Notes to Financial Statements

(In millions, except per share amounts)

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Significant Accounting Policies

Accounting principles. The financial statements are prepared on a basis

consistent with U.S. generally accepted accounting principles and International

Accounting Standards formulated by the International Accounting Standards

Committee (IASC).

Principles of consolidation. The financial statements include the accounts of

Microsoft and its subsidiaries. Significant intercompany transactions and

balances have been eliminated. Investments in 50% owned joint ventures are

accounted for using the equity method; the Company's share of joint ventures'

activities is reflected in other expenses.

Estimates and assumptions. Preparing financial statements requires management

to make estimates and assumptions that affect the reported amounts of assets,

liabilities, revenue, and expenses. Examples include provisions for returns and

bad debts and the length of product life cycles and buildings' lives. Actual

results may differ from these estimates.

Foreign currencies. Assets and liabilities recorded in foreign currencies are

translated at the exchange rate on the balance sheet date. Translation

adjustments resulting from this process are charged or credited to equity.

Revenue, costs, and expenses are translated at average rates of exchange

prevailing during the year. Gains and losses on foreign currency transactions

are included in other expenses.

Revenue recognition.

Revenue is recognized when earned. Revenue from products

licensed to original equipment manufacturers is recorded when OEMs ship licensed

products while revenue from corporate and organization license programs is

recorded when the user installs the product. Revenue from packaged product

sales to distributors and resellers is recorded when related products are

shipped. Maintenance and subscription revenue is recognized ratably over the

contract period. Revenue attributable to significant support (technical support

and unspecified enhancements such as service packs and Internet browser updates)

is based on the price charged or derived value of the undelivered elements and

is recognized ratably on a straight-line basis over the product's life cycle.

Costs related to insignificant obligations, which include telephone support for

certain products, are accrued. Provisions are recorded for returns and bad

debts.

Research and development. Research and development costs are expensed as

incurred. The current U.S. accounting rule, Statement of Financial Accounting

Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold,

Leased, or Otherwise Marketed, does not materially affect the Company.

Telephone support. Telephone support costs are included in sales and marketing.

Income taxes. Income tax expense includes U.S. and international income taxes,

plus an accrual for U.S. taxes on undistributed earnings of international

subsidiaries. Certain items of income and expense are not reported in tax

returns and financial statements in the same year. The tax effect of this

difference is reported as deferred income taxes. Tax credits are accounted for

as a reduction of tax expense in the year in which the credits reduce taxes

payable.

Earnings per share. Earnings per share is computed on the basis of the weighted

average number of common shares outstanding plus the effect of outstanding stock

options using the "treasury stock" method and preferred shares using the "if-

converted" method. Beginning in the second quarter of 1998, Microsoft will be

required to report earnings per outstanding common share in addition to diluted

earnings per share. Earnings per common share computed under the new

pronouncement would have been $1.25, $1.85, and $2.87 while reported diluted

earnings per share were $1.16, $1.71, and $2.63 in 1995, 1996, and 1997.

Stock split. In December 1996, outstanding shares of common stock were split

two-for-one. All share and per share amounts have been restated.

Financial instruments. The Company considers all liquid interest-earning

investments with a maturity of three months or less at the date of purchase to

be cash equivalents. Short-term investments generally mature between three

months and five years from the purchase date. All cash and short-term

investments are classified as available for sale and are recorded at market.

Cost approximates market for all classifications of cash and short-term

investments; realized and unrealized gains and losses were not material.

Publicly tradeable equity securities are recorded at market; unrealized gains

and losses are reflected in stockholders' equity.

Property, plant, and equipment. Property, plant, and equipment is stated at

cost and depreciated using the straight-line method over the shorter of the

estimated life of the asset or the lease term, ranging from one to 30 years.

Reclassifications. Certain reclassifications have been made for consistent

presentation.

Unearned Revenue

In fiscal 1996, Microsoft committed to integrating its Internet technologies,

such as the Company's Internet browser, Microsoft Internet Explorer, into

existing products at no additional cost to its customers. Given this strategy

and other support commitments such as telephone support, Internet-based

technical support, and unspecified product enhancements, Microsoft recognizes

approximately 20% of Windows operating systems revenue over the product life

cycles, currently estimated at two years. The unearned portion of revenue from

Windows operating systems was $425 million and $860 million at June 30, 1996 and

1997.

Since Office 97 is also tightly integrated with the rapidly evolving Internet,

and subsequent delivery of new Internet technologies, enhancements, and other

support is likely to be more than minimal, a ratable revenue recognition policy

became effective for Office 97 licenses beginning in 1997. Approximately 20% of

Office 97 revenue is recognized ratably over the estimated 18-month product life

cycle. Unearned revenue associated with Office 97 totaled $300 million at June

30, 1997.

Unearned revenue also includes maintenance and other subscription contracts,

including custom corporate license agreements.

Financial Risks

The Company's investment portfolio is diversified and consists primarily of

short-term investment grade securities. At June 30, 1996 and 1997,

approximately 38% and 31% of accounts receivable represented amounts due from 10

channel purchasers. One customer accounted for approximately 12%, 13%, and 12%

of revenue while another customer accounted for approximately 12%, 8%, and 5% of

revenue in 1995, 1996, and 1997.

Finished goods sales to international customers in Europe, Japan, and Australia

are primarily billed in local currencies. Payment cycles are relatively short,

generally less than 90 days. European manufacturing costs and international

selling, distribution, and support costs are generally disbursed in local

currencies. Local currency cash balances in excess of short-term operating

needs are generally converted into U.S. dollar cash and short-term investments

on receipt. Therefore, foreign exchange rate fluctuations generally do not

create a risk of material balance sheet gains or losses. As a result,

Microsoft's hedging activities for balance sheet exposures have been minimal.

At June 30, 1997, the Company had contracts to deliver $500 million in a foreign

currency, expiring July 1998, which hedge foreign exchange rate risk related to

a foreign currency denominated investment.

Foreign exchange rates affect the translated results of operations of the

Company's foreign subsidiaries. The Company hedges a percentage of planned

international revenue with purchased options. The notional amount of the

options outstanding at June 30, 1997 was $2.1 billion. At June 30, 1997, the

fair value and premiums paid for the options were not material.

Cash and Short-Term Investments

Property, Plant, and Equipment

During 1996 and 1997, depreciation expense, of which the majority related to

computer equipment, was $363 million and $353 million; disposals were

immaterial.

Income Taxes

Income taxes have been settled with the Internal Revenue Service for all years

through 1989. The IRS has assessed taxes for 1990 and 1991 that the Company is

contesting in Tax Court. The IRS is examining the Company's U.S. income tax

returns for 1992 through 1994. Management believes any related adjustments that

might be required will not be material to the financial statements. Income

taxes paid were $430 million, $758 million, and $1.1 billion in 1995, 1996, and

1997.

Convertible Preferred Stock

During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible

exchangeable principal-protected preferred stock. Dividends are payable

quarterly in arrears. Preferred shareholders have preference over common

stockholders in dividends and liquidation rights. In December 1999, each

preferred share is convertible into common shares or an equivalent amount of

cash determined by a formula that provides a floor price of $79.875 and a cap of

$102.24 per preferred share. Net proceeds of $980 million were used to

repurchase common shares.

Common Stock

Shares of common stock outstanding were as follows:

The Company repurchases its common stock in the open market to provide shares

for issuing to employees under stock option and stock purchase plans. The

Company's Board of Directors authorized continuation of this program in 1998.

Put Warrants

To enhance its stock repurchase program, the Company sells put warrants to

independent third parties. These put warrants entitle the holders to sell

shares of Microsoft common stock to the Company on certain dates at specified

prices. On June 30, 1996 and 1997, 13.0 million and 3.0 million warrants were

outstanding. Outstanding put warrants at June 30, 1997 expire in September 1997

and have strike prices of $105 per share. At June 30, 1996, the outstanding put

warrants were settleable in cash at Microsoft's option thus resulting in a

reclassification of the maximum potential repurchase obligation of $635 million

from stockholders' equity to put warrants. The outstanding put warrants at June

30, 1997 permitted a net-share settlement at the Company's option and did not

result in a put warrant liability on the balance sheet.

Employee Stock and Savings Plans

Employee stock purchase plan. The Company has an employee stock purchase plan

for all eligible employees. Under the plan, shares of the Company's common

stock may be purchased at six-month intervals at 85% of the lower of the fair

market value on the first or the last day of each six-month period. Employees

may purchase shares having a value not exceeding 10% of their gross compensation

during an offering period. During 1995, 1996, and 1997, employees purchased 2.1

million, 1.8 million, and 1.4 million shares at average prices of $23.38,

$37.72, and $59.64 per share. At June 30, 1997, 19.4 million shares were

reserved for future issuance.

Savings plan. The Company has a savings plan, which qualifies under Section

401(k) of the Internal Revenue Code. Participating employees may defer up to

15% of pretax salary, but not more than statutory limits. The Company

contributes fifty cents for each dollar a participant contributes, with a

maximum contribution of 3% of a participant's earnings. Matching contributions

were $12 million, $15 million, and $28 million in 1995, 1996, and 1997.

Stock option plans. The Company has stock option plans for directors, officers,

and all employees, which provide for nonqualified and incentive stock options.

The option exercise price is the fair market value at the date of grant.

Options granted prior to 1995 generally vest over four and one-half years and

expire 10 years from the date of grant. Options granted during and after 1995

generally vest over four and one-half years and expire seven years from the date

of grant, while certain options vest over seven and one-half years and expire

after 10 years. At June 30, 1997, options for 113 million shares were vested

and 290 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

For various price ranges, weighted average characteristics of outstanding stock

options at June 30, 1997 were as follows:

The Company follows APB Opinion 25, Accounting for Stock Issued to Employees, to

account for stock option and employee stock purchase plans. No compensation

cost is recognized because the option exercise price is equal to the market

price of the underlying stock on the date of grant. Had compensation cost for

these plans been determined based on the Black-Scholes value at the grant dates

for awards as prescribed by SFAS Statement 123, Accounting for Stock-Based

Compensation, pro forma net income and earnings per share would have been:

The pro forma disclosures above include the amortization of the fair value of

all options vested during 1995, 1996, and 1997. If only options granted during

1996 and 1997 were valued, as prescribed by SFAS 123, pro forma net income would

have been $2,073 million and $3,179 million, and earnings per share would have

been $1.62 and $2.42 for 1996 and 1997.

The weighted average Black-Scholes value of options granted under the stock

option plans during 1995, 1996, and 1997 was $10.46, $17.72, and $23.43. Value

was estimated using an expected life of five years, no dividends, volatility of

.30, and risk-free interest rates of 7.0%, 6.0%, and 6.5% in 1995, 1996, and

1997.

MSN, The Microsoft Network

During October 1996, Microsoft and a subsidiary of Tele-Communications, Inc.

(TCI) terminated a partnership under which TCI owned a 20% minority interest in

The Microsoft Network, LLC, owner of the business assets of MSN, an online

service. Due to the evolving nature of the online industry and the move by MSN

to a Web-based offering, the original direction of the partnership changed and

both Microsoft and TCI agreed to terminate this partnership focused exclusively

on MSN. In return for approximately $125 million of TCI securities, Microsoft

became the sole owner of MSN and the minority interest on the accompanying

balance sheet was eliminated. There was no other material financial impact of

the dissolution.

Acquisition

On August 1, 1997, the Company acquired WebTV Networks, Inc. (WebTV), an online

service that enables consumers to experience the Internet through their

televisions via set-top terminals based on proprietary technologies. A director

of the

Company owned 10% of WebTV. Microsoft paid $425 million in stock and

cash for WebTV. The Company expects to record an in-process R&D write-off of

$300 million in the first quarter of 1998.

Commitments and Contingencies

The Company has operating leases for most U.S. and international sales and

support offices and certain equipment. Rental expense for operating leases was

$86 million, $92 million, and $92 million in 1995, 1996, and 1997. Future

minimum rental commitments under noncancelable leases, in millions of dollars,

are: 1998, $67; 1999, $54; 2000, $43; 2001, $30; 2002, $12; and thereafter, $16.

In connection with the Company's communications infrastructure and the operation

of MSN, Microsoft has certain communication usage commitments. Future related

minimum commitments, in millions of dollars, are: 1998, $133; 1999, $119; 2000,

$92; and 2001, $20. Also, Microsoft has committed to certain volumes of

outsourced telephone support and manufacturing of packaged product and has

committed $300 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two

MSNBC joint ventures: a 24-hour cable news and information channel and an

interactive online news service. Microsoft agreed to pay $220 million over a

five-year period for its interest in the cable venture, to pay one-half of

operational funding of both joint ventures for a multiyear period, and to

guarantee a portion of MSNBC debt.

In an ongoing investigation, the Antitrust Division of the U.S. Department of

Justice requested information from Microsoft concerning various issues.

Microsoft is also subject to various legal proceedings and claims that arise in

the ordinary course of business. Management currently believes that resolving

these matters will not have a material adverse impact on the Company's financial

position or its results of operations.

Geographic Information

Intercompany sales between geographic areas are accounted for at prices

representative of unaffiliated party transactions. "U.S. operations" include

shipments to customers in the United States, licensing to OEMs, and exports of

finished goods directly to international customers, primarily in Asia, South

America, and Canada. Exports and international OEM transactions are primarily in

U.S. dollars and totaled $1.3 billion, $2.1 billion, and $2.5 billion in 1995,

1996, and 1997.

"Other international operations" primarily include subsidiaries in Japan,

Canada, Australia, and Brazil. International revenue, which includes European

operations, other international operations, exports, and OEM distribution, was

55%, 56%, and 56% of total revenue in 1995, 1996, and 1997. Most international

identifiable assets are U.S. dollar denominated investment securities.