Notes to Financial Statements

Accounting Policies

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with

generally accepted accounting principles in the United States.

Principles of Consolidation

The financial statements include the accounts of Microsoft and its subsidiaries.

Significant intercompany transactions and balances have been eliminated.

Investments in unconsolidated joint ventures are accounted for using the equity

method; the Company's share of joint ventures' activities is reflected in other

expenses.

Estimates and Assumptions

Preparing financial statements requires management to make estimates and

assumptions that affect the reported amounts of assets, liabilities, revenue,

and expenses. Examples include provisions for returns, concessions and bad

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

results may differ from these estimates.

Foreign Currencies

Assets and liabilities recorded in foreign currencies are translated at the

exchange rate on the balance sheet date. Translation adjustments resulting from

this process are charged or credited to other comprehensive income. Revenue and

expenses are translated at average rates of exchange prevailing during the year.

Gains and losses on foreign currency transactions are included in other

expenses.

Revenue Recognition

Revenue is recognized when earned. The Company's revenue recognition policies

are in compliance with all applicable accounting regulations, including American

Institute of Certified Public Accountants (AICPA) Statement of Position (SOP)

97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, With

Respect to Certain Transactions. Revenue from products licensed to original

equipment manufacturers is recorded when OEMs ship licensed products while

revenue from certain license programs is recorded when the software has been

delivered and the customer is invoiced. Revenue from packaged product sales to

and through distributors and resellers is recorded when related products are

shipped. Maintenance and subscription revenue is recognized ratably over the

contract period. Revenue attributable to undelivered elements, including

technical support and Internet browser technologies, is based on the average

sales price of those elements and is recognized ratably on a straight-line basis

over the product's life cycle. When the revenue recognition criteria required

for distributor and reseller arrangements are not met, revenue is recognized as

payments are received. Costs related to insignificant obligations, which

include telephone support for certain products, are accrued. Provisions are

recorded for returns, concessions and bad debts.

Cost of Revenue

Cost of revenue includes direct costs to produce and distribute product and

direct costs to provide online services, consulting, product support, and

training and certification of system integrators.

Research and Development

Research and development costs are expensed as incurred. Statement of Financial

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

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

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was $732

million in 1998, $804 million in 1999, and $1.1 billion in 2000.

Income Taxes

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

provision for U.S. taxes on undistributed earnings of international

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

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

difference is reported as deferred income taxes.

Financial Instruments

The Company considers all liquid interest-earning investments with a maturity of

three months or less at the date of purchase to be cash equivalents. Short-term

investments generally mature between three months and six years from the

purchase date. All cash and short-term investments are classified as available

for sale and are recorded at market

using the specific identification method; unrealized gains and losses are

reflected in other comprehensive income. Cost approximates market for all

classifications of cash and short-term investments; realized and unrealized

gains and losses were not material.

Equity and other investments include debt and equity instruments. Debt

securities and publicly traded equity securities are classified as available for

sale and are recorded at market using the specific identification method.

Unrealized gains and losses are reflected in other comprehensive income. All

other investments, excluding joint venture arrangements, are recorded at cost.

Derivative financial instruments are used to hedge certain investments,

international revenue, accounts receivable, and interest rate risks, and are,

therefore, held primarily for purposes other than trading. These instruments

may involve elements of credit and market risk in excess of the amounts

recognized in the financial statements. The Company monitors its positions and

the credit quality of counter parties, consisting primarily of major financial

institutions, and does not anticipate nonperformance by any counter-party.

SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as

amended by SFAS 137, Accounting for Derivative Instruments and Hedging

Activities - Deferral of the Effective Date of FASB Statement No. 133, and SFAS

138, Accounting for Certain Derivative Instruments and Certain Hedging

Activities, is effective for the Company as of July 1, 2000. SFAS 133 requires

that an entity recognize all derivatives as either assets or liabilities

measured at fair value. The accounting for changes in the fair value of a

derivative depends on the use of the derivative. Adoption of these new

accounting standards will result in cumulative after-tax reductions in net

income of approximately $350 million and other comprehensive income of

approximately $50 million in the first quarter of fiscal 2001. The adoption

will also impact assets and liabilities recorded on the balance sheet.

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line

method over the shorter of the estimated life of the asset or the lease term,

ranging from one to 15 years. As required by SOP 98-1, Accounting for Costs of

Computer Software Developed or Obtained for Internal Use, Microsoft began

capitalizing certain computer software developed or obtained for internal use in

fiscal 2000. Capitalized computer software is depreciated using the straight-

line method over the shorter of the estimated life of the software or three

years.

Reclassifications

As required by Emerging Issues Task Force (EITF) Issue 00-15, Classification in

the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon

Exercise of a Nonqualified Employee Stock Option, stock option income tax

benefits are classified as cash from operations in the cash flows statement.

Prior period cash flows statements have been restated to conform with this

presentation. Certain other reclassifications have been made for consistent

presentation.

Unearned Revenue

A portion of Microsoft's revenue is earned ratably over the product life cycle

or, in the case of subscriptions, over the period of the license agreement.

End users receive certain elements of the Company's products over a period of

time. These elements include items such as browser technologies and technical

support. Consequently, Microsoft's earned revenue reflects the recognition of

the fair value of these elements over the product's life cycle. Upon adoption

of SOP 98-9 during the fourth quarter of fiscal 1999, the Company was required

to change the methodology of attributing the fair value to undelivered elements.

The percentages of undelivered elements in relation to the total arrangement

decreased, reducing the amount of Windows and Office revenue treated as

unearned, and increasing the amount of revenue recognized upon shipment. The

percentage of revenue recognized ratably decreased from a range of 20% to 35% to

a range of approximately 15% to 25% of Windows desktop operating systems. For

desktop applications, the percentage decreased from approximately 20% to a range

of approximately 10% to 20%. The ranges depend on the terms and conditions of

the license and prices of the elements. In addition, in the fourth quarter of

fiscal 1999, the Company extended the life cycle of Windows from two to three

years based upon management's review of product shipment cycles. Product life

cycles are currently estimated at 18 months for desktop applications. The

Company also sells subscriptions to certain products via maintenance and certain

organizational license agreements. At June 30, 1999 and 2000, Windows Platforms

products unearned revenue was $2.17 billion and $2.61 billion and unearned

revenue associated with Productivity Applications and Developer products totaled

$1.96 billion and $1.99 billion. Unearned revenue for other miscellaneous

programs totaled $116 million and $210 million at June 30, 1999 and 2000.

Financial Risks

The Company's cash and short-term investment portfolio is diversified and

consists primarily of investment grade securities. Investments are held with

high-quality financial institutions, government and government agencies, and

corporations, thereby reducing credit risk concentrations. Interest rate

fluctuations impact the carrying value of the portfolio. The Company routinely

hedges the portfolio with options in the event of a catastrophic increase in

interest rates. The notional amount of the options outstanding was $4.0 billion

and $3.6 billion at June 30, 1999 and 2000. The fair value and premiums paid for

the options were not material. Much of the Company's equity security portfolio

is highly volatile, so certain positions are hedged.

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

Australia are primarily billed in local currencies. Payment cycles are

relatively short, generally less than 90 days. Certain international

manufacturing and operational costs are incurred in local currencies. Local

currency cash balances in excess of short-term operating needs are generally

converted into U.S. dollar cash and short-term investments on receipt. Although

foreign exchange rate fluctuations generally do not create a risk of material

balance sheet gains or losses, the Company hedges a portion of accounts

receivable balances denominated in local currencies, primarily with purchased

options. The notional amount of options outstanding was $662 million and $1.46

billion at June 30, 1999 and 2000. The fair value and premiums paid for the

options were not material.

Foreign exchange rates affect the translated results of operations of the

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

international revenue with purchased options. The notional amount of the

options outstanding was $2.25 billion and $2.08 billion at June 30, 1999 and

2000. The fair value and premiums paid for the options were not material.

At June 30, 1999 and 2000, approximately 50% and 42% of accounts receivable

represented amounts due from 10 customers. A single customer accounted for

approximately 8%, 11%, and 9% of revenue in 1998, 1999, and 2000.

Microsoft lends certain fixed income and equity securities to enhance investment

income. Collateral and/or security interest is determined based upon the

underlying security and the credit worthiness of the borrower.

Cash and Short-Term Investments

During 1998, 1999, and 2000, depreciation expense, of which the majority related

to computer equipment, was $528 million, $483 million, and $668 million;

disposals were not material.

Equity and Other Investments

Debt securities include corporate and government notes and bonds and derivative

securities. Debt securities maturing beyond 15 years are composed entirely of

AT&T 5% convertible preferred debt with a contractual maturity of 30 years. The

debt is convertible into AT&T common stock on or after December 1, 2000, or may

be redeemed by AT&T upon satisfaction of certain conditions on or after June 1,

2002. Equity securities that are restricted for more than one year or not

publicly traded are recorded at cost. At June 30, 1999 and 2000, the estimated

fair value of these investments in excess of their recorded basis was $2.3

billion and $2.7 billion, based on publicly available market information or

other estimates determined by management. The Company hedges the risk of

significant market declines on certain highly volatile equity securities with

options. The options are recorded at market, consistent with the underlying

equity securities. At June 30, 1999 and 2000, the notional amount of the

options outstanding was $2.1 billion and $4.0 billion; the fair value represents

obligations of $1.0 billion and $1.7 billion; and premiums paid for the options

were not material. Realized gains and losses of equity and other investments in

1998 were not material; realized gains were $623 million and $1.7 billion in

1999 and 2000 and losses were not material in 1999 and 2000.

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

The effective income tax rate increased to 36.9% in 1998 due to the

nondeductible write-off of WebTV in-process technologies. In 1999, the

effective tax rate was 35.0%, excluding the impact of the gain on the sale of

Softimage, Inc. In 2000, the effective tax rate was 34.0%, and included the

effect of a 2.5% reduction from the U.S. statutory rate for tax credits and a

1.5% increase for other items. The components of the differences between the

U.S. statutory tax rate and the Company's effective tax rate in 1998 and 1999

were not significant.

Deferred income taxes as of June 30 were:

The Internal Revenue Service (IRS) has assessed taxes for 1990 and 1991, which

the Company is contesting in U.S. Tax Court. Income taxes, except for taxes

related to the 1990 and 1991 assessments, have been settled with the IRS for all

years through 1994. The IRS is examining the Company's U.S. income tax returns

for 1995 and 1996. Management believes any related adjustments that might be

required will not be material to the financial statements. Income taxes paid

were $1.1 billion in 1998, $874 million in 1999, and $800 million in 2000.

Convertible Preferred Stock

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

exchangeable principal-protected preferred stock. Net proceeds of $980 million

were used to repurchase common shares. The Company's convertible preferred

stock matured on December 15, 1999. Each preferred share was converted into

1.1273 common shares.

Common Stock

Shares of common stock outstanding were as follows:

Repurchase Program

In January 2000, the Company terminated its stock buyback program. Prior to

this termination, the Company periodically repurchased its common shares in the

open market to provide shares for issuance to employees under stock option and

stock purchase plans. During 1998, the Company executed two forward settlement

structured repurchase agreements with an independent third party totaling 42

million shares of stock and paid cash for a portion of the purchase price. In

1999, the Company settled the agreements by returning 28 million shares of

stock, based upon the stock price on the date of settlement. The timing and

method of settlement were at the discretion of the Company. The differential

between the cash paid and the price of Microsoft common stock on the date of the

agreement was originally reflected in common stock and paid-in capital.

Put Warrants

Prior to the termination of the stock buyback program, Microsoft enhanced the

program by selling put warrants to independent third parties. These put

warrants entitle the holders to sell shares of Microsoft common stock to the

Company on certain dates at specified prices. On June 30, 2000, warrants to put

157 million shares were outstanding with strike prices ranging from $70 to $78

per share. The put warrants expire between September 2000 and December 2002.

The outstanding put warrants permit a net-share settlement at the Company's

option and do not result in a put warrant liability on the balance sheet.

Other Comprehensive Income

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

Employee Stock and Savings Plans

Employee Stock Purchase Plan

The Company has an employee stock purchase plan for all eligible employees.

Under the plan, shares of the Company's common stock may be purchased at six-

month intervals at 85% of the lower of the fair market value on the first or the

last day of each six-month period. Employees may purchase shares having a value

not exceeding 10% of their gross compensation during an offering period. During

1998, 1999, and 2000, employees purchased 4.4 million, 2.7 million, and 2.5

million shares at average prices of $27.21, $52.59, and $72.38 per share. At

June 30, 2000, 68.4 million shares were reserved for future issuance.

Savings Plan

The Company has a savings plan, which qualifies under Section 401(k) of the

Internal Revenue Code. Participating employees may contribute up to 15% of

their pretax salary, but not more than statutory limits. The Company

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

maximum contribution of 3% of a

participant's earnings. Matching contributions were $39 million, $49 million,

and $65 million in 1998, 1999, and 2000.

Stock Option Plans

The Company has stock option plans for directors, officers, and employees, which

provide for nonqualified and incentive stock options. Options granted prior to

1995 generally vest over four and one-half years and expire 10 years from the

date of grant. Options granted during and after 1995 generally vest over four

and one-half years and expire seven years from the date of grant, while certain

options vest either over four and one-half years or over seven and one-half

years and expire after 10 years. At June 30, 2000, options for 341 million

shares were vested and 734 million shares were available for future grants under

the plans.

Stock options outstanding were as follows:

For various price ranges, weighted average characteristics of outstanding stock

options at June 30, 2000 were as follows:

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

option plans during 1998, 1999, and 2000 was $11.81, $20.90, and $36.67. Value

was estimated using a weighted average expected life of 5.3 years in 1998, 5.0

years in 1999, and 6.2 years in 2000, no dividends, volatility of .32 in 1998

and 1999 and .33 in 2000, and risk-free interest rates of 5.7%, 4.9%, and 6.2%

in 1998, 1999, and 2000.

Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number

of common shares outstanding. Diluted earnings per share is computed on the

basis of the weighted average number of common shares outstanding plus the

effect of outstanding preferred shares using the "if-converted" method, assumed

net-share settlement of common stock structured repurchases, and outstanding

stock options using the "treasury stock" method.

The components of basic and diluted earnings per share were as follows:

Operational Transactions

In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that

enables consumers to experience the Internet through their televisions via set-

top terminals based on proprietary technologies. A director of the Company

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

The Company recorded an in-process technologies write-off of $296 million in the

first quarter of fiscal 1998.

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to

Avid Technology, Inc. and recorded a pretax gain of $160 million. As part of a

transitional service agreement, Microsoft agreed to make certain development

tools and management systems available to Avid for use in the Softimage

business.

In November 1998, Microsoft acquired LinkExchange, Inc., a leading provider of

online marketing services to Web site owners and small and medium-sized

businesses. Microsoft paid $265 million in stock.

In September 1999, the Company sold the entertainment city guide portion of MSN

Sidewalk to Ticketmaster Online-CitySearch, Inc. (TMCS) for a combination of

TMCS stock and warrants with a value of $223 million. The transaction also

included a distribution agreement. Microsoft recognized a gain of $156 million

on the sale and will recognize revenue amounts related to the distribution

arrangement over the term of the agreement.

In November 1999, Expedia, Inc. completed an initial public offering of its

common stock. Expedia, which is majority-owned by Microsoft, is a leading

provider of branded online travel services for leisure and small business

travelers. Expedia's financial results and financial condition are consolidated

with the operations of Microsoft.

In January 2000, the Company merged with Visio Corporation in a transaction that

was accounted for as a pooling of interests. Microsoft issued 14 million shares

in the exchange for the outstanding stock of Visio. Visio's assets and

liabilities, which were nominal, are included with those of Microsoft as of the

merger. Operating results for Visio from periods prior to the merger were not

material to the combined results of the two companies. Accordingly, the

financial statements for such periods have not been restated.

During fiscal 1999 and 2000, Microsoft also acquired several other entities

primarily providing online technologies and services. The Company did not

record significant in-process technology write-offs in connection with these

transactions.

Commitments

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

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

$95 million, $135 million, and $201 million in 1998, 1999, and 2000. Future

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

are: 2001, $178; 2002, $172; 2003, $160; 2004, $151; 2005, $139; and thereafter,

$437.

Microsoft has committed $299 million for constructing new buildings and $200

million for the manufacturing of products. During 1996, Microsoft and National

Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable

news and information channel and an interactive online news service. Microsoft

agreed to pay $220 million over a five-year period for its interest in the cable

venture, to pay one-half of operational funding of both joint ventures for a

multiyear period, and to guarantee a portion of MSNBC debt.

Contingencies

On October 7, 1997, Sun Microsystems, Inc. ("Sun") brought suit against

Microsoft in the U.S. District Court for the Northern District of California.

Sun's complaint alleges several claims against Microsoft, all related to the

parties' relationship under a March 11, 1996 Technology License and Distribution

Agreement (Agreement) concerning certain Java programming language technology.

On March 24, 1998, the Court entered an order enjoining Microsoft from using the

Java Compatibility logo on Internet Explorer 4.0 and the Microsoft Software

Developers Kit (SDK) for Java 2.0. Microsoft has taken steps to fully comply

with the order.

On November 17, 1998, the Court entered an order granting Sun's request for a

preliminary injunction, holding that Sun had established a likelihood of success

on its copyright infringement claims, because Microsoft's use of Sun's

technology in its products was beyond the scope of the parties' license

agreement. The Court ordered Microsoft to make certain changes in its products

that include Sun's Java technology and to make certain changes in its Java

software development tools. The Court also enjoined Microsoft from entering

into any licensing agreements that were conditioned on exclusive use of

Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th

Circuit Court of Appeals on December 16, 1998.

On August 23, 1999 the 9th Circuit Court of Appeals vacated the November 1998

preliminary injunction and remanded the case to the District Court for further

proceedings. Sun immediately filed two motions to reinstate and expand the

scope of the earlier injunction on the basis of copyright infringement and

unfair competition. On January 25, 2000, the Court issued rulings on the two

motions, denying Sun's motion to reinstate the preliminary injunction on the

basis of copyright infringement and granting, in part, Sun's motion to reinstate

the preliminary injunction based on unfair competition. Microsoft is in

compliance with the terms of the partially reinstated preliminary injunction and

will not need to undertake any further action to comply with the terms of the

injunction. No other hearing or trial dates have been set.

The parties have filed multiple summary judgment motions on the interpretation

of the Agreement and on Sun's copyright and trademark infringement claims. On

February 25, 2000, the Court entered an order denying both parties' motions for

summary judgment as to whether the Agreement authorizes Microsoft to distribute

independently developed Java Technology. On April 5, 2000, the Trial Court

entered an order denying Sun's motion for summary judgment regarding the

interpretation of Section 2.7(a), which sets forth certain requirements that Sun

must meet when they deliver Java Technology to Microsoft. On May 9, 2000, the

Court entered an order granting Microsoft's motion to dismiss Sun's copyright

infringement claim and on May 25, 2000, the Court issued a tentative order

granting Microsoft's motion to dismiss Sun's claim that it is entitled to

liquidated damages based on the alleged improper posting of its source code by

Microsoft. The Court has indicated its intention to set a hearing on the

remaining motions in September 2000.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ)

and a group of state Attorneys General filed two antitrust cases against

Microsoft in the U.S. District Court for the District of Columbia. The DOJ

complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ

complaint seeks declaratory relief as to the violations it asserts and

preliminary and permanent injunctive relief regarding: the inclusion of Internet

browsing software (or other software products) as part of Windows; the terms of

agreements regarding non-

Microsoft Internet browsing software (or other software products); taking or

threatening "action adverse" in consequence of a person's failure to license or

distribute Microsoft Internet browsing software (or other software product) or

distributing competing products or cooperating with the government; and

restrictions on the screens, boot-up sequence, or functions of Microsoft's

operating system products. The state Attorneys General allege largely the same

claims and various pendent state claims. The states seek declaratory relief and

preliminary and permanent injunctive relief similar to that sought by the DOJ,

together with statutory penalties under the state law claims. The foregoing

description is qualified in its entirety by reference to the full text of the

complaints and other papers on file in those actions, case numbers 98-1232 and

98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted

Microsoft's motion for summary judgment as to the states' monopoly leverage

claim and permitted the remaining claims to proceed to trial. Trial began on

October 19, 1998 and ended with closing arguments on September 21, 1999. On

November 5, 1999, Judge Jackson issued his Findings of Fact. On April 3, 2000

the Court entered its Conclusions of Law, determining that Microsoft "tied"

Internet Explorer and Windows 95/98 in violation of Section 1 of the Sherman

Act, that Microsoft violated Section 2 of the Sherman Act by taking actions to

maintain its monopoly in the desktop-PC operating system market, and that

Microsoft attempted to monopolize the Internet browser market in violation of

Section 2 of the Sherman Act. The Court also held that Microsoft did not

violate Section 1 of the Sherman Act by entering into a number of contracts

challenged by the government. The Court established a schedule for

consideration of the remedy to be imposed in a final judgment. On April 28,

2000, the plaintiffs submitted a joint proposed remedy that included a proposed

break-up of Microsoft into two companies, an operating systems company, and a

company that would own all of Microsoft's other products and businesses.

Microsoft submitted its proposed remedy and its proposal for further remedy

proceedings on May 10, 2000. On June 7, 2000, Judge Jackson entered the

government's proposed order nearly verbatim as his final judgment in the case.

That judgment orders a divestiture that will create two separate companies, an

"Operating Systems Business" and an "Applications Business," to be implemented

one year following a final decision on appeal. It also provides for a broad

range of "conduct" remedies that would have gone into effect in 90 days, absent

a stay. On June 13, 2000, Microsoft appealed to the United States Court of

Appeals. The Court of Appeals immediately entered an order notifying the parties

that the Court would hear all matters related to this appeal en banc. The

government then asked Judge Jackson to enter an order certifying the case for

direct appeal to the Supreme Court. On June 20, 2000, Judge Jackson certified

the case for direct appeal to the Supreme Court and simultaneously granted

Microsoft's request to stay the entire remedy pending final appeal. The

certification divests the Court of Appeals of jurisdiction over the case until

the Supreme Court decides whether or not to accept jurisdiction of the case,

which is entirely discretionary. The parties have agreed to a briefing schedule

on this issue, according to which Microsoft filed its Jurisdictional Statement

on July 26, 2000, the government responded on August 15, 2000, and Microsoft

replied on August 22, 2000. If the Supreme Court declines to accept

jurisdiction, the appeal will return to the Court of Appeals. If the Supreme

Court accepts jurisdiction, a schedule will be established for briefing and oral

argument on the merits of our appeal.

In other ongoing investigations, the DOJ and several state Attorneys General

have requested information from Microsoft concerning various issues. In

addition, the European Commission has instituted proceedings in which it alleges

that Microsoft has failed to disclose information that Sun claims it needs to

interoperate fully with Windows 2000 clients and has engaged in discriminatory

licensing of such technology. The remedies sought, though not fully defined,

include mandatory disclosure of Microsoft intellectual property concerning

Windows operating systems and imposition of fines. Microsoft denies the

Commission's allegations and intends to contest the proceedings vigorously.

A large number of antitrust class action lawsuits have been initiated against

Microsoft. These cases allege that Microsoft has competed unfairly and

unlawfully monopolized alleged markets for operating systems and certain

software applications and seek to recover alleged overcharges that the

complaints contend Microsoft charged for these products. Microsoft believes the

claims are without merit and is vigorously defending the cases.

The Securities and Exchange Commission is conducting a non-public investigation

into the Company's accounting reserve practices. Microsoft is also subject to

various legal proceedings and claims that arise in the ordinary course of

business.

Management currently believes that resolving these matters will not have a

material adverse impact on the Company's financial position or its results of

operations.

Segment Information

The Company's organizational structure and fundamental approach to business

reflect the needs of its customers. As such, Microsoft has three major

segments: Windows Platforms; Productivity Applications and Developer; and

Consumer and Other. Windows Platforms includes the Windows Division, which is

primarily responsible for developing and marketing Windows NT Workstation,

Windows 2000 Professional, Windows 98, Windows 95, Windows NT Server, and

Windows 2000 Server. Productivity Applications and Developer includes the

Business Productivity Division, which is responsible for developing and

marketing desktop applications, server applications, and developer tools.

Consumer and Other products and services include primarily learning,

entertainment, and PC input device products; WebTV and PC online access; and

portal and vertical properties. Assets of the segment groups are not relevant

for management of the businesses nor for disclosure.

Segment information is presented in accordance with SFAS 131, Disclosures about

Segments of an Enterprise and Related Information. This standard is based on a

management approach, which requires segmentation based upon the Company's

internal organization and disclosure of revenue and operating income based upon

internal accounting methods. The Company's financial reporting systems present

various data for management to run the business, including internal profit and

loss statements (P&Ls) prepared on a basis not consistent with generally

accepted accounting principles. Reconciling items include certain elements of

unearned revenue, the treatment of certain channel inventory amounts and

estimates, and the classification of revenue from product support and

consulting. Additionally, the internal P&Ls use accelerated methods of

depreciation and amortization. In fiscal 2000, the Company's internal P&Ls

included the Black-Scholes value of employee stock option grants, amortized over

the remaining months of the fiscal year of the grant, as well as minor changes

to the segments' composition due to various internal reorganizations during the

year. Fiscal 1999 disclosures have been restated for consistent presentation.

It is not practicable to restate fiscal 1998 for these changes.

Revenue attributable to U.S. operations includes shipments to customers in the

United States, licensing to OEMs and certain multinational organizations, and

exports of finished goods, primarily to Asia, Latin America, and Canada.

Revenue from U.S operations totaled $10.1 billion, $13.7 billion, and $15.7

billion in 1998, 1999, and 2000. Revenue from outside the United States,

excluding licensing to OEMs and certain multinational organizations and U.S.

exports, totaled $5.2 billion, $6.0 billion, and $7.3 billion in 1998, 1999, and

2000.

Long-lived assets totaled $1.5 billion and $1.8 billion in the United States in

1999 and 2000 and $154 million and $126 million in other countries in 1999 and

2000.