services directly at 800-285-7772, option 4 between the hours of 6:00 a.m. and 4:00 p.m. Pacific Time, Monday through Friday or visit Mellon's Investor Service Direct(SM) online at:
http://www.melloninvestor.com/isd

You can e-mail the transfer agent at:
msft@melloninvestor.com

You can also send mail to the transfer agent at:
Mellon Investor Services
P.O. Box 358015
Pittsburgh, PA 15252

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 account can contact their broker to request consolidation of their accounts.

Shareholders can sign up for electronic alerts to access the annual report and proxy statement online. The service gets you the information you need faster and also gives you the power and convenience of online proxy voting. To sign up for this free service, visit the Annual Report site on the Investor Relations website at:
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