

MICROSOFT CORP
Form 10-Q
April 26, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended March 31, 2007

OR

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

For the Transition Period From to

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of

incorporation or organization)

One Microsoft Way, Redmond, Washington
(Address of principal executive offices)

91-1144442
(I.R.S. Employer
Identification No.)

98052-6399
(Zip Code)

(425) 882-8080

Edgar Filing: MICROSOFT CORP - Form 10-Q

(Registrant's telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 23, 2007
Common Stock, \$0.00000625 par value per share	9,566,808,383 shares

Table of Contents

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended March 31, 2007

INDEX

	Page
<i>Part I.</i> <u>Financial Information</u>	
Item 1. <u>Financial Statements</u>	
a) <u>Income Statements for the Three and Nine Months Ended March 31, 2007 and 2006</u>	1
b) <u>Balance Sheets as of March 31, 2007 and June 30, 2006</u>	2
c) <u>Cash Flows Statements for the Three and Nine Months Ended March 31, 2007 and 2006</u>	3
d) <u>Stockholders' Equity Statements for the Three and Nine Months Ended March 31, 2007 and 2006</u>	4
e) <u>Notes to Financial Statements</u>	5
f) <u>Report of Independent Registered Public Accounting Firm</u>	14
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	28
Item 4. <u>Controls and Procedures</u>	29
<i>Part II.</i> <u>Other Information</u>	
Item 1. <u>Legal Proceedings</u>	30
Item 1A. <u>Risk Factors</u>	30
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	37
Item 6. <u>Exhibits</u>	37
<u>Signature</u>	38

Table of Contents**Part I. Financial Information****Item 1. Financial Statements****MICROSOFT CORPORATION****INCOME STATEMENTS****(In millions, except per share amounts)(Unaudited)**

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2007	2006	2007	2006
Revenue	\$ 14,398	\$ 10,900	\$ 37,751	\$ 32,478
Operating expenses:				
Cost of revenue	2,140	2,028	7,456	5,520
Research and development	1,750	1,617	5,173	4,723
Sales and marketing	2,936	2,362	8,126	6,996
General and administrative	983	1,005	2,461	2,648
Total operating expenses	7,809	7,012	23,216	19,887
Operating income	6,589	3,888	14,535	12,591
Investment income and other	382	427	1,282	1,413
Income before income taxes	6,971	4,315	15,817	14,004
Provision for income taxes	2,045	1,338	4,787	4,233
Net income	\$ 4,926	\$ 2,977	\$ 11,030	\$ 9,771
Earnings per share:				
Basic	\$ 0.51	\$ 0.29	\$ 1.12	\$ 0.93
Diluted	\$ 0.50	\$ 0.29	\$ 1.11	\$ 0.92
Weighted average shares outstanding:				
Basic	9,725	10,303	9,821	10,521
Diluted	9,862	10,415	9,955	10,627
Cash dividends declared per common share	\$ 0.10	\$ 0.09	\$ 0.30	\$ 0.26

See accompanying notes.

Table of Contents**MICROSOFT CORPORATION****BALANCE SHEETS****(In millions)**

	March 31, 2007	June 30, 2006(1)
	(Unaudited)	
Assets		
Current assets:		
Cash and equivalents	\$ 7,611	\$ 6,714
Short-term investments (including securities pledged as collateral of \$2,758 and \$3,065)	20,625	27,447
Total cash, equivalents, and short-term investments	28,236	34,161
Accounts receivable, net of allowance for doubtful accounts of \$141 and \$142	8,454	9,316
Inventories, net	1,750	1,478
Deferred income taxes	1,969	1,940
Other	2,374	2,115
Total current assets	42,783	49,010
Property and equipment, net	3,923	3,044
Equity and other investments	9,624	9,232
Goodwill	4,217	3,866
Intangible assets, net	699	539
Deferred income taxes	1,417	2,611
Other long-term assets	1,228	1,295
Total assets	\$ 63,891	\$ 69,597
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	\$ 2,843	\$ 2,909
Accrued compensation	1,878	1,938
Income taxes	1,930	1,557
Short-term unearned revenue	8,551	9,138
Securities lending payable	3,032	3,117
Other	3,393	3,783
Total current liabilities	21,627	22,442
Long-term unearned revenue	1,732	1,764
Other long-term liabilities	5,559	5,287
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding 9,572 and 10,062	60,827	59,005
Retained deficit, including accumulated other comprehensive income of \$1,535 and \$1,229	(25,854)	(18,901)
Total stockholders equity	34,973	40,104
Total liabilities and stockholders equity	\$ 63,891	\$ 69,597

(1) Derived from audited financial statements

See accompanying notes.

Table of Contents**MICROSOFT CORPORATION****CASH FLOWS STATEMENTS****(In millions)(Unaudited)**

	Three Months Ended		Nine Months Ended	
	March 31,		March 31,	
	2007	2006	2007	2006
Operations				
Net income	\$ 4,926	\$ 2,977	\$ 11,030	\$ 9,771
Depreciation, amortization, and other noncash items	445	177	1,059	642
Stock-based compensation expense	321	374	1,214	1,352
Net recognized gains on investments	(61)	(59)	(296)	(264)
Excess tax benefits from stock-based payment arrangements	(7)	(23)	(55)	(67)
Deferred income taxes	981	(271)	630	(229)
Unearned revenue	4,551	3,670	13,797	10,372
Recognition of unearned revenue	(6,121)	(3,615)	(14,436)	(10,656)
Accounts receivable	1,455	972	1,011	368
Other current assets	7	(134)	(350)	(828)
Other long-term assets	(32)	(4)	(431)	(12)
Other current liabilities	772	229	(424)	(69)
Other long-term liabilities	54	270	645	743
Net cash from operations	7,291	4,563	13,394	11,123
Financing				
Common stock issued	784	442	5,618	1,909
Common stock repurchased	(6,878)	(4,675)	(20,358)	(15,226)
Common stock cash dividends	(976)	(925)	(2,853)	(2,628)
Excess tax benefits from stock-based payment arrangements	7	23	55	67
Other	0	0	(23)	0
Net cash used for financing	(7,063)	(5,135)	(17,561)	(15,878)
Investing				
Additions to property and equipment	(461)	(302)	(1,444)	(833)
Acquisition of companies, net of cash acquired	(41)	(83)	(502)	(333)
Purchases of investments	(7,257)	(10,082)	(29,214)	(45,643)
Maturities of investments	1,688	1,208	3,847	2,900
Sales of investments	6,264	8,755	32,413	46,836
Securities lending payable	318	1,337	(86)	1,337
Net cash from investing	511	833	5,014	4,264
Net change in cash and equivalents	739	261	847	(491)
Effect of exchange rates on cash and equivalents	13	7	50	(9)
Cash and equivalents, beginning of period	6,859	4,083	6,714	4,851
Cash and equivalents, end of period	\$ 7,611	\$ 4,351	\$ 7,611	\$ 4,351

See accompanying notes.

Table of Contents

MICROSOFT CORPORATION
STOCKHOLDERS EQUITY STATEMENTS

(In millions)(Unaudited)

	Three Months Ended		Nine Months Ended	
	March 31,		March 31,	
	2007	2006	2007	2006
Common stock and paid-in capital				
Balance, beginning of period	\$ 61,152	\$ 60,140	\$ 59,005	\$ 60,413
Common stock issued	782	443	5,616	1,732
Common stock repurchased	(1,499)	(1,052)	(4,605)	(3,412)
Stock-based compensation expense	321	374	1,214	1,352
Stock option income tax benefits/(deficiencies)	71	(55)	(410)	(236)
Other	0	0	7	1
Balance, end of period	60,827	59,850	60,827	59,850
Retained deficit				
Balance, beginning of period	(24,519)	(15,932)	(18,901)	(12,298)
Net income	4,926	2,977	11,030	9,771
Other comprehensive income:				
Net gains/(losses) on derivative instruments	(31)	(27)	(59)	109
Net unrealized investments gains/(losses)	(41)	(92)	296	(425)
Translation adjustments and other	25	6	69	(13)
Comprehensive income	4,879	2,864	11,336	9,442
Common stock cash dividends	(955)	(912)	(2,904)	(2,692)
Common stock repurchased	(5,259)	(3,832)	(15,385)	(12,264)
Balance, end of period	(25,854)	(17,812)	(25,854)	(17,812)
Total stockholders equity	\$ 34,973	\$ 42,038	\$ 34,973	\$ 42,038

See accompanying notes.

Table of Contents

MICROSOFT CORPORATION
NOTES TO FINANCIAL STATEMENTS

(Unaudited)

Note 1 Basis of Presentation and Consolidation***Basis of Presentation***

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). 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 life cycles, 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; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and the financial statements and notes thereto included in the Microsoft Corporation 2006 Form 10-K.

As discussed in Note 8, effective July 1, 2006, we reorganized our business into five operating segments, organized under one of three operating divisions. Accordingly, we have restated prior period segment information to conform to the current period presentation.

Basis 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 exercise 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 are accounted for under the cost method.

Note 2 Inventories, net

Components of inventories were as follows:

(In millions)	March 31, 2007	June 30, 2006
Finished goods	\$ 1,330	\$ 1,013
Raw materials and work in process	420	465
Inventories, net	\$ 1,750	\$ 1,478

Note 3 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.

Table of Contents**MICROSOFT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)***(Unaudited)*

Components of basic and diluted earnings per share were as follows:

(In millions, except earnings per share)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2007	2006	2007	2006
Net income available for common shareholders (A)	\$ 4,926	\$ 2,977	\$ 11,030	\$ 9,771
Weighted average outstanding shares of common stock (B)	9,725	10,303	9,821	10,521
Dilutive effect of employee stock options and awards	137	112	134	106
Common stock and common stock equivalents (C)	9,862	10,415	9,955	10,627
Earnings per share:				
Basic (A/B)	\$ 0.51	\$ 0.29	\$ 1.12	\$ 0.93
Diluted (A/C)	\$ 0.50	\$ 0.29	\$ 1.11	\$ 0.92

The following shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. In addition, the following shared performance stock awards 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.

(In millions)	Three Months Ended		Nine Months Ended	
	March 31, 2007	March 31, 2006	March 31, 2007	March 31, 2006
Shares excluded from calculation of diluted EPS	230	556	248	563
Shared performance stock awards excluded from calculation of diluted EPS	10	19	10	19

Note 4 Unearned Revenue

Components of unearned revenue were as follows:

(In millions)	March 31, 2007	June 30, 2006
Volume licensing programs	\$ 6,946	\$ 7,661
Undelivered elements	1,968	2,066
Other	1,369	1,175
Unearned revenue	\$ 10,283	\$ 10,902

Unearned revenue by segment was as follows:

Edgar Filing: MICROSOFT CORP - Form 10-Q

(In millions)	March 31, 2007	June 30, 2006
Client	\$ 2,684	\$ 2,851
Server and Tools	2,825	2,910
Microsoft Business Division	4,341	4,783
Other	433	358
Unearned revenue	\$ 10,283	\$ 10,902

Table of Contents**MICROSOFT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)***(Unaudited)***Note 5 Stockholders Equity**

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a \$20.0 billion tender offer, which was completed on August 17, 2006; and authorization for up to an additional \$20.0 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 \$3.8 billion at a price per share of \$24.75. On August 18, 2006, we announced that the authorization for the \$20.0 billion ongoing share repurchase program had been increased by approximately \$16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to \$36.2 billion through June 30, 2011. As of March 31, 2007, approximately \$22.5 billion remained of the \$36.2 billion approved repurchase amount. All repurchases were made using cash resources. The repurchase program may be suspended or discontinued at any time without notice. In any period, cash used in financing activities related to common stock repurchased may differ from the comparable change in stockholders equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

We repurchased common stock in fiscal year 2006 pursuant to the repurchase program approved by our Board of Directors on July 20, 2004 to buy back up to \$30.0 billion of Microsoft common stock. On July 20, 2006, we announced the completion of that repurchase program. The repurchases were made using our cash resources.

We repurchased the following shares of common stock under the above-described repurchase plans:

	Nine Months Ended			
	Three Months Ended		March 31,	
	2007	2006	2007	2006
Shares of common stock repurchased (in millions)	237	181	728	578
Value of common stock repurchased (in billions)	\$ 6.7	\$ 4.9	\$ 19.7	\$ 15.6

In December 2006, JP Morgan Chase Bank (JPMorgan) exercised approximately 113 million call options for \$3.3 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.

During the nine months ended March 31, 2007 and 2006, our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
<i>(Fiscal year 2007)</i>				
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	\$ 957(1)	June 14, 2007
<i>(Fiscal year 2006)</i>				
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

Edgar Filing: MICROSOFT CORP - Form 10-Q

- (1) This dividend was included in other current liabilities on our balance sheet as of March 31, 2007.

Table of Contents**MICROSOFT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)***(Unaudited)***Note 6 Investment Income and Other**

Components of investment income and other were as follows:

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2007	2006	2007	2006
Dividends and interest	\$ 333	\$ 369	\$ 1,018	\$ 1,127
Net recognized gains on investments	39	67	505	305
Net gains/(losses) on derivatives	22	(8)	(209)	(107)
Other, net	(12)	(1)	(32)	88
Investment income and other	\$ 382	\$ 427	\$ 1,282	\$ 1,413

Note 7 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. On March 1, 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 (\$2.7 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 March 31, 2007 is \$1.2 billion. We have submitted a written response to the statement of objections and are seeking to determine the royalty rates that the Commission will deem reasonable.

In December 2005, the Korean Fair Trade Commission (KFTC) ruled in its investigation of us 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. On

Table of Contents

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

August 23, 2006, we released the mandated versions of Windows XP Home Edition and Windows XP Professional Edition.

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 March 31, 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 35 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. The actual costs will depend upon many unknown factors such as the outcome of a retrial of the plaintiff's claims.

Table of Contents

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

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. Trial on a third group of patents is scheduled to begin in May 2007. The court has not assigned a trial date on an additional group of patents.

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. The case is set for trial in 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.

The actual costs to resolve these cases will depend upon many unknown 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.

Table of Contents

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of March 31, 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 \$3.7 billion in aggregate beyond recorded amounts. One or more unfavorable outcomes may result in a material adverse impact on the Company's future financial position, results of operations, and cash flows.

Note 8 Segment Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, 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 run the business, including internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. Effective July 1, 2006, we reorganized our business into five operating segments, organized under one of three operating divisions—Platforms and Services Division, Microsoft Business Division, and Entertainment and Devices Division.

The five operating segments are described below. The first three of these comprise the Platforms and Services Division.

Client includes the former Client segment. Client generates nearly all of its revenue from the licensing of the Windows line of operating systems, including Windows Vista, Windows XP Professional and Home, Media Center Edition, Tablet PC Edition, and other standard Windows operating systems.

Server and Tools includes the former Server and Tools segment, excluding Exchange Server, Exchange client access licenses and a portion of Core client access licenses that are now a part of the Microsoft Business Division. Server and Tools generates revenues from the following products: Windows Server operating system, Microsoft SQL Server, Visual Studio, Forefront security family of products, and Biz Talk Server among others. In addition, Server and Tools provides the following services: Microsoft Consulting Services; Premier; and professional support services.

Online Services Business (OSB) includes the former MSN segment and Windows Live. OSB derives its revenue principally through the delivery of online advertising. OSB also generates services revenue through providing the following online offerings: MSN Internet Access; MSN Premium Web Services (consisting of MSN Internet Software Subscriptions, MSN Hotmail Plus, MSN Bill Pay, and MSN Radio Plus); and MSN Mobile Services.

Microsoft Business Division (MBD) includes the former Information Worker and Microsoft Business Solutions segments, and the Exchange Server business and certain client access licenses formerly included in the Server and Tools segment. MBD derives its revenues principally through the Microsoft Office system which includes: Microsoft Office, Microsoft Project; Microsoft Visio; Microsoft Access; SharePoint Portal Server client access licenses; OneNote; Office Communication Server; Microsoft Office Small Business Accounting; and revenues generated by Microsoft LiveMeeting. Product revenues are also derived through licensing the Dynamics suite of software including: Microsoft Dynamics AX; Microsoft Dynamics CRM; Microsoft Dynamics GP; Microsoft Dynamics NAV; Microsoft Dynamics SL; and Microsoft Dynamics Retail Management System.

Entertainment and Devices Division (EDD) includes the former Home and Entertainment and Mobile and Embedded Devices segments. EDD generates product revenues through both hardware and software sales

Table of Contents

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

and licensing. The Xbox 360 console generates the majority of hardware revenue with the remainder driven by consumer peripherals and accessories, including the Zune digital music and entertainment device. Software revenues are generated by Xbox games; games for Windows; Mac Office; MSTV Platforms; Windows Mobile software platform and Windows Embedded device operating system. Online services revenues are generated by certain product support and Xbox Live.

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

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2007	2006	2007	2006
Revenue				
Client	\$ 5,279	\$ 3,135	\$ 11,110	\$ 9,721
Server and Tools	2,755	2,396	8,105	6,970
OSB	622	564	1,785	1,725
MBD	4,833	3,612	11,769	10,582
EDD	947	1,165	4,968	3,464
Unallocated and other	(38)	28	14	16
Consolidated	\$ 14,398	\$ 10,900	\$ 37,751	\$ 32,478
Operating income/(loss)				
Client	\$ 4,280	\$ 2,475	\$ 8,731	\$ 7,755
Server and Tools	938	748	2,837	2,256
OSB	(205)	(29)	(496)	183
MBD	3,393	2,406	7,787	7,155
EDD	(330)	(438)	(749)	(894)
Reconciling amounts	(1,487)	(1,274)	(3,575)	(3,864)
Consolidated	\$ 6,589	\$ 3,888	\$ 14,535	\$ 12,591

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. Intersegment cost commissions are estimated by management and used to compensate or charge each segment for such shared costs and to incent shared efforts.

Reconciling amounts include adjustments to conform significant internal accounting policies with U.S. GAAP and corporate-level activity not specifically attributed to a segment. Certain revenue and expenses, including legal settlements and legal contingencies, are excluded from segments or included in corporate-level activity. Significant reconciling items to arrive at operating income were as follows:

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2007	2006	2007	2006
Summary of reconciling amounts:				
Corporate-level activity	\$ (1,540)	\$ (1,331)	\$ (3,754)	\$ (3,629)

Edgar Filing: MICROSOFT CORP - Form 10-Q

Stock-based compensation expense	103	0	44	(264)
Revenue reconciling amounts	(34)	28	(7)	16
Other	(16)	29	142	13
Total	\$ (1,487)	\$ (1,274)	\$ (3,575)	\$ (3,864)

Table of Contents**MICROSOFT CORPORATION****NOTES TO FINANCIAL STATEMENTS (Continued)***(Unaudited)***Note 9 Goodwill**

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

(In millions)

	Balance as of July 1, 2006	Acquisitions /purchase accounting adjustments	Balance as of September 30, 2006	Acquisitions /purchase accounting adjustments	Balance as of December 31, 2006	Acquisitions /purchase accounting adjustments	Balance as of March 31, 2007
Client	\$ 74	\$	\$ 74	\$ (2)	\$ 72	\$ 5	\$ 77
Server and Tools	256	295	551	12	563	17	580
Online Services Business	455	4	459	47	506	3	509
Microsoft Business Division	2,682	(11)	2,671	(45)	2,626	(1)	2,625
Entertainment and Devices Division	399	(1)	398	24	422	4	426
Total	\$ 3,866	\$ 287	\$ 4,153	\$ 36	\$ 4,189	\$ 28	\$ 4,217

During the nine months ended March 31, 2007, we acquired Softricity, Inc., a provider of application virtualization and dynamic streaming technologies, and ten other companies for total consideration of approximately \$550 million, which was primarily paid in cash. As a result of these acquisitions, we recorded \$433 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 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.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation) as of March 31, 2007, and the related consolidated statements of income, stockholders equity, and cash flows for the three-month and nine-month periods ended March 31, 2007 and 2006. These interim financial statements are the responsibility of the Corporation s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2006, and the related consolidated statements of income, stockholders equity, and cash flows for the year then ended (not presented herein); and in our report dated August 22, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2006 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

DELOITTE & TOUCHE LLP

/s/ DELOITTE & TOUCHE LLP
Seattle, Washington

April 25, 2007

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Special Note About Forward-Looking Statements**

Certain statements in Management's Discussion and Analysis (MD&A), 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, 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 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 (refer to Part II, Item 1A). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

OVERVIEW

The following MD&A is intended to help the reader understand the results of operations, financial condition, and cash flows 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 Live Search capabilities.

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. 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, Entertainment and Devices has generated over 40% of its yearly segment revenues in our second fiscal quarter. We believe the seasonality of revenue is likely to continue in the future.

Summary

(In millions, except percentages)	Three months ended		Percentage Change	Nine months ended		Percentage Change
	March 31,			March 31,		
	2007	2006		2007	2006	
Revenue	\$ 14,398	\$ 10,900	32%	\$ 37,751	\$ 32,478	16%
Operating income	\$ 6,589	\$ 3,888	69%	\$ 14,535	\$ 12,591	15%

For the three months ended March 31, 2007, our revenue growth was driven primarily by licensing of Windows Vista and the 2007 Microsoft Office system, both of which became available to consumers in January 2007, and increased licensing of Windows Server, SQL Server, and Visual Studio. During the quarter, we

Table of Contents

recognized approximately \$1.7 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 consumers 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 revenue increase for the nine months ended March 31, 2007 was driven primarily by licensing of Windows Vista and the 2007 Microsoft Office system, sales of the Xbox 360 console which was launched in November 2005, and increased licensing of SQL Server, Windows Server, and Visual Studio.

For the three months ended March 31, 2007, operating income increased driven primarily by the increased revenue, partially offset by increased headcount-related costs and increased marketing and advertising expenses primarily related to our recent product launches. The increase in operating income during the quarter also reflects a decrease in cost of revenue due to a shift to products with higher margins. For the nine months ended March 31, 2007, operating income increased driven primarily by the increased revenue, partially offset by increased costs of revenue associated with the Xbox 360 console and increased headcount-related costs as we continue to invest in offerings such as the Windows Live platform and recently launched products such as the 2007 Microsoft Office system, Windows Vista and Zune. Headcount-related costs, increased 15% during the three and nine months ended March 31, 2007, reflecting a 13% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount, partially offset by a decrease in stock-based compensation expense.

We expect revenue to continue to grow during the fourth quarter of fiscal year 2007 compared to the same quarter of the prior year primarily due to our recent product launches. We estimate that PC unit growth for the quarter will be 10% to 12%. Within the overall PC market, we expect current trends to continue with consumer segment growth exceeding that of the business segment and emerging market growth exceeding that of mature markets. We also expect operating income to continue to grow during the fourth quarter of fiscal year 2007 compared to the same quarter of the prior year.

SEGMENT PRODUCT REVENUE AND OPERATING INCOME (LOSS)

Revenue and operating income/(loss) amounts in this section are presented on a basis consistent with U.S. GAAP and include certain reconciling items that have been attributed to each of the segments. Segment information appearing in Note 8 Segment Information of the Notes is presented on a basis consistent with the Company's current 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 segment operating results and is presented separately. Fiscal year 2006 amounts have been restated for certain internal reorganizations.

Client

(In millions, except percentages)	Three months ended March 31,		Percentage Change	Nine months ended March 31,		Percentage Change
	2007	2006		2007	2006	
Revenue	\$ 5,272	\$ 3,151	67%	\$ 11,164	\$ 9,742	15%
Operating income	\$ 4,244	\$ 2,496	70%	\$ 8,785	\$ 7,750	13%

Client consists 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

Table of Contents

systems as a percentage of total OEM Windows operating systems licensed (OEM premium mix), changes in the geographical mix, and the channel mix of products sold by large, multi-national OEMs versus those sold by local and regional system builders.

Client revenue increased for the three months ended March 31, 2007, primarily reflecting licensing of Windows Vista, including recognition of approximately \$1.2 billion of revenue previously deferred in fiscal year 2007 pending the January 2007 release to consumers. The increased revenue also reflects 20% growth in OEM license units from increased PC unit shipments and retail sales. During the quarter, the OEM premium mix increased 18 percentage points over the prior year to 71% driven by the demand for Windows Vista Home Premium. Client revenue increased during the nine months ended March 31, 2007, reflecting the increased revenue primarily associated with Windows Vista and 13% growth in OEM license units from increased PC unit shipments. The increase during the nine months ended March 31, 2007 also reflects growth in OEM revenue of \$1.0 billion or 13% and growth in commercial and retail licensing of Windows operating systems of \$384 million or 27%. Based on our preliminary estimates, total worldwide PC shipments from all sources grew 10% to 12% from the third quarter of the previous year and approximately 8% to 10% from the first nine months of the previous year driven by strong consumer demand in both emerging and mature markets.

Client operating income increased during the three and nine months ended March 31, 2007, reflecting the increased revenue, partially offset by increased sales and marketing expenses associated with the recent launch and increased costs of revenue, including support costs.

Headcount-related costs increased 6% during the three months ended March 31, 2007, reflecting an increase in salaries and benefits for existing headcount and a 1% increase in headcount, partially offset by decreased stock-based compensation expense. Headcount-related costs remained flat during the nine months ended March 31, 2007.

We expect revenue to continue to grow during the fourth quarter of fiscal year 2007, reflecting improvement in the commercial and retail portion of the business due to the launch of Windows Vista. 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

(In millions, except percentages)	Three months ended March 31,		Percentage Change	Nine months ended March 31,		Percentage Change
	2007	2006		2007	2006	
Revenue	\$ 2,749	\$ 2,396	15%	\$ 8,093	\$ 6,961	16%
Operating income	\$ 979	\$ 744	32%	\$ 2,846	\$ 2,122	34%

Server and Tools consists 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.

Server and server application revenue, including CAL revenue, and developer tools, training and certification revenue, increased \$237 million or 12% during the three months and \$880 million or 15% during the nine months ended March 31, 2007. This increase was primarily driven by increased revenue associated with Windows Server, SQL Server, and Visual Studio, and reflects broad adoption of Windows Server products. Overall revenue growth was also driven by Consulting, Premier, and Professional product support services revenue which grew \$116 million or 28% during the three months and \$252 million or 20% during the nine months ended March 31, 2007.

Table of Contents

Server and Tools operating income increased during the three and nine months ended March 31, 2007, primarily reflecting the increased revenue, partially offset by increased headcount-related costs and cost of revenue for services. Headcount-related costs increased 11% in the three months and 12% in the nine months ended March 31, 2007, respectively, reflecting an increase in salaries and benefits for existing headcount and a 13% increase in headcount, partially offset by a decrease in stock-based compensation. Cost of revenue increased \$63 million or 13% in the third quarter and \$156 million or 11% in the first nine months of fiscal year 2007, reflecting the growth in consulting services provided.

We expect continued revenue growth from fiscal year 2006 product launches and the expansion of our products in security, management and overall Windows Server growth during the fourth quarter of fiscal year 2007. Market analysts currently forecast 4% to 6% growth in server hardware unit shipments in fiscal year 2007. In addition to server hardware growth, overall Server and Tools revenue is influenced by a number of factors, including spending on information technology services, licensing and purchasing patterns of enterprise companies, spending on database tools and management software and our ability to grow in those areas. Additional factors include our ability to develop and bring new products to market.

Online Services Business

(In millions, except percentages)	Three months ended		Percentage Change	Nine months ended		Percentage Change
	March 31,			March 31,		
	2007	2006		2007	2006	
Revenue	\$ 623	\$ 562	11%	\$ 1,786	\$ 1,719	4%
Operating income (loss)	\$ (200)	\$ (24)	*	\$ (494)	\$ 113	*

* Not meaningful

Online Services Business (OSB) includes personal communications services, such as e-mail and instant messaging, and 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 One Care. We derive 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. We continue to launch new online initiatives and expect to do so in the future. In the first nine months of fiscal year 2007, we launched 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, and other offerings.

OSB revenue increased during the three and nine months ended March 31, 2007, primarily driven by advertising revenue which increased \$85 million or 23% to \$456 million and \$179 million or 16% to \$1.3 billion, respectively, due primarily to growth in advertising for home page, email, and messaging services. The advertising revenue increases were partially offset by a \$37 million or 31% and a \$122 million or 31% decline in access revenue in the respective three and nine month periods. At March 31, 2007, OSB had 1.5 million access subscribers and 11 million total subscribers compared with 2.3 million access subscribers and 10.1 million total subscribers at March 31, 2006. In addition, we estimate that OSB has over 285 million active Hotmail accounts and over 278 million active Messenger accounts.

OSB operating income decreased for the three and nine months ended March 31, 2007, primarily reflecting increased headcount-related costs mainly as a result of continued investments in Windows Live and other properties, and increased cost of revenue as a result of costs associated with our data centers. Headcount-related costs increased 31% and 36%, respectively, during the three and nine months ended March 31, 2007, reflecting both a 24% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

Table of Contents

For fourth quarter of fiscal year 2007, we expect increased growth in advertising revenue as the portals, channels, and communications services continue to expand globally and the overall Internet advertising market continues to expand. Advertising revenue is expected to benefit from the transition to adCenter despite market share pressure, while revenue from narrowband Internet Access is expected to continue to decline.

Microsoft Business Division

(In millions, except percentages)	Three months ended		Percentage Change	Nine months ended		Percentage Change
	March 31,			March 31,		
	2007	2006		2007	2006	
Revenue	\$ 4,829	\$ 3,609	34%	\$ 11,764	\$ 10,581	11%
Operating income	\$ 3,421	\$ 2,405	42%	\$ 7,845	\$ 7,096	11%

Microsoft Business Division (MBD) consists of programs, servers, services, and solutions designed to increase personal, team, and organization productivity. MBD includes the Microsoft Office system, Microsoft Dynamics, and the Microsoft Partner Program. MBD also includes the Small and Mid-market Solutions & Partners organization, which focuses on helping Microsoft, its customers, and industry partners in the small and mid-market customer segments. Our Office System products represent over 90% of Microsoft Business Division revenues and include Microsoft Office, Microsoft Exchange Server and CALs, Microsoft Project, Microsoft Visio, Microsoft Office Communications Server, Microsoft Office SharePoint Server and CALs, Microsoft LiveMeeting, and OneNote. We grow revenue by adding value to the core Office product set and expanding our product offerings in other information worker and business solution areas such as document lifecycle management, collaboration, business intelligence, customer relationship management, and enterprise resource planning. We evaluate our results based upon the nature of the end user in two primary parts business revenue which includes revenue generated through volume licensing agreements and Microsoft Dynamics, and consumer revenue which includes revenue from retail packaged product sales, OEM revenue, and sales of pre-installed versions of Office in Japan.

MBD revenue increased during the three and nine months ended March 31, 2007, primarily reflecting sales of the 2007 Microsoft Office system, which was launched to consumers in January 2007. Revenue from consumer sales increased \$727 million or 81% during the three months ended March 31, 2007, reflecting the recognition of approximately \$500 million of revenue previously deferred in fiscal year 2007 prior to the launch. Revenue from business sales increased \$493 million or 18% and included a 20% increase in Microsoft Dynamics customer billings. During the nine months ended March 31, 2007, revenue from consumer sales increased \$239 million or 9% while revenue from business sales increased \$944 million or 12%.

MBD operating income increased during the three and nine months ended March 31, 2007, reflecting the increase in revenue partially offset by an increase in sales and marketing expenses and cost of revenue associated with the 2007 Microsoft Office system. During the three and nine months ended March 31, 2007, headcount-related costs increased 9% and 10%, respectively, reflecting a 7% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

In the fourth quarter of fiscal year 2007, we expect revenue to continue to increase over the prior year due to the recent launch of the 2007 Microsoft Office system. We continue to develop plans to grow revenue in new areas such as unified communications and through our existing portfolio of Microsoft Dynamics products.

Entertainment and Devices Division

(In millions, except percentages)	Three months ended		Percentage Change	Nine months ended		Percentage Change
	March 31,			March 31,		
	2007	2006		2007	2006	
Revenue	\$ 929	\$ 1,182	(21)%	\$ 4,923	\$ 3,475	42%
Operating loss	\$ (315)	\$ (402)	22%	\$ (693)	\$ (861)	20%

Table of Contents

Entertainment and Devices Division (EDD) products include the Microsoft Xbox video game console system, PC games, consumer software and hardware products, the Zune digital music and entertainment device, TV platform products for the interactive television industry, and Mobile and Embedded devices (principally Windows Mobile software platform and Windows Embedded device operating system). The success of video game consoles is determined by console innovation, 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 competitive consoles launched during 2006.

EDD revenue decreased during the three months ended March 31, 2007 primarily because of decreased Xbox 360 console sales. During the quarter, we shipped 0.5 million Xbox 360 consoles as compared to 1.7 million consoles in the third quarter of fiscal year 2006, which was the first full quarter of Xbox 360 console sales. Xbox and PC game revenue decreased \$393 million or 44% during the three months ended March 31, 2007 due to the decrease in console sales. Revenue from Zune, consumer hardware and software, and TV platforms increased \$103 million or 61% during the three months ended March 31, 2007, primarily reflecting the recent release of Zune and new consumer hardware products. Mobile and Embedded Devices revenue increased \$38 million or 30% during the three months ended March 31, 2007 driven by sales growth in Windows Mobile software and Windows Embedded operating systems.

EDD revenue increased during the nine months ended March 31, 2007 primarily due to increased Xbox 360 console sales, sales of Zune, and increased Xbox accessories and video game sales. We shipped approximately 5.9 million Xbox 360 consoles during the first nine months of fiscal year 2007. Since the Xbox 360 console was launched in November 2005, we have shipped approximately 11 million units. Xbox and PC game revenue increased \$914 million or 37% during the nine months ended March 31, 2007 as a result of the increased number of consoles sold and related accessories and video game sales. Revenue from Zune, consumer hardware and software, and TV platforms increased \$426 million or 68% during the nine months ended March 31, 2007, primarily reflecting the release of Zune and new consumer hardware products. Mobile and Embedded Devices revenue increased \$109 million or 31% during the nine months ended March 31, 2007, driven by sales growth in Windows Mobile software and Windows Embedded operating systems.

EDD operating loss decreased during the three months ended March 31, 2007 primarily due to decreased products costs from lower sales of Xbox 360 consoles and increased Mobile and Embedded Devices revenue, partially offset by expenses related to the launch of Zune and increased Xbox 360 console warranty expenses. EDD operating loss decreased during the nine months ended March 31, 2007 primarily due to increased Xbox 360 platform sales and improved Xbox 360 console margins, partially offset by expenses related to the launch of Zune and increased Xbox 360 console warranty expenses. Headcount-related costs increased 10% and 13% during the three and nine months ended March 31, 2007, reflecting an increase in salaries and benefits for existing headcount and a 13% increase in headcount, partially offset by decreased stock-based compensation expense.

For fiscal year 2007, we expect revenue to increase due to the increased availability of Xbox 360 during the entire fiscal year and sales of Zune after its November 2006 launch. Revenue from 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.

Corporate-Level Results

(In millions, except percentages)	Three months ended		Percentage Change	Nine months ended		Percentage Change
	March 31,			March 31,		
	2007	2006		2007	2006	
Corporate-level results	\$ (1,544)	\$ (1,331)	(16)%	\$ (3,733)	\$ (3,629)	(3)%

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

Table of Contents

resources, legal, finance, information technology, corporate development and procurement activities, research and development and other costs, and legal settlements and contingencies.

Corporate-level expenses increased during the three and nine months ended March 31, 2007, primarily reflecting increased headcount-related costs, partially offset by decreased costs for legal settlements and legal contingencies. Headcount-related costs increased 27% during the three and nine months ended March 31, 2007, reflecting a 22% increase in headcount and an increase in salaries and benefits for existing headcount. During the three months ended March 31, 2007 and 2006, we incurred \$296 million and \$397 million, respectively, of legal charges primarily related to antitrust and unfair competition consumer class actions, intellectual property claims, and extension payments to Sun Microsystems, Inc. under our existing Limited Patent Covenant and Standstill Agreement. During the nine months ended March 31, 2007 and 2006, we incurred \$494 million and \$913 million, respectively, in legal charges. Legal charges during the first nine months of fiscal year 2006 included a \$361 million charge related to our settlement with RealNetworks, Inc.

Operating Expenses*Cost of Revenue*

(In millions, except percentages)	Three months ended March 31,		Percentage Change	Nine months ended March 31,		Percentage Change
	2007	2006		2007	2006	
Cost of revenue	\$ 2,140	\$ 2,028	6%	\$ 7,456	\$ 5,520	35%
As a percent of revenue	15%	19%	(4)ppt	20%	17%	3ppt

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, and costs associated with the delivery of consulting services. Cost of revenue increased in the three months ended March 31, 2007, primarily driven by Windows Vista product costs, OSB data center costs, and costs associated with the growth in consulting services, partially offset by decreased Xbox console costs from lower console sales. Cost of revenue increased during the nine months ended March 31, 2007, primarily driven by an increase in the number of total Xbox consoles sold, OSB costs related to data center depreciation, product costs associated with Windows Vista, and costs associated with the growth in consulting services.

Research and Development

(In millions, except percentages)	Three months ended March 31,		Percentage Change	Nine months ended March 31,		Percentage Change
	2007	2006		2007	2006	
Research and development	\$ 1,750	\$ 1,617	8%	\$ 5,173	\$ 4,723	10%
As a percent of revenue	12%	15%	(3)ppt	14%	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 the three and nine months ended March 31, 2007, primarily because of increased headcount-related costs, which were partially offset during the nine-month period by the capitalization of approximately \$120 million of certain software development costs primarily associated with Windows Vista and the 2007 Microsoft Office system. Headcount-related costs increased 11% and 8% during the three and nine months ended March 31, 2007, respectively, reflecting a 14% increase in headcount, an increase in salaries and benefits for existing headcount, and an offsetting impact of four percentage points in the nine months ended

Table of Contents

March 31, 2007 reflecting the capitalization of certain software development costs. The increase in headcount-related costs was also partially offset by a decrease in stock-based compensation expense.

Sales and Marketing

(In millions, except percentages)	Three months ended			Nine months ended		
	March 31,		Percentage Change	March 31,		Percentage Change
	2007	2006		2007	2006	
Sales and marketing	\$ 2,936	\$ 2,362	24%	\$ 8,126	\$ 6,996	16%
As a percent of revenue	20%	22%	(2)ppt	22%	22%	ppt

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 the three and nine months ended March 31, 2007, primarily as a result of increased headcount-related costs and other marketing costs related to recent product launches. Headcount-related costs increased 20% and 23% during the three and nine months ended March 31, 2007, respectively, reflecting an increase in salaries and benefits for existing headcount and a 13% increase in headcount, partially offset by a decrease in stock-based compensation expense.

General and Administrative

(In millions, except percentages)	Three months ended			Nine months ended		
	March 31,		Percentage Change	March 31,		Percentage Change
	2007	2006		2007	2006	
General and administrative	\$ 983	\$ 1,005	(2)%	\$ 2,461	\$ 2,648	(7)%
As a percent of revenue	7%	9%	(2)ppt	7%	8%	(1)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 the three and nine months ended March 31, 2007, primarily reflecting decreased costs for legal settlements and legal contingencies, partially offset by increased headcount-related costs. During the three months ended March 31, 2007 and 2006, we incurred \$296 million and \$397 million, respectively, of legal charges primarily related to antitrust and unfair competition consumer class actions, intellectual property claims, and extension payments to Sun Microsystems, Inc. under our existing Limited Patent Covenant and Standstill Agreement. During the nine months ended March 31, 2007 and 2006, we incurred \$494 million and \$913 million, respectively, in legal charges. Legal charges during the first nine months of fiscal year 2006 included a \$361 million charge related to our settlement with RealNetworks, Inc.

INVESTMENT INCOME, INCOME TAXES, AND OTHER**Investment Income and Other**

The components of investment income and other were as follows:

(In millions)	Three Months Ended			Nine Months Ended		
	March 31,		Change	March 31,		Change
	2007	2006		2007	2006	
Dividends and interest	\$ 333	\$ 369	\$ (36)	\$ 1,018	\$ 1,127	\$ (109)
Net recognized gains on investments	39	67	(28)	505	305	200
Net gains/(losses) on derivatives	22	(8)	30	(209)	(107)	(102)
Other, net	(12)	(1)	(11)	(32)	88	(120)

Edgar Filing: MICROSOFT CORP - Form 10-Q

Investment income and other	\$ 382	\$ 427	\$ (45)	\$ 1,282	\$ 1,413	\$ (131)
-----------------------------	---------------	--------	---------	-----------------	----------	----------

Table of Contents

For the three months and nine months ended March 31, 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.

Other-than-temporary impairments in the third quarter of fiscal 2007 were not material. For the nine months ended March 31, 2007, net recognized gains increased primarily due to gains on sales of fixed-income investments in the current period as compared to losses in the prior period, partly offset by fewer gains on the sale of equity investments in the current period as compared to the prior period.

We use derivative instruments to manage exposures to interest rates, equity prices, and foreign currency markets and to facilitate 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. Net losses related to foreign currency contracts relate primarily to changes in time value of options used to hedge anticipated foreign currency revenues. Additionally, net gains and losses on foreign exchange contracts include the changes in the fair value of derivatives used as economic hedges. These gains and losses are partially offset economically by unrealized losses and gains, respectively, in the underlying assets which are included in other comprehensive income.

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.

Income Taxes

The effective tax rate was 29% and 30% for the three and nine months ended March 31, 2007, respectively. The effective tax rate was 31% and 30% for the three and nine months ended March 31, 2006, respectively. The fiscal year 2007 rate reflects an increase in the recurring effective tax rate to 31.5% due to a higher mix of earnings in high-rate tax jurisdictions and was 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.

FINANCIAL CONDITION

Cash and equivalents and short-term investments totaled \$28.2 billion as of March 31, 2007, compared to \$34.2 billion as of June 30, 2006. Equity and other investments were \$9.6 billion as of March 31, 2007, compared to \$9.2 billion as of June 30, 2006. 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 \$25.9 billion at March 31, 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

Table of Contents

upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis, 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, TV platform, Microsoft Business Solutions, advertising, and subscriptions 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.

Unearned revenue as of March 31, 2007 decreased \$1.6 billion from December 31, 2006, primarily reflecting recognition of the \$1.7 billion previously deferred for the technology guarantee programs and pre-shipments of Windows Vista and the 2007 Microsoft Office system. Unearned revenue decreased \$619 million from June 30, 2006, as a result of recognition of unearned revenue from multi-year licensing outpacing deferrals by \$715 million, a \$98 million decrease in revenue deferred for undelivered elements, and a \$194 million increase primarily in unearned revenue for services and promotional EDD product.

The following table outlines the expected recognition of unearned revenue as of March 31, 2007:

(In millions)	Recognition of Unearned Revenue
Three months ended:	
June 30, 2007	\$ 3,624
September 30, 2007	2,397
December 31, 2007	1,697
March 31, 2008	833
Thereafter	1,732
Unearned revenue	\$ 10,283

See Note 4 Unearned Revenue of the Notes to Financial Statements (Part I, Item 1)

Cash Flows

Cash flow from operations for the nine months ended March 31, 2007 increased \$2.3 billion from the first nine months of fiscal year 2006 to \$13.4 billion due to an increase in cash received from customers, including an increase in accounts receivable collections of \$643 million. The increase also reflects a reduction in cash paid for income taxes, including changes in deferred taxes of \$859 million. Cash used for financing was \$17.6 billion in the first nine months of fiscal year 2007, an increase of \$1.7 billion from the corresponding period in fiscal year 2006. Several events occurred during the first nine months of fiscal year 2007 that affected cash used for financing. JPMorgan exercised approximately 113 million call options for \$3.3 billion in December 2006 which was included in the \$5.6 billion of common stock issued during the nine months ended March 31, 2007, an increase of \$3.7 billion from the same period in fiscal year 2006. We also completed our tender offer on August 17, 2006, which was included in the \$20.4 billion of common stock repurchases in the nine months ended March 31, 2007, an increase of \$5.1 billion from the same period in fiscal year 2006. Cash from investing was \$5.0 billion in the first nine months of fiscal year 2007, an increase of \$750 million from the first nine months of fiscal year 2006, due to a \$3.0 billion increase in net cash from combined investment purchases, sales, and maturities, partially offset by increased additions to property and equipment and a decline in returns from our securities lending program in which we lend certain fixed-income and equity securities to increase investment returns.

We have no material long-term borrowings. Stockholders' equity at March 31, 2007, was \$35.0 billion. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices. We have not engaged in any related party transactions or

Table of Contents

arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of requirements for capital resources.

During the nine months ended March 31, 2007 and 2006, our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
<i>(Fiscal year 2007)</i>				
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	\$ 957	June 14, 2007
<i>(Fiscal year 2006)</i>				
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

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a \$20 billion tender offer, which was completed on August 17, 2006; and authorization for up to an additional \$20 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 \$3.8 billion at a price per share of \$24.75. On August 18, 2006, we announced that the authorization for the \$20 billion ongoing share repurchase program had been increased by approximately \$16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to \$36.2 billion through June 30, 2011. As of March 31, 2007, approximately \$22.52 billion remained of the \$36.2 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

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 FASB Interpretation No. 45, *Guarantors 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.

RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements*. SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect

Table of Contents

transition adjustment. SAB No. 108 is effective for our fiscal year 2007 annual financial statements. We are currently assessing the potential impact that adoption of SAB No. 108 will have 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 are currently assessing the potential impact that adoption of SFAS No. 157 will have on our financial statements.

In June 2006, the FASB issued 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 prescribes 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. FIN No. 48 requires recognition of tax benefits that satisfy a greater than 50% probability threshold. 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. We are currently assessing the potential impact that adoption of FIN No. 48 will have on our financial statements.

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 are currently assessing the financial impact of this guidance and the method of adoption that will be used.

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 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.

Table of Contents

SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and SAB 59, *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. During the second quarter of fiscal year 2007, we determined that technological feasibility was reached with Windows Vista and the 2007 Microsoft Office system. Accordingly, we capitalized approximately \$120 million of software development costs during the quarter. No amounts were capitalized during the third quarter of fiscal year 2007. Previously, such costs were expensed. The amortization of these costs will be included in cost of revenue over the estimated life of the products.

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.

Table of Contents

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.

Item 3. 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

Table of Contents

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 three months ended March 31, 2007, and as of June 30, 2006:

(In millions) Risk Categories	June 30, 2006	March 31, 2007	Three months ended March 31, 2007		
			Average	High	Low
Interest rates	\$ 66	\$ 40	\$ 41	\$ 44	\$ 38
Currency rates	91	53	27	53	15
Equity prices	88	60	59	62	57
Commodity prices	12	7	7	8	6

Total one-day VaR for the combined risk categories was \$98 million at March 31, 2007 and \$158 million at June 30, 2006. The total VaR is 39% less at March 31, 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.

Item 4. 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. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

Part II. Other Information

Item 1. Legal Proceedings

On March 1, 2007, the European Commission announced a new statement of objections in its competition law proceeding against us. The new statement of objections claims that the pricing terms we proposed for licensing certain server protocol technology as required by the Commission's 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 (\$2.7 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 March 31, 2007 is \$1.2 billion. We have submitted a written response to the statement of objections and are seeking to determine the royalty rates that the Commission will deem reasonable.

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 \$1.52 billion in damages. The trial court has dismissed Alcatel-Lucent's claims with respect to a second group of patents. Trial on a third group of patents is scheduled to begin in May 2007. The court has not assigned a trial date on an additional group of patents.

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 in, asserting IPTV and various networking functionalities violate seven of its patents. The case is set for trial in 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.

The actual costs to resolve these cases will depend upon many unknown factors such as the outcome of post-trial motions, any appeals, and the results of the remaining trials. See Note 7 Contingencies of the Notes to Financial Statements (Part I, Item 1) for information on other legal proceedings in which we are involved.

Item 1A. Risk Factors

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and trading price of our common stock. Please refer also to our annual report on Form 10-K for fiscal year 2006 for additional information concerning these and other uncertainties that could negatively impact the Company.

Challenges to our business model may reduce our revenues and operating margins. Our business model has been based upon customers paying a fee to license software that we developed and distributed. Under this license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from

Table of Contents

the distribution of their products. We believe the license-based software model has had substantial benefits for users of software, allowing them to rely on our expertise and the expertise of other software developers that have powerful incentives to develop innovative software that is useful, reliable, and compatible with other software and hardware. In recent years, certain open source software business models have evolved into a growing challenge to our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not have to bear the full costs of research and development for the software. A prominent example of open source software is the Linux operating system. Although we believe our products provide customers with significant advantages in security and productivity, and generally have a lower total cost of ownership than open source software, the popularization of the open source software model continues to pose a significant challenge to our business model, including continuing efforts by proponents of open source software to convince governments worldwide to mandate the use of open source software in their purchase and deployment of software products. To the extent open source software gains increasing market acceptance, sales of our products may decline, we may have to reduce the prices we charge for our products, and revenue and operating margins may consequently decline.

Another development is the software-as-a-service business model, by which companies provide applications, data, and related services over the Internet. Providers use primarily advertising or subscription-based revenue models. Recent advances in computing and communications technologies have made this model viable and enabled the rapid growth of some of our competitors. We are devoting significant resources toward developing our own software-as-a-service strategies. It is uncertain whether these strategies will prove successful.

We face intense competition. We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio offers benefits to our customers that are a competitive advantage, our competitors that are focused on a narrower product line may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low. The Internet as a distribution channel and the non-commercial software model described above have reduced barriers to entry even further. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products. In response to competitive factors, we are developing versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins and operating income.

We may not be able to protect our intellectual property rights against piracy, infringement of our patents by third parties, or declining legal protection for intellectual property. We defend our intellectual property rights and combat unlicensed copying and use of software and intellectual property rights through a variety of techniques. Preventing unauthorized use or infringement of our rights is difficult. Piracy of our products represents a loss of revenue to us. While this adversely affects U.S. revenue, the impact on revenue from outside the United States is more significant, particularly in countries where laws are less protective of intellectual property rights. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Future legal changes could make this even more challenging. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights or compliance with additional intellectual property obligations impacting the rights of software developers could both adversely affect revenue.

Table of Contents

Third parties may claim we infringe their intellectual property rights. From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. Responding to these claims may require us to enter into royalty and licensing agreements on less favorable terms, require us to stop selling or to redesign affected products, or to pay damages or to satisfy indemnification commitments with our customers including contractual provisions under various license arrangements. If we are required to enter into such agreements or take such actions, our operating margins may decline as a result. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code. Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license certain portions of our source code for various software programs and operating systems to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. The loss of future trade secret protection could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code could also increase the risks described in the next paragraph.

Security vulnerabilities in our products could lead to reduced revenues or to liability claims. Maintaining the security of computers and computer networks is a critical issue for us and our customers. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products. Although this is an industry-wide problem that affects computers across all platforms, it affects our products in particular because hackers tend to focus their efforts on the most popular operating systems and programs and we expect them to continue to do so. We devote significant resources to address these critical issues. We focus on engineering more secure products, enhancing security and reliability options and settings when we deliver products, and providing guidance to help our customers make the best use of our products and services to protect against computer viruses and other attacks on their computing environment. In addition, we are working to improve the deployment of software updates to address security vulnerabilities discovered after our products are released. We are also investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed. We advise customers on how to help protect themselves from security threats through the use of our online automated security tools, our published security guidance, and the deployment of security software such as firewalls, anti-virus, and other security software. The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will be held effective under applicable laws and judicial decisions.

We are subject to government litigation and regulatory activity that affects how we design and market our products. As a leading global software maker, we receive scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers based on alleged anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in November 2001 and a Final Judgment entered in November 2002. These proceedings imposed regulatory constraints on our Windows operating system businesses, including limits on certain contracting practices, required disclosure of certain software program interfaces, limits on Microsoft's ability to ensure the visibility of certain Windows features in new PCs, and

Table of Contents

required licensing of certain communications protocols. Although we believe we currently are in full compliance with the Decree and Judgment, if we fail to comply with them in the future additional restrictions could be imposed on us that would adversely affect our business.

In March 2004, the European Commission determined that we must create new versions of Windows that do not include certain multimedia technologies, many of which are required for certain Web sites, software applications and other aspects of Windows to function properly, and we must provide our competitors with specifications for how to implement certain communications protocols supported in Windows. Microsoft has appealed both determinations to European courts. As a result of the Commission decision, we have incurred and will (absent a reversal of this ruling) continue to incur duplicative development costs. The Commission ruling obligates Microsoft to make available specifications for certain Windows communications protocol technologies on licensing terms that are closely regulated by the Commission. The availability of these licenses may enable competitors to develop software products that better mimic the functionality of Microsoft's own products which could result in a reduction in sales of our products. Pending resolution of Microsoft's appeal, there will remain uncertainty about the legal principles that govern product design issues for future releases of Microsoft products in Europe.

In February 2006, the Korean Fair Trade Commission (KFTC) completed an investigation of whether including streaming media technology or instant messenger technology in Windows, or including Windows Media Services as an optional component of Windows Server, violates the Korean Fair Trade Act. The KFTC ruled that we had violated the law and issued a remedial order requiring us to offer two versions of Windows PC operating systems, one with Windows Media Player and instant messenger removed and another with those functionalities but also including opportunities for OEMs to install competing media player and instant messaging programs. If upheld on appeal, these remedies could adversely affect the utility and competitive position of Windows PC operating systems in the Korean market.

We believe our integrated approach to delivery of product innovation benefits consumers and business. Current or future government regulatory efforts and court decisions may hinder or delay our ability to provide these benefits thereby reducing the attractiveness of our products and the revenues that come from them. Moreover, there always remains the risk of new legal action, either by these or other governments or private claimants including with respect to products or features that have not been scrutinized or been the subject of objections in the past. The outcome of such legal actions could adversely affect us in a variety of ways, including:

We may have to design or develop alternative versions of products for specific geographical markets to remove or limit visibility of certain functionality, resulting in reduced customer benefits, additional costs and delays in the release of product lines or specific product versions, or withdraw products from a market to avoid fines or penalties.

Mandated alternative versions of our software may cause confusion that harms our reputation, including among consumers and with third-party software and Web site developers who rely on the functionality removed from these alternative versions.

Competition authorities may authorize competitors to distribute implementations of Microsoft communications protocols in source code form without proper contractual provisions to protect our intellectual property.

We may have to disclose otherwise confidential and trade secret information concerning the operation of our software that may facilitate the development of competing software.

If not reversed or limited on appeal, the rulings described above may be cited as a precedent in other proceedings that seek to limit our ability to continue to improve Windows by adding new functionality in response to consumer demand.

Our online offerings are subject to government regulation of the Internet domestically and internationally in areas such as user privacy, data protection, and online content. The application of these laws and regulations to

Table of Contents

our business is often unclear and sometimes may conflict. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we cease conducting the noncompliant activity.

Our business depends largely on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected.

Delays in product development schedules may adversely affect our revenues. The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could adversely affect our revenue.

We make significant investments in new products and services that may not be profitable. We have made and will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including Windows Vista, the 2007 Microsoft Office system, Xbox 360, Live Search, Windows Server, Zune, and Windows Live. Investments in new technology are inherently speculative. Commercial success depends on many factors including innovativeness, developer support, and effective distribution and marketing. Significant revenue from new product and service investments may not be achieved for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

Declines in demand for software could occur. If overall market demand for PCs, servers, and other computing devices declines significantly, or consumer or corporate spending for such products declines, our revenue will be adversely affected. In addition, our revenue would be unfavorably impacted if customers reduce their purchases of new software products or upgrades to existing products because new product offerings are not perceived as providing significant new functionality or other value to prospective purchasers. If Windows Vista and the 2007 Microsoft Office system are not perceived as offering significant new functionality or value to prospective purchasers, our revenue and operating margins could be adversely affected.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of the claims pending against us may result in significant monetary damages or injunctive relief against us that could adversely affect our ability to conduct our business. Although management currently believes that resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial position, results of operations, or cash flows, the litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. There exists the possibility of a material adverse impact on our financial position, results of operations, and cash flows for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

We may have additional tax liabilities. We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. 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. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation 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.

We may be at risk of having insufficient supplies of certain Xbox 360 components or console inventory. Some components of the Xbox 360 are obtained from a single supplier and others may be subject to

Table of Contents

an industry-wide supply shortage. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain replacement supplies on a timely basis, resulting in reduced console and game sales. Components are ordered based on forecasted console demand, so we may experience component shortages for the Xbox 360 or, alternatively, excess console inventory that may require us to record charges to cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenues and operating margins.

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

Changes in accounting may affect our reported earnings and operating income. Generally accepted accounting principles and accompanying accounting pronouncements, implementation guidelines, and interpretations for many aspects of our business, such as revenue recognition for software, accounting for investments, and treatment of goodwill or amortizable intangible assets, are highly complex and involve subjective judgments. Changes in these rules or their interpretation or changes in our products or business could significantly change our reported earnings and operating income and could add significant volatility to those measures, without a comparable underlying change in cash flow from operations. See Note 1 Basis of Presentation and Consolidation of the Notes to Financial Statements (Part I, Item 1) and Management's Discussion and Analysis of Financial Condition and Results of Operations Application of Critical Accounting Policies (Part I, Item 2) of this report.

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment; changes in regulatory requirements for software; social, political, labor or economic conditions in a specific country or region; and difficulties in staffing and managing foreign operations. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

General economic and geo-political risks may affect our revenue and profitability. Inflation, softness in corporate information technology spending, or other changes in general economic conditions that affect demand for computer hardware or software could adversely affect our revenue or our investment portfolio. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries or generally and could require changes in our operations and security arrangements, thus increasing our operating costs. These conditions may lend additional uncertainty to the timing and budget for technology investment decisions by our customers.

Catastrophic events may disrupt our business. We are a highly automated business and a disruption or failure of our systems in the event of a major earthquake, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales and providing services. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our future operating results could be adversely affected.

Table of Contents

Acquisitions and joint ventures may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don't realize a satisfactory return on the investment we make, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management's attention from our other businesses. These factors could adversely affect our operating results or financial condition.

We have limited insurance. We maintain third party insurance coverage against various liability risks and risks of property loss. Because of the unavailability or high cost of conventional insurance arrangements, we have entered into captive insurance arrangements for the purpose of protecting against possible catastrophic and other risks not covered by traditional insurance markets. As of March 31, 2007, the face value of captive insurance arrangements was \$2.0 billion. Actual value at any particular time will vary due to deductibles, exclusions, other restrictions, and claims. Although we believe these arrangements are an effective way to insure against liability and property damage risks, the potential liabilities associated with the risks discussed in this report or other events could exceed the coverage provided by such arrangements.

Improper disclosure of personal data could result in liability and harm our reputation. We store and process significant amounts of personally identifiable information as we offer a large array of products and services to our customers. It is possible that our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information. Such disclosure could harm our reputation and subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products also enable our customers to store and process personal data. Perceptions that our products do not adequately protect the privacy of personal information could inhibit sales of our products.

Other risks that may affect our business. Other factors that may affect our performance may include:

Sales channel disruption, such as the bankruptcy of a major distributor

Our ability to implement operating cost structures that align with revenue growth

The continued availability of third-party distribution channels for MSN service and other online offerings

Disruption to our operations as a result of weather-related events

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Items 2(a) and (b) are inapplicable.

(c) STOCK REPURCHASES

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) Maximum number of shares (or approximate dollar value of shares) that may yet be purchased under the plans or programs (in millions)
January 1, 2007	January 31, 2007		\$		\$
February 1, 2007	February 28, 2007	125,827,584	29.05	125,827,584	25,607
March 1, 2007	March 31, 2007	111,670,143	27.66	111,670,143	22,518
		237,497,727		237,497,727	

On July 20, 2006, we announced that our Board of Directors authorized a \$20 billion ongoing share repurchase program with an expiration of June 30, 2011. On August 18, 2006, we announced that the authorization for the \$20 billion ongoing share repurchase program had been increased by approximately \$16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to \$36.2 billion through June 30, 2011. The repurchase program may be suspended or discontinued at any time without prior notice. During the third quarter of fiscal year 2007, we repurchased 237 million shares for \$6.7 billion under the plan. The transactions occurred in open market purchases and pursuant to a trading plan under Rule 10b5-1.

Item 6. Exhibits

- 15 Letter re unaudited interim financial information
- 31.1 Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Items 3, 4, and 5 are not applicable and have been omitted.

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: April 26, 2007

Microsoft Corporation

By: /s/ FRANK H. BROD
Frank H. Brod

Corporate Vice President, Finance and Administration;

Chief Accounting Officer

(Principal Authorized Officer)