

## NOTES TO FINANCIAL STATEMENTS

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### ACCOUNTING POLICIES

> **ACCOUNTING PRINCIPLES** The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles.

> **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 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 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.

> **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. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

> **STOCK SPLIT** During March 1999, 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 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.

During June 1999, the Financial Accounting Standards Board (FASB) issued SFAS 137, Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement 133. The Statement defers the effective date of SFAS 133 to fiscal 2001. Management is evaluating SFAS 133 and does not believe that adoption of the Statement will have a material impact on its financial statements.

> **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.

> **RECLASSIFICATIONS** The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also 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 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. The impact on fiscal 1999 was to increase reported revenue \$170 million. In addition, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. The impact on fiscal 1999 was to decrease reported revenue \$90 million. 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, Windows platforms products unearned revenue was \$2.17 billion and unearned revenue associated with productivity applications and developer products totaled \$1.96 billion. Unearned revenue for other miscellaneous programs totaled \$116 million at June 30, 1999.

#### 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's return with options in the event of a catastrophic increase in interest rates. At June 30, 1999, the notional amount of the options outstanding was \$4.0 billion. 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 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. 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. At June 30, 1999, the notional amount of options outstanding was \$662 million. 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 at June 30, 1999 was \$2.25 billion. The fair value and premiums paid for the options were not material.

At June 30, 1998 and 1999, approximately 40% and 50% of accounts receivable represented amounts due from 10 customers. One customer accounted for approximately 12%, 8%, and 11% of revenue in 1997, 1998, and 1999.

NOTES continued (in millions)

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

#### CASH AND SHORT-TERM INVESTMENTS

| June 30                               | 1998     | 1999   |
|---------------------------------------|----------|--------|
| Cash and equivalents:                 |          |        |
| Cash                                  | \$ 195   | \$ 635 |
| Commercial paper                      | 2,771    | 3,805  |
| Certificates of deposit               | 419      | 522    |
| Money market preferreds               | 454      | 13     |
| Cash and equivalents                  | 3,839    | 4,975  |
| Short-term investments:               |          |        |
| Commercial paper                      | 868      | 1,026  |
| U.S. government and agency securities | 3,511    | 3,592  |
| Corporate notes and bonds             | 3,998    | 6,996  |
| Municipal securities                  | 1,361    | 247    |
| Certificates of deposit               | 350      | 400    |
| Short-term investments                | 10,088   | 12,261 |
| Cash and short-term investments       | \$13,927 | \$     |
| <b>17,236</b>                         |          |        |

#### PROPERTY AND EQUIPMENT

| June 30                          | 1998     | 1999    |
|----------------------------------|----------|---------|
| Land                             | \$ 183   | \$ 158  |
| Buildings                        | 1,259    | 1,347   |
| Computer equipment               | 1,182    | 1,433   |
| Other                            | 428      | 578     |
| Property and equipment – at cost | 3,052    | 3,516   |
| Accumulated depreciation         | (1,547)  | (1,905) |
| Property and equipment – net     | \$ 1,505 | \$      |
| <b>1,611</b>                     |          |         |

During 1997, 1998, and 1999, depreciation expense, of which the majority related to computer equipment, was \$353 million, \$528 million, and \$483 million; disposals were not material.

NOTES continued (in millions)

EQUITY AND OTHER INVESTMENTS

| June 30, 1999   | Cost Basis | Net<br>Unrealized<br>Gains | Recorded<br>Basis |
|---|------------|----------------------------|-------------------|
| Debt securities recorded at market, maturing:         |            |                            |                   |
| Within one year                                       | \$ 682     | \$ 8                       | \$ 690            |
| Between 10 and 15 years                               | 533        | (3)                        | 530               |
| Beyond 15 years (AT&T)                                | 4,731      | 347                        | 5,078             |
| Debt securities recorded at market                    | 5,946      | 352                        | 6,298             |
| Equity securities recorded at market:                 |            |                            |                   |
| Comcast Corporation common stock                      | 500        | 1,394                      | 1,894             |
| MCI Worldcom, Inc. common stock                       | 14         | 1,088                      | 1,102             |
| Other   | 849        | 1,102                      | 1,951             |
| Unrealized hedge loss                                 | —          | (785)                      | (785)             |
| Equity securities recorded at market                  | 1,363      | 2,799                      | 4,162             |
| Equity securities and instruments recorded at cost:   |            |                            |                   |
| Nextel Communications, Inc. common stock              | 600        | —                          | 600               |
| Comcast Corporation convertible preferred stock       | 555        | —                          | 555               |
| NTL, Inc. convertible preferred stock                 | 511        | —                          | 511               |
| Other   | 2,179      | —                          | 2,179             |
| Equity securities and<br>instruments recorded at cost | 3,845      | —                          | 3,845             |
| Other investments                                     | 67         | —                          | 67                |
| Equity and other investments                          | \$11,221   | \$3,151                    | \$                |
| <b>14,372</b>   |            |                            |                   |

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. Unrealized gains on equity securities recorded at market were \$1.4 billion on June 30, 1998. Equity securities and instruments recorded at cost include primarily preferred stock, common stock, and warrants that are restricted or not publicly traded. At June 30, 1998 and 1999, the estimated fair value of these investments was \$2.4 billion and \$6.1 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, the notional amount of the options outstanding was \$2.1 billion; the fair value was \$1.0 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1997 and 1998 were not material; realized gains were \$623 million and losses were not material in 1999.

NOTES continued (in millions)

## INCOME TAXES

> The provision for income taxes consisted of:

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| Current taxes:             |         |         |              |
| U.S. and state             | \$1,710 | \$2,518 | \$           |
| <b>4,027</b>               |         |         |              |
| International              | 412     | 526     | <b>281</b>   |
| Current taxes              | 2,122   | 3,044   |              |
| <b>4,308</b>               |         |         |              |
| Deferred taxes             | (262)   | (417)   | <b>(202)</b> |
| Provision for income taxes | \$1,860 | \$2,627 | \$           |
| <b>4,106</b>               |         |         |              |

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

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| U.S.                       | \$3,775 | \$5,072 | \$           |
| <b>10,649</b>              |         |         |              |
| International              | 1,539   | 2,045   | <b>1,242</b> |
| Income before income taxes | \$5,314 | \$7,117 | \$           |
| <b>11,891</b>              |         |         |              |

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the non-deductible 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. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate were not significant.

Income taxes payable were:

| June 30                          | 1998     | 1999         |
|----------------------------------|----------|--------------|
| Deferred income tax assets:      |          |              |
| Revenue items                    | \$ 713   | \$ 1,145     |
| Expense items                    | 613      | <b>648</b>   |
| Deferred income tax assets       | 1,326    | <b>1,793</b> |
| Deferred income tax liabilities: |          |              |
| Unrealized gain on investments   | (479)    |              |
| <b>(1,046)</b>                   |          |              |
| International earnings           | (373)    | <b>(647)</b> |
| Other                            | (26)     | <b>(16)</b>  |
| Deferred income tax liabilities  | (878)    |              |
| <b>(1,709)</b>                   |          |              |
| Current income tax liabilities   | (1,363)  |              |
| <b>(1,691)</b>                   |          |              |
| Income taxes payable             | \$ (915) | \$           |
| <b>(1,607)</b>                   |          |              |

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. 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 \$1.1 billion in 1997, \$1.1 billion in 1998, and \$874 million in 1999.

NOTES continued (in millions)

#### CONVERTIBLE PREFERRED STOCK

> During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred stockholders 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, equivalent to \$19.97 and \$25.56 per common share. Net proceeds of \$980 million were used to repurchase common shares.

#### COMMON STOCK

> ISSUED AND OUTSTANDING      Shares of common stock outstanding were as follows:

| Year Ended June 30         | 1997  | 1998  | 1999  |
|----------------------------|-------|-------|-------|
| Balance, beginning of year | 4,776 | 4,816 | 4,940 |
| Issued                     | 188   | 202   | 213   |
| Repurchased                | (148) | (78)  | (44)  |
| Balance, end of year       | 4,816 | 4,940 | 5,109 |

> REPURCHASE PROGRAM      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 2000.

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

> To enhance its stock repurchase program, Microsoft 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, 1999, 163 million warrants were outstanding with strike prices ranging from \$59 to \$65 per share. The put warrants expire between September 1999 and March 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

NOTES continued (in millions, except per share amounts)

#### 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 1997, 1998, and 1999, employees purchased 5.6 million, 4.4 million, and 2.7 million shares at average prices of \$14.91, \$27.21, and \$52.59 per share. At June 30, 1999, 70.9 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 \$28 million, \$39 million, and \$49 million in 1997, 1998, and 1999.

> **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 over seven and one-half years and expire after 10 years. At June 30, 1999, options for 406 million shares were vested and 998 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

|                        |        | Price per Share |           |                  |
|------------------------|--------|-----------------|-----------|------------------|
|                        | Shares | Range           |           | Weighted Average |
| Balance, June 30, 1996 | 952    | \$ 0.28         | – \$14.74 | \$ 5.52          |
| Granted                | 220    | 13.83           | – 29.80   |                  |
| 14.58                  |        |                 |           |                  |
| Exercised              | (180)  | 0.28            | – 14.74   | 3.32             |
| Canceled               | (36)   | 4.25            | – 24.29   | 9.71             |
| Balance, June 30, 1997 | 956    | 0.56            | – 29.80   | 7.86             |
| Granted                | 138    | 16.56           | – 43.63   |                  |
| 31.28                  |        |                 |           |                  |
| Exercised              | (176)  | 0.56            | – 31.24   | 4.64             |
| Canceled               | (25)   | 4.25            | – 41.94   |                  |
| 14.69                  |        |                 |           |                  |
| Balance, June 30, 1998 | 893    | 0.56            | – 43.63   |                  |
| 11.94                  |        |                 |           |                  |
| Granted                | 78     | 45.59           | – 83.28   |                  |
| 54.62                  |        |                 |           |                  |
| Exercised              | (175)  | 0.56            | – 53.63   | 6.29             |
| Canceled               | (30)   | 4.25            | – 74.28   |                  |
| 21.06                  |        |                 |           |                  |
| Balance, June 30, 1999 | 766    | 0.56            | – 83.28   |                  |
| 17.28                  |        |                 |           |                  |

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1999 were as follows:

| Range of<br>Exercise Prices | Outstanding Options |                              |                              | Exercisable Options |                              |
|-----------------------------|---------------------|------------------------------|------------------------------|---------------------|------------------------------|
|                             | Shares              | Remaining<br>Life<br>(Years) | Weighted<br>Average<br>Price | Shares              | Weighted<br>Average<br>Price |
| \$ 0.56 – \$ 5.97           | 242                 | 2.9                          | \$ 4.31                      | 230                 | \$ 4.24                      |
| 5.98 – 13.62                | 158                 | 3.9                          | 10.85                        | 89                  | 10.62                        |

|       |   |       |     |     |       |    |       |
|-------|---|-------|-----|-----|-------|----|-------|
| 13.63 | - | 29.80 | 173 | 4.7 | 14.92 | 66 | 14.67 |
| 29.81 | - | 43.62 | 117 | 5.5 | 32.06 | 21 | 31.83 |
| 43.63 | - | 83.28 | 76  | 6.2 | 55.04 | -  | -     |



NOTES continued (in millions, except per share amounts)

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of \$217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.

An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards, pro forma income statements for 1997, 1998, and 1999 would have been as follows:

| Year Ended June 30              | 1997     |           | 1998     |           | 1999     |           |
|---------------------------------|----------|-----------|----------|-----------|----------|-----------|
|                                 | Reported | Pro forma | Reported | Pro forma | Reported | Pro forma |
| Revenue                         | \$11,936 | \$11,936  | \$15,262 | \$15,262  | \$19,747 | \$19,747  |
| Operating expenses:             |          |           |          |           |          |           |
| Cost of revenue                 | 2,170    | 2,290     | 2,460    | 2,628     | 2,814    | 3,024     |
| Research and development        | 1,863    | 2,168     | 2,601    | 3,023     | 2,970    | 3,504     |
| Acquired in-process technology  | —        | —         | 296      | 296       | —        | —         |
| Sales and marketing             | 2,411    | 2,539     | 2,828    | 3,003     | 3,231    | 3,448     |
| General and administrative      | 362      | 424       | 433      | 520       | 689      | 822       |
| Other expenses                  | 259      | 259       | 230      | 230       | 115      | 115       |
| Total operating expenses        | 7,065    | 7,680     | 8,848    | 9,700     | 9,819    | 10,913    |
| Operating income                | 4,871    | 4,256     | 6,414    | 5,562     | 9,928    | 8,834     |
| Investment income               | 443      | 443       | 703      | 703       | 1,803    | 1,803     |
| Gain on sale of Softimage, Inc. | —        | —         | —        | —         | 160      | 160       |
| Income before income taxes      | 5,314    | 4,699     | 7,117    | 6,265     | 11,891   | 10,797    |
| Provision for income taxes      | 1,860    | 1,646     | 2,627    | 2,325     | 4,106    | 3,723     |
| Net income                      | 3,454    | 3,053     | 4,490    | 3,940     | 7,785    | 7,074     |
| Preferred stock dividends       | 15       | 15        | 28       | 28        | 28       | 28        |
| Net income available for        |          |           |          |           |          |           |
| Common shareholders             | \$ 3,439 | \$ 3,038  | \$ 4,462 | \$ 3,912  | \$ 7,757 | \$ 7,046  |
| Diluted earnings per share      | \$ 0.66  | \$ 0.58   | \$ 0.84  | \$ 0.73   | \$ 1.42  | \$ 1.29   |

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1997, 1998, and 1999, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been \$3,179 million, \$4,019 million, and \$7,109 million, and earnings per share would have been \$0.61, \$0.75, and \$1.30 for 1997, 1998, and 1999.

The weighted average Black-Scholes value of options granted under the stock option plans during 1997, 1998, and 1999 was \$5.86, \$11.81, and \$20.90. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1999 and 1998 and .30 in 1997, and risk-free interest rates of 6.5%, 5.7%, and 4.9% in 1997, 1998, and 1999.

NOTES continued (in millions, except per share amounts)

#### EARNINGS PER SHARE

> Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding preferred shares using the "if-converted" method, assumed net-share settlement of common stock structured repurchases, and outstanding stock options using the "treasury stock" method.

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

| Year Ended June 30                                  | 1997    | 1998    | 1999           |
|---|---------|---------|----------------|
| Net income  | \$3,454 | \$4,490 | \$             |
| <b>7,785</b>  |         |         |                |
| Preferred stock dividends                           | 15      | 28      | <b>28</b>      |
| Net income available for common shareholders        | \$3,439 | \$4,462 | \$             |
| <b>7,757</b>  |         |         |                |
| Weighted average outstanding shares of common stock | 4,782   | 4,864   | <b>5,028</b>   |
| Dilutive effect of:                                 |         |         |                |
| Common stock under structured repurchases           | —       | 6       | <b>13</b>      |
| Preferred stock                                     | 26      | 34      | <b>16</b>      |
| Employee stock options                              | 436     | 458     | <b>425</b>     |
| Common stock and common stock equivalents           | 5,244   | 5,362   | <b>5,482</b>   |
| Earnings per share:                                 |         |         |                |
| Basic   | \$ 0.72 | \$ 0.92 | <b>\$ 1.54</b> |
| Diluted   | \$ 0.66 | \$ 0.84 | <b>\$ 1.42</b> |

#### 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, Inc. 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. During fiscal 1999, 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.

In July 1999, Ticketmaster Online CitySearch, Inc. agreed to purchase certain online properties of Sidewalk in exchange for stock and warrants at a price to be determined upon closing.

#### 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 \$92 million, \$95 million, and \$135 million in 1997, 1998, and 1999. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2000, \$133; 2001, \$121; 2002, \$97; 2003, \$83; 2004, \$75; and thereafter, \$194.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 2000, \$125 and 2001, \$22. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed \$275 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

## NOTES continued

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. 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. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java compatibility logo, and against distributing Internet Explorer 4.0 browser technology unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary, and punitive damages, and liquidated damages of \$35 million for the alleged source code disclosure.

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 on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On July 23, 1999 the court also granted Microsoft's motion to increase the bond on the preliminary injunction from \$15 million to \$35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the court issued tentative rulings on three of the motions. In the preliminary rulings, the court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++® 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the court heard oral argument on the three tentative rulings. No final orders have been issued. At the hearing, the court also directed the parties to identify other pending summary judgment motions that the court should next consider. There are no other hearing or trial dates set.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of 20 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. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS® operating system and Windows in the late 80s and early 90s — essentially the same complaints that

NOTES continued (in millions)

resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

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

| Year Ended June 30 | Windows<br>Platforms | Productivity<br>Applications<br>and<br>Developer | Consumer,<br>Commerce,<br>and Other | Reconciling<br>Amounts | Consolidated |
|--------------------|----------------------|--|-------------------------------------|------------------------|--------------|
| <b>1997</b>        |                      |  |                                     |                        |              |
| Revenue            | \$5,213              | \$5,992  | \$ 1,129                            | \$ (398)               | \$           |
|                    | 11,936               |  |                                     |                        |              |
| <b>1998</b>        |                      |  |                                     |                        |              |
| Revenue            | \$6,236              | \$7,458  | \$ 1,765                            | \$ (197)               | \$           |
|                    | 15,262               |  |                                     |                        |              |
| Operating income   | 3,661                | 4,824  | (1,050)                             | (1,021)                | 6,414        |
| <b>1999</b>        |                      |  |                                     |                        |              |
| Revenue            | \$8,590              | \$8,686  | \$ 1,784                            | \$ 687                 | \$           |
|                    | 19,747               |  |                                     |                        |              |
| Operating income   | 6,007                | 5,568  | (1,072)                             | (575)                  | 9,928        |

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, Commerce, and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and other Internet services. Assets of the segment groups are not relevant for management of the businesses nor for disclosure. In addition, it is not practicable to discern operating income for 1997 for the above segments due to previous internal reorganizations.

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 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 revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization, but do not reflect the charge for the ESO exercise price methodology previously employed by the Company.

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 \$7.8 billion, \$10.1 billion, and \$13.7 billion in 1997, 1998, and 1999. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled \$4.1 billion, \$5.2 billion, and \$6.0 billion in 1997, 1998, and 1999.

Long-lived assets totaled \$1.2 billion and \$1.5 billion in the United States in 1998 and 1999 and \$287 million and \$154 million in other countries in 1998 and 1999.

QUARTERLY INFORMATION (in millions, except per share amounts, unaudited)

|                               | Quarter Ended |         |         |         |          |
|-------------------------------|---------------|---------|---------|---------|----------|
|                               | Sept. 30      | Dec. 31 | Mar. 31 | June 30 | Year     |
| 1997                          |               |         |         |         |          |
| Revenue                       | \$2,405       | \$2,808 | \$3,365 | \$3,358 | \$11,936 |
| Gross profit                  | 1,923         | 2,250   | 2,782   | 2,811   | 9,766    |
| Net income                    | 614           | 741     | 1,042   | 1,057   | 3,454    |
| Basic earnings per share      | 0.13          | 0.15    | 0.22    | 0.22    | 0.72     |
| Diluted earnings per share    | 0.12          | 0.14    | 0.20    | 0.20    | 0.66     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 17.33         | 21.54   | 25.88   | 33.74   | 33.74    |
| Low                           | 13.44         | 16.36   | 20.19   | 22.44   | 13.44    |
| 1998                          |               |         |         |         |          |
| Revenue                       | \$3,334       | \$3,792 | \$3,984 | \$4,152 | \$       |
| 15,262                        |               |         |         |         |          |
| Gross profit                  | 2,800         | 3,179   | 3,344   | 3,479   | 12,802   |
| Net income                    | 663           | 1,133   | 1,337   | 1,357   | 4,490    |
| Basic earnings per share      | 0.14          | 0.24    | 0.27    | 0.27    | 0.92     |
| Diluted earnings per share    | 0.13          | 0.21    | 0.25    | 0.25    | 0.84     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 37.69         | 36.66   | 45.47   | 54.28   | 54.28    |
| Low                           | 30.82         | 29.50   | 31.10   | 40.94   | 29.50    |
| 1999                          |               |         |         |         |          |
| Revenue                       | \$4,193       | \$5,195 | \$4,595 | \$5,764 | \$       |
| 19,747                        |               |         |         |         |          |
| Gross profit                  | 3,544         | 4,407   | 3,887   | 5,095   | 16,933   |
| Net income                    | 1,683         | 1,983   | 1,917   | 2,202   | 7,785    |
| Basic earnings per share      | 0.34          | 0.40    | 0.38    | 0.43    | 1.54     |
| Diluted earnings per share    | 0.31          | 0.36    | 0.35    | 0.40    | 1.42     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 59.81         | 72.00   | 94.63   | 95.63   | 95.63    |
| Low                           | 47.25         | 48.13   | 68.00   | 75.50   | 47.25    |

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1999, there were NOTES TO FINANCIAL STATEMENTS

msft

ACCOUNTING POLICIES

> **ACCOUNTING PRINCIPLES** The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles.

> **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 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 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.

> **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. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

> **STOCK SPLIT** During March 1999, 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 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.

During June 1999, the Financial Accounting Standards Board (FASB) issued SFAS 137, Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement 133. The Statement defers the effective date of SFAS 133 to fiscal 2001. Management is evaluating SFAS 133 and does not believe that adoption of the Statement will have a material impact on its financial statements.

> **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.

> **RECLASSIFICATIONS** The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also 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 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. The impact on fiscal 1999 was to increase reported revenue \$170 million. In addition, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. The impact on fiscal 1999 was to decrease reported revenue \$90 million. 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, Windows platforms products unearned revenue was \$2.17 billion and unearned revenue associated with productivity applications and developer products totaled \$1.96 billion. Unearned revenue for other miscellaneous programs totaled \$116 million at June 30, 1999.

#### 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's return with options in the event of a catastrophic increase in interest rates. At June 30, 1999, the notional amount of the options outstanding was \$4.0 billion. 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 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. 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. At June 30, 1999, the notional amount of options outstanding was \$662 million. 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 at June 30, 1999 was \$2.25 billion. The fair value and premiums paid for the options were not material.

At June 30, 1998 and 1999, approximately 40% and 50% of accounts receivable represented amounts due from 10 customers. One customer accounted for approximately 12%, 8%, and 11% of revenue in 1997, 1998, and 1999.

#### NOTES continued (in millions)

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

#### CASH AND SHORT-TERM INVESTMENTS

| June 30                               | 1998   | 1999   |
|---------------------------------------|--------|--------|
| Cash and equivalents:                 |        |        |
| Cash                                  | \$ 195 | \$ 635 |
| Commercial paper                      | 2,771  | 3,805  |
| Certificates of deposit               | 419    | 522    |
| Money market preferreds               | 454    | 13     |
| Cash and equivalents                  | 3,839  | 4,975  |
| Short-term investments:               |        |        |
| Commercial paper                      | 868    | 1,026  |
| U.S. government and agency securities | 3,511  | 3,592  |
| Corporate notes and bonds             | 3,998  | 6,996  |



|                                 |          |        |
|---------------------------------|----------|--------|
| Municipal securities            | 1,361    | 247    |
| Certificates of deposit         | 350      | 400    |
| Short-term investments          | 10,088   | 12,261 |
| Cash and short-term investments | \$13,927 | \$     |
| <b>17,236</b>                   |          |        |

PROPERTY AND EQUIPMENT

|                                  |          |         |
|----------------------------------|----------|---------|
| June 30                          | 1998     | 1999    |
| Land                             | \$ 183   | \$ 158  |
| Buildings                        | 1,259    | 1,347   |
| Computer equipment               | 1,182    | 1,433   |
| Other                            | 428      | 578     |
| Property and equipment – at cost | 3,052    | 3,516   |
| Accumulated depreciation         | (1,547)  | (1,905) |
| Property and equipment – net     | \$ 1,505 | \$      |
| <b>1,611</b>                     |          |         |

During 1997, 1998, and 1999, depreciation expense, of which the majority related to computer equipment, was \$353 million, \$528 million, and \$483 million; disposals were not material.

NOTES continued (in millions)

EQUITY AND OTHER INVESTMENTS

| June 30, 1999   | Cost Basis | Net<br>Unrealized<br>Gains | Recorded<br>Basis |
|---|------------|----------------------------|-------------------|
| Debt securities recorded at market, maturing:         |            |                            |                   |
| Within one year                                       | \$ 682     | \$ 8                       | \$ 690            |
| Between 10 and 15 years                               | 533        | (3)                        | 530               |
| Beyond 15 years (AT&T)                                | 4,731      | 347                        | 5,078             |
| Debt securities recorded at market                    | 5,946      | 352                        | 6,298             |
| Equity securities recorded at market:                 |            |                            |                   |
| Comcast Corporation common stock                      | 500        | 1,394                      | 1,894             |
| MCI Worldcom, Inc. common stock                       | 14         | 1,088                      | 1,102             |
| Other   | 849        | 1,102                      | 1,951             |
| Unrealized hedge loss                                 | —          | (785)                      | (785)             |
| Equity securities recorded at market                  | 1,363      | 2,799                      | 4,162             |
| Equity securities and instruments recorded at cost:   |            |                            |                   |
| Nextel Communications, Inc. common stock              | 600        | —                          | 600               |
| Comcast Corporation convertible preferred stock       | 555        | —                          | 555               |
| NTL, Inc. convertible preferred stock                 | 511        | —                          | 511               |
| Other   | 2,179      | —                          | 2,179             |
| Equity securities and<br>instruments recorded at cost | 3,845      | —                          | 3,845             |
| Other investments                                     | 67         | —                          | 67                |
| Equity and other investments                          | \$11,221   | \$3,151                    | \$                |
| <b>14,372</b>   |            |                            |                   |

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. Unrealized gains on equity securities recorded at market were \$1.4 billion on June 30, 1998. Equity securities and instruments recorded at cost include primarily preferred stock, common stock, and warrants that are restricted or not publicly traded. At June 30, 1998 and 1999, the estimated fair value of these investments was \$2.4 billion and \$6.1 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, the notional amount of the options outstanding was \$2.1 billion; the fair value was \$1.0 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1997 and 1998 were not material; realized gains were \$623 million and losses were not material in 1999.

NOTES continued (in millions)

## INCOME TAXES

> The provision for income taxes consisted of:

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| Current taxes:             |         |         |              |
| U.S. and state             | \$1,710 | \$2,518 | \$           |
| <b>4,027</b>               |         |         |              |
| International              | 412     | 526     | <b>281</b>   |
| Current taxes              | 2,122   | 3,044   |              |
| <b>4,308</b>               |         |         |              |
| Deferred taxes             | (262)   | (417)   | <b>(202)</b> |
| Provision for income taxes | \$1,860 | \$2,627 | \$           |
| <b>4,106</b>               |         |         |              |

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

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| U.S.                       | \$3,775 | \$5,072 | \$           |
| <b>10,649</b>              |         |         |              |
| International              | 1,539   | 2,045   | <b>1,242</b> |
| Income before income taxes | \$5,314 | \$7,117 | \$           |
| <b>11,891</b>              |         |         |              |

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the non-deductible 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. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate were not significant.

Income taxes payable were:

| June 30                          | 1998     | 1999         |
|----------------------------------|----------|--------------|
| Deferred income tax assets:      |          |              |
| Revenue items                    | \$ 713   | \$ 1,145     |
| Expense items                    | 613      | <b>648</b>   |
| Deferred income tax assets       | 1,326    | <b>1,793</b> |
| Deferred income tax liabilities: |          |              |
| Unrealized gain on investments   | (479)    |              |
| <b>(1,046)</b>                   |          |              |
| International earnings           | (373)    | <b>(647)</b> |
| Other                            | (26)     | <b>(16)</b>  |
| Deferred income tax liabilities  | (878)    |              |
| <b>(1,709)</b>                   |          |              |
| Current income tax liabilities   | (1,363)  |              |
| <b>(1,691)</b>                   |          |              |
| Income taxes payable             | \$ (915) | \$           |
| <b>(1,607)</b>                   |          |              |

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. 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 \$1.1 billion in 1997, \$1.1 billion in 1998, and \$874 million in 1999.

NOTES continued (in millions)

#### CONVERTIBLE PREFERRED STOCK

> During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred stockholders 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, equivalent to \$19.97 and \$25.56 per common share. Net proceeds of \$980 million were used to repurchase common shares.

#### COMMON STOCK

> ISSUED AND OUTSTANDING      Shares of common stock outstanding were as follows:

| Year Ended June 30         | 1997  | 1998  | 1999  |
|----------------------------|-------|-------|-------|
| Balance, beginning of year | 4,776 | 4,816 | 4,940 |
| Issued                     | 188   | 202   | 213   |
| Repurchased                | (148) | (78)  | (44)  |
| Balance, end of year       | 4,816 | 4,940 | 5,109 |

> REPURCHASE PROGRAM      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 2000.

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

> To enhance its stock repurchase program, Microsoft 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, 1999, 163 million warrants were outstanding with strike prices ranging from \$59 to \$65 per share. The put warrants expire between September 1999 and March 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

NOTES continued (in millions, except per share amounts)

#### 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 1997, 1998, and 1999, employees purchased 5.6 million, 4.4 million, and 2.7 million shares at average prices of \$14.91, \$27.21, and \$52.59 per share. At June 30, 1999, 70.9 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 \$28 million, \$39 million, and \$49 million in 1997, 1998, and 1999.

> **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 over seven and one-half years and expire after 10 years. At June 30, 1999, options for 406 million shares were vested and 998 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

|                        |        | Price per Share |           |                  |
|------------------------|--------|-----------------|-----------|------------------|
|                        | Shares | Range           |           | Weighted Average |
| Balance, June 30, 1996 | 952    | \$ 0.28         | – \$14.74 | \$ 5.52          |
| Granted                | 220    | 13.83           | – 29.80   |                  |
| 14.58                  |        |                 |           |                  |
| Exercised              | (180)  | 0.28            | – 14.74   | 3.32             |
| Canceled               | (36)   | 4.25            | – 24.29   | 9.71             |
| Balance, June 30, 1997 | 956    | 0.56            | – 29.80   | 7.86             |
| Granted                | 138    | 16.56           | – 43.63   |                  |
| 31.28                  |        |                 |           |                  |
| Exercised              | (176)  | 0.56            | – 31.24   | 4.64             |
| Canceled               | (25)   | 4.25            | – 41.94   |                  |
| 14.69                  |        |                 |           |                  |
| Balance, June 30, 1998 | 893    | 0.56            | – 43.63   |                  |
| 11.94                  |        |                 |           |                  |
| Granted                | 78     | 45.59           | – 83.28   |                  |
| 54.62                  |        |                 |           |                  |
| Exercised              | (175)  | 0.56            | – 53.63   | 6.29             |
| Canceled               | (30)   | 4.25            | – 74.28   |                  |
| 21.06                  |        |                 |           |                  |
| Balance, June 30, 1999 | 766    | 0.56            | – 83.28   |                  |
| 17.28                  |        |                 |           |                  |

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1999 were as follows:

| Range of<br>Exercise Prices | Outstanding Options |                              |                              | Exercisable Options |                              |
|-----------------------------|---------------------|------------------------------|------------------------------|---------------------|------------------------------|
|                             | Shares              | Remaining<br>Life<br>(Years) | Weighted<br>Average<br>Price | Shares              | Weighted<br>Average<br>Price |
| \$ 0.56 – \$ 5.97           | 242                 | 2.9                          | \$ 4.31                      | 230                 | \$ 4.24                      |
| 5.98 – 13.62                | 158                 | 3.9                          | 10.85                        | 89                  | 10.62                        |

|       |   |       |     |     |       |    |       |
|-------|---|-------|-----|-----|-------|----|-------|
| 13.63 | - | 29.80 | 173 | 4.7 | 14.92 | 66 | 14.67 |
| 29.81 | - | 43.62 | 117 | 5.5 | 32.06 | 21 | 31.83 |
| 43.63 | - | 83.28 | 76  | 6.2 | 55.04 | -  | -     |

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NOTES continued (in millions, except per share amounts)

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of \$217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.

An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards, pro forma income statements for 1997, 1998, and 1999 would have been as follows:

| Year Ended June 30              | 1997     |           | 1998     |           | 1999     |           |
|---------------------------------|----------|-----------|----------|-----------|----------|-----------|
|                                 | Reported | Pro forma | Reported | Pro forma | Reported | Pro forma |
| Revenue                         | \$11,936 | \$11,936  | \$15,262 | \$15,262  | \$19,747 | \$19,747  |
| Operating expenses:             |          |           |          |           |          |           |
| Cost of revenue                 | 2,170    | 2,290     | 2,460    | 2,628     | 2,814    | 3,024     |
| Research and development        | 1,863    | 2,168     | 2,601    | 3,023     | 2,970    | 3,504     |
| Acquired in-process technology  | —        | —         | 296      | 296       | —        | —         |
| Sales and marketing             | 2,411    | 2,539     | 2,828    | 3,003     | 3,231    | 3,448     |
| General and administrative      | 362      | 424       | 433      | 520       | 689      | 822       |
| Other expenses                  | 259      | 259       | 230      | 230       | 115      | 115       |
| Total operating expenses        | 7,065    | 7,680     | 8,848    | 9,700     | 9,819    | 10,913    |
| Operating income                | 4,871    | 4,256     | 6,414    | 5,562     | 9,928    | 8,834     |
| Investment income               | 443      | 443       | 703      | 703       | 1,803    | 1,803     |
| Gain on sale of Softimage, Inc. | —        | —         | —        | —         | 160      | 160       |
| Income before income taxes      | 5,314    | 4,699     | 7,117    | 6,265     | 11,891   | 10,797    |
| Provision for income taxes      | 1,860    | 1,646     | 2,627    | 2,325     | 4,106    | 3,723     |
| Net income                      | 3,454    | 3,053     | 4,490    | 3,940     | 7,785    | 7,074     |
| Preferred stock dividends       | 15       | 15        | 28       | 28        | 28       | 28        |
| Net income available for        |          |           |          |           |          |           |
| Common shareholders             | \$ 3,439 | \$ 3,038  | \$ 4,462 | \$ 3,912  | \$ 7,757 | \$ 7,046  |
| Diluted earnings per share      | \$ 0.66  | \$ 0.58   | \$ 0.84  | \$ 0.73   | \$ 1.42  | \$ 1.29   |

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1997, 1998, and 1999, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been \$3,179 million, \$4,019 million, and \$7,109 million, and earnings per share would have been \$0.61, \$0.75, and \$1.30 for 1997, 1998, and 1999.

The weighted average Black-Scholes value of options granted under the stock option plans during 1997, 1998, and 1999 was \$5.86, \$11.81, and \$20.90. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1999 and 1998 and .30 in 1997, and risk-free interest rates of 6.5%, 5.7%, and 4.9% in 1997, 1998, and 1999.

NOTES continued (in millions, except per share amounts)

#### EARNINGS PER SHARE

> Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding preferred shares using the "if-converted" method, assumed net-share settlement of common stock structured repurchases, and outstanding stock options using the "treasury stock" method.

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

| Year Ended June 30                                  | 1997    | 1998    | 1999           |
|---|---------|---------|----------------|
| Net income  | \$3,454 | \$4,490 | \$             |
| <b>7,785</b>  |         |         |                |
| Preferred stock dividends                           | 15      | 28      | <b>28</b>      |
| Net income available for common shareholders        | \$3,439 | \$4,462 | \$             |
| <b>7,757</b>  |         |         |                |
| Weighted average outstanding shares of common stock | 4,782   | 4,864   | <b>5,028</b>   |
| Dilutive effect of:                                 |         |         |                |
| Common stock under structured repurchases           | —       | 6       | <b>13</b>      |
| Preferred stock                                     | 26      | 34      | <b>16</b>      |
| Employee stock options                              | 436     | 458     | <b>425</b>     |
| Common stock and common stock equivalents           | 5,244   | 5,362   | <b>5,482</b>   |
| Earnings per share:                                 |         |         |                |
| Basic   | \$ 0.72 | \$ 0.92 | <b>\$ 1.54</b> |
| Diluted   | \$ 0.66 | \$ 0.84 | <b>\$ 1.42</b> |

#### 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, Inc. 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. During fiscal 1999, 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.

In July 1999, Ticketmaster Online CitySearch, Inc. agreed to purchase certain online properties of Sidewalk in exchange for stock and warrants at a price to be determined upon closing.

#### 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 \$92 million, \$95 million, and \$135 million in 1997, 1998, and 1999. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2000, \$133; 2001, \$121; 2002, \$97; 2003, \$83; 2004, \$75; and thereafter, \$194.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 2000, \$125 and 2001, \$22. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed \$275 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

## NOTES continued

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. 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. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java compatibility logo, and against distributing Internet Explorer 4.0 browser technology unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary, and punitive damages, and liquidated damages of \$35 million for the alleged source code disclosure.

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 on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On July 23, 1999 the court also granted Microsoft's motion to increase the bond on the preliminary injunction from \$15 million to \$35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the court issued tentative rulings on three of the motions. In the preliminary rulings, the court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++® 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the court heard oral argument on the three tentative rulings. No final orders have been issued. At the hearing, the court also directed the parties to identify other pending summary judgment motions that the court should next consider. There are no other hearing or trial dates set.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of 20 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. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS® operating system and Windows in the late 80s and early 90s — essentially the same complaints that

NOTES continued (in millions)

resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

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

| Year Ended June 30 | Windows<br>Platforms | Productivity<br>Applications<br>and<br>Developer | Consumer,<br>Commerce,<br>and Other | Reconciling<br>Amounts | Consolidated |
|--------------------|----------------------|--|-------------------------------------|------------------------|--------------|
| <b>1997</b>        |                      |  |                                     |                        |              |
| Revenue            | \$5,213              | \$5,992  | \$ 1,129                            | \$ (398)               | \$           |
|                    | 11,936               |  |                                     |                        |              |
| <b>1998</b>        |                      |  |                                     |                        |              |
| Revenue            | \$6,236              | \$7,458  | \$ 1,765                            | \$ (197)               | \$           |
|                    | 15,262               |  |                                     |                        |              |
| Operating income   | 3,661                | 4,824  | (1,050)                             | (1,021)                | 6,414        |
| <b>1999</b>        |                      |  |                                     |                        |              |
| Revenue            | \$8,590              | \$8,686  | \$ 1,784                            | \$ 687                 | \$           |
|                    | 19,747               |  |                                     |                        |              |
| Operating income   | 6,007                | 5,568  | (1,072)                             | (575)                  | 9,928        |

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, Commerce, and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and other Internet services. Assets of the segment groups are not relevant for management of the businesses nor for disclosure. In addition, it is not practicable to discern operating income for 1997 for the above segments due to previous internal reorganizations.

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 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 revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization, but do not reflect the charge for the ESO exercise price methodology previously employed by the Company.

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 \$7.8 billion, \$10.1 billion, and \$13.7 billion in 1997, 1998, and 1999. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled \$4.1 billion, \$5.2 billion, and \$6.0 billion in 1997, 1998, and 1999.

Long-lived assets totaled \$1.2 billion and \$1.5 billion in the United States in 1998 and 1999 and \$287 million and \$154 million in other countries in 1998 and 1999.

QUARTERLY INFORMATION (in millions, except per share amounts, unaudited)

|                               | Quarter Ended |         |         |         |          |
|-------------------------------|---------------|---------|---------|---------|----------|
|                               | Sept. 30      | Dec. 31 | Mar. 31 | June 30 | Year     |
| 1997                          |               |         |         |         |          |
| Revenue                       | \$2,405       | \$2,808 | \$3,365 | \$3,358 | \$11,936 |
| Gross profit                  | 1,923         | 2,250   | 2,782   | 2,811   | 9,766    |
| Net income                    | 614           | 741     | 1,042   | 1,057   | 3,454    |
| Basic earnings per share      | 0.13          | 0.15    | 0.22    | 0.22    | 0.72     |
| Diluted earnings per share    | 0.12          | 0.14    | 0.20    | 0.20    | 0.66     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 17.33         | 21.54   | 25.88   | 33.74   | 33.74    |
| Low                           | 13.44         | 16.36   | 20.19   | 22.44   | 13.44    |
| 1998                          |               |         |         |         |          |
| Revenue                       | \$3,334       | \$3,792 | \$3,984 | \$4,152 | \$       |
| 15,262                        |               |         |         |         |          |
| Gross profit                  | 2,800         | 3,179   | 3,344   | 3,479   | 12,802   |
| Net income                    | 663           | 1,133   | 1,337   | 1,357   | 4,490    |
| Basic earnings per share      | 0.14          | 0.24    | 0.27    | 0.27    | 0.92     |
| Diluted earnings per share    | 0.13          | 0.21    | 0.25    | 0.25    | 0.84     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 37.69         | 36.66   | 45.47   | 54.28   | 54.28    |
| Low                           | 30.82         | 29.50   | 31.10   | 40.94   | 29.50    |
| 1999                          |               |         |         |         |          |
| Revenue                       | \$4,193       | \$5,195 | \$4,595 | \$5,764 | \$       |
| 19,747                        |               |         |         |         |          |
| Gross profit                  | 3,544         | 4,407   | 3,887   | 5,095   | 16,933   |
| Net income                    | 1,683         | 1,983   | 1,917   | 2,202   | 7,785    |
| Basic earnings per share      | 0.34          | 0.40    | 0.38    | 0.43    | 1.54     |
| Diluted earnings per share    | 0.31          | 0.36    | 0.35    | 0.40    | 1.42     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 59.81         | 72.00   | 94.63   | 95.63   | 95.63    |
| Low                           | 47.25         | 48.13   | 68.00   | 75.50   | 47.25    |

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1999, there were 92,169 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

92,169 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its

NOTES TO FINANCIAL STATEMENTS

msft

ACCOUNTING POLICIES

> **ACCOUNTING PRINCIPLES** The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles.

> **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 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 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.

> **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. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

> **STOCK SPLIT** During March 1999, 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 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.

During June 1999, the Financial Accounting Standards Board (FASB) issued SFAS 137, Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement 133. The Statement defers the effective date of SFAS 133 to fiscal 2001. Management is evaluating SFAS 133 and does not believe that adoption of the Statement will have a material impact on its financial statements.

> **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.

> **RECLASSIFICATIONS** The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also 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 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. The impact on fiscal 1999 was to increase reported revenue \$170 million. In addition, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. The impact on fiscal 1999 was to decrease reported revenue \$90 million. 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, Windows platform products unearned revenue was \$2.17 billion and unearned revenue associated with productivity applications and developer products totaled \$1.96 billion. Unearned revenue for other miscellaneous programs totaled \$116 million at June 30, 1999.

## 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's return with options in the event of a catastrophic increase in interest rates. At June 30, 1999, the notional amount of the options outstanding was \$4.0 billion. 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 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. 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. At June 30, 1999, the notional amount of options outstanding was \$662 million. 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 at June 30, 1999 was \$2.25 billion. The fair value and premiums paid for the options were not material.

At June 30, 1998 and 1999, approximately 40% and 50% of accounts receivable represented amounts due from 10 customers. One customer accounted for approximately 12%, 8%, and 11% of revenue in 1997, 1998, and 1999.

## NOTES continued (in millions)

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

## CASH AND SHORT-TERM INVESTMENTS

| June 30                 | 1998   | 1999   |
|-------------------------|--------|--------|
| Cash and equivalents:   |        |        |
| Cash                    | \$ 195 | \$ 635 |
| Commercial paper        | 2,771  | 3,805  |
| Certificates of deposit | 419    | 522    |
| Money market preferreds | 454    | 13     |
| Cash and equivalents    | 3,839  | 4,975  |

|                                       |          |               |
|---------------------------------------|----------|---------------|
| Short-term investments:               |          |               |
| Commercial paper                      | 868      | <b>1,026</b>  |
| U.S. government and agency securities | 3,511    | <b>3,592</b>  |
| Corporate notes and bonds             | 3,998    | <b>6,996</b>  |
| Municipal securities                  | 1,361    | <b>247</b>    |
| Certificates of deposit               | 350      | <b>400</b>    |
| Short-term investments                | 10,088   | <b>12,261</b> |
| Cash and short-term investments       | \$13,927 | <b>\$</b>     |
| <b>17,236</b>                         |          |               |

#### PROPERTY AND EQUIPMENT

|                                  |          |                |
|----------------------------------|----------|----------------|
| June 30                          | 1998     | <b>1999</b>    |
| Land                             | \$ 183   | <b>\$ 158</b>  |
| Buildings                        | 1,259    | <b>1,347</b>   |
| Computer equipment               | 1,182    | <b>1,433</b>   |
| Other                            | 428      | <b>578</b>     |
| Property and equipment – at cost | 3,052    | <b>3,516</b>   |
| Accumulated depreciation         | (1,547)  | <b>(1,905)</b> |
| Property and equipment – net     | \$ 1,505 | <b>\$</b>      |
| <b>1,611</b>                     |          |                |

During 1997, 1998, and 1999, depreciation expense, of which the majority related to computer equipment, was \$353 million, \$528 million, and \$483 million; disposals were not material.

NOTES continued (in millions)

EQUITY AND OTHER INVESTMENTS

| June 30, 1999   | Cost Basis | Net<br>Unrealized<br>Gains | Recorded<br>Basis |
|---|------------|----------------------------|-------------------|
| Debt securities recorded at market, maturing:         |            |                            |                   |
| Within one year                                       | \$ 682     | \$ 8                       | \$ 690            |
| Between 10 and 15 years                               | 533        | (3)                        | 530               |
| Beyond 15 years (AT&T)                                | 4,731      | 347                        | 5,078             |
| Debt securities recorded at market                    | 5,946      | 352                        | 6,298             |
| Equity securities recorded at market:                 |            |                            |                   |
| Comcast Corporation common stock                      | 500        | 1,394                      | 1,894             |
| MCI Worldcom, Inc. common stock                       | 14         | 1,088                      | 1,102             |
| Other   | 849        | 1,102                      | 1,951             |
| Unrealized hedge loss                                 | —          | (785)                      | (785)             |
| Equity securities recorded at market                  | 1,363      | 2,799                      | 4,162             |
| Equity securities and instruments recorded at cost:   |            |                            |                   |
| Nextel Communications, Inc. common stock              | 600        | —                          | 600               |
| Comcast Corporation convertible preferred stock       | 555        | —                          | 555               |
| NTL, Inc. convertible preferred stock                 | 511        | —                          | 511               |
| Other   | 2,179      | —                          | 2,179             |
| Equity securities and<br>instruments recorded at cost | 3,845      | —                          | 3,845             |
| Other investments                                     | 67         | —                          | 67                |
| Equity and other investments                          | \$11,221   | \$3,151                    | \$                |
| <b>14,372</b>   |            |                            |                   |

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. Unrealized gains on equity securities recorded at market were \$1.4 billion on June 30, 1998. Equity securities and instruments recorded at cost include primarily preferred stock, common stock, and warrants that are restricted or not publicly traded. At June 30, 1998 and 1999, the estimated fair value of these investments was \$2.4 billion and \$6.1 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, the notional amount of the options outstanding was \$2.1 billion; the fair value was \$1.0 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1997 and 1998 were not material; realized gains were \$623 million and losses were not material in 1999.



NOTES continued (in millions)

## INCOME TAXES

> The provision for income taxes consisted of:

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| Current taxes:             |         |         |              |
| U.S. and state             | \$1,710 | \$2,518 | \$           |
| <b>4,027</b>               |         |         |              |
| International              | 412     | 526     | <b>281</b>   |
| Current taxes              | 2,122   | 3,044   |              |
| <b>4,308</b>               |         |         |              |
| Deferred taxes             | (262)   | (417)   | <b>(202)</b> |
| Provision for income taxes | \$1,860 | \$2,627 | \$           |
| <b>4,106</b>               |         |         |              |

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

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| U.S.                       | \$3,775 | \$5,072 | \$           |
| <b>10,649</b>              |         |         |              |
| International              | 1,539   | 2,045   | <b>1,242</b> |
| Income before income taxes | \$5,314 | \$7,117 | \$           |
| <b>11,891</b>              |         |         |              |

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the non-deductible 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. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate were not significant.

Income taxes payable were:

| June 30                          | 1998     | 1999         |
|----------------------------------|----------|--------------|
| Deferred income tax assets:      |          |              |
| Revenue items                    | \$ 713   | \$ 1,145     |
| Expense items                    | 613      | <b>648</b>   |
| Deferred income tax assets       | 1,326    | <b>1,793</b> |
| Deferred income tax liabilities: |          |              |
| Unrealized gain on investments   | (479)    |              |
| <b>(1,046)</b>                   |          |              |
| International earnings           | (373)    | <b>(647)</b> |
| Other                            | (26)     | <b>(16)</b>  |
| Deferred income tax liabilities  | (878)    |              |
| <b>(1,709)</b>                   |          |              |
| Current income tax liabilities   | (1,363)  |              |
| <b>(1,691)</b>                   |          |              |
| Income taxes payable             | \$ (915) | \$           |
| <b>(1,607)</b>                   |          |              |

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. 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 \$1.1 billion in 1997, \$1.1 billion in 1998, and \$874 million in 1999.

NOTES continued (in millions)

#### CONVERTIBLE PREFERRED STOCK

> During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred stockholders 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, equivalent to \$19.97 and \$25.56 per common share. Net proceeds of \$980 million were used to repurchase common shares.

#### COMMON STOCK

> ISSUED AND OUTSTANDING      Shares of common stock outstanding were as follows:

| Year Ended June 30         | 1997  | 1998  | 1999  |
|----------------------------|-------|-------|-------|
| Balance, beginning of year | 4,776 | 4,816 | 4,940 |
| Issued                     | 188   | 202   | 213   |
| Repurchased                | (148) | (78)  | (44)  |
| Balance, end of year       | 4,816 | 4,940 | 5,109 |

> REPURCHASE PROGRAM      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 2000.

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

> To enhance its stock repurchase program, Microsoft 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, 1999, 163 million warrants were outstanding with strike prices ranging from \$59 to \$65 per share. The put warrants expire between September 1999 and March 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

NOTES continued (in millions, except per share amounts)

#### 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 1997, 1998, and 1999, employees purchased 5.6 million, 4.4 million, and 2.7 million shares at average prices of \$14.91, \$27.21, and \$52.59 per share. At June 30, 1999, 70.9 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 \$28 million, \$39 million, and \$49 million in 1997, 1998, and 1999.

> **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 over seven and one-half years and expire after 10 years. At June 30, 1999, options for 406 million shares were vested and 998 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

|                        |        | Price per Share |           |                  |
|------------------------|--------|-----------------|-----------|------------------|
|                        | Shares | Range           |           | Weighted Average |
| Balance, June 30, 1996 | 952    | \$ 0.28         | – \$14.74 | \$ 5.52          |
| Granted                | 220    | 13.83           | – 29.80   |                  |
| 14.58                  |        |                 |           |                  |
| Exercised              | (180)  | 0.28            | – 14.74   | 3.32             |
| Canceled               | (36)   | 4.25            | – 24.29   | 9.71             |
| Balance, June 30, 1997 | 956    | 0.56            | – 29.80   | 7.86             |
| Granted                | 138    | 16.56           | – 43.63   |                  |
| 31.28                  |        |                 |           |                  |
| Exercised              | (176)  | 0.56            | – 31.24   | 4.64             |
| Canceled               | (25)   | 4.25            | – 41.94   |                  |
| 14.69                  |        |                 |           |                  |
| Balance, June 30, 1998 | 893    | 0.56            | – 43.63   |                  |
| 11.94                  |        |                 |           |                  |
| Granted                | 78     | 45.59           | – 83.28   |                  |
| 54.62                  |        |                 |           |                  |
| Exercised              | (175)  | 0.56            | – 53.63   | 6.29             |
| Canceled               | (30)   | 4.25            | – 74.28   |                  |
| 21.06                  |        |                 |           |                  |
| Balance, June 30, 1999 | 766    | 0.56            | – 83.28   |                  |
| 17.28                  |        |                 |           |                  |

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1999 were as follows:

| Range of<br>Exercise Prices | Outstanding Options |                              |                              | Exercisable Options |                              |
|-----------------------------|---------------------|------------------------------|------------------------------|---------------------|------------------------------|
|                             | Shares              | Remaining<br>Life<br>(Years) | Weighted<br>Average<br>Price | Shares              | Weighted<br>Average<br>Price |
| \$ 0.56 – \$ 5.97           | 242                 | 2.9                          | \$ 4.31                      | 230                 | \$ 4.24                      |
| 5.98 – 13.62                | 158                 | 3.9                          | 10.85                        | 89                  | 10.62                        |

|       |   |       |     |     |       |    |       |
|-------|---|-------|-----|-----|-------|----|-------|
| 13.63 | - | 29.80 | 173 | 4.7 | 14.92 | 66 | 14.67 |
| 29.81 | - | 43.62 | 117 | 5.5 | 32.06 | 21 | 31.83 |
| 43.63 | - | 83.28 | 76  | 6.2 | 55.04 | -  | -     |

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NOTES continued (in millions, except per share amounts)

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of \$217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.

An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards, pro forma income statements for 1997, 1998, and 1999 would have been as follows:

| Year Ended June 30              | 1997     |           | 1998     |           | 1999     |           |
|---------------------------------|----------|-----------|----------|-----------|----------|-----------|
|                                 | Reported | Pro forma | Reported | Pro forma | Reported | Pro forma |
| Revenue                         | \$11,936 | \$11,936  | \$15,262 | \$15,262  | \$19,747 | \$19,747  |
| Operating expenses:             |          |           |          |           |          |           |
| Cost of revenue                 | 2,170    | 2,290     | 2,460    | 2,628     | 2,814    | 3,024     |
| Research and development        | 1,863    | 2,168     | 2,601    | 3,023     | 2,970    | 3,504     |
| Acquired in-process technology  | —        | —         | 296      | 296       | —        | —         |
| Sales and marketing             | 2,411    | 2,539     | 2,828    | 3,003     | 3,231    | 3,448     |
| General and administrative      | 362      | 424       | 433      | 520       | 689      | 822       |
| Other expenses                  | 259      | 259       | 230      | 230       | 115      | 115       |
| Total operating expenses        | 7,065    | 7,680     | 8,848    | 9,700     | 9,819    | 10,913    |
| Operating income                | 4,871    | 4,256     | 6,414    | 5,562     | 9,928    | 8,834     |
| Investment income               | 443      | 443       | 703      | 703       | 1,803    | 1,803     |
| Gain on sale of Softimage, Inc. | —        | —         | —        | —         | 160      | 160       |
| Income before income taxes      | 5,314    | 4,699     | 7,117    | 6,265     | 11,891   | 10,797    |
| Provision for income taxes      | 1,860    | 1,646     | 2,627    | 2,325     | 4,106    | 3,723     |
| Net income                      | 3,454    | 3,053     | 4,490    | 3,940     | 7,785    | 7,074     |
| Preferred stock dividends       | 15       | 15        | 28       | 28        | 28       | 28        |
| Net income available for        |          |           |          |           |          |           |
| Common shareholders             | \$ 3,439 | \$ 3,038  | \$ 4,462 | \$ 3,912  | \$ 7,757 | \$ 7,046  |
| Diluted earnings per share      | \$ 0.66  | \$ 0.58   | \$ 0.84  | \$ 0.73   | \$ 1.42  | \$ 1.29   |

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1997, 1998, and 1999, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been \$3,179 million, \$4,019 million, and \$7,109 million, and earnings per share would have been \$0.61, \$0.75, and \$1.30 for 1997, 1998, and 1999.

The weighted average Black-Scholes value of options granted under the stock option plans during 1997, 1998, and 1999 was \$5.86, \$11.81, and \$20.90. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1999 and 1998 and .30 in 1997, and risk-free interest rates of 6.5%, 5.7%, and 4.9% in 1997, 1998, and 1999.

NOTES continued (in millions, except per share amounts)

#### EARNINGS PER SHARE

> Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding preferred shares using the "if-converted" method, assumed net-share settlement of common stock structured repurchases, and outstanding stock options using the "treasury stock" method.

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

| Year Ended June 30                                  | 1997    | 1998    | 1999           |
|---|---------|---------|----------------|
| Net income  | \$3,454 | \$4,490 | \$             |
| <b>7,785</b>  |         |         |                |
| Preferred stock dividends                           | 15      | 28      | <b>28</b>      |
| Net income available for common shareholders        | \$3,439 | \$4,462 | \$             |
| <b>7,757</b>  |         |         |                |
| Weighted average outstanding shares of common stock | 4,782   | 4,864   | <b>5,028</b>   |
| Dilutive effect of:                                 |         |         |                |
| Common stock under structured repurchases           | —       | 6       | <b>13</b>      |
| Preferred stock                                     | 26      | 34      | <b>16</b>      |
| Employee stock options                              | 436     | 458     | <b>425</b>     |
| Common stock and common stock equivalents           | 5,244   | 5,362   | <b>5,482</b>   |
| Earnings per share:                                 |         |         |                |
| Basic   | \$ 0.72 | \$ 0.92 | <b>\$ 1.54</b> |
| Diluted   | \$ 0.66 | \$ 0.84 | <b>\$ 1.42</b> |

#### 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, Inc. 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. During fiscal 1999, 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.

In July 1999, Ticketmaster Online CitySearch, Inc. agreed to purchase certain online properties of Sidewalk in exchange for stock and warrants at a price to be determined upon closing.

#### 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 \$92 million, \$95 million, and \$135 million in 1997, 1998, and 1999. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2000, \$133; 2001, \$121; 2002, \$97; 2003, \$83; 2004, \$75; and thereafter, \$194.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 2000, \$125 and 2001, \$22. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed \$275 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

## NOTES continued

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. 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. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java compatibility logo, and against distributing Internet Explorer 4.0 browser technology unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary, and punitive damages, and liquidated damages of \$35 million for the alleged source code disclosure.

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 on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On July 23, 1999 the court also granted Microsoft's motion to increase the bond on the preliminary injunction from \$15 million to \$35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the court issued tentative rulings on three of the motions. In the preliminary rulings, the court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++® 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the court heard oral argument on the three tentative rulings. No final orders have been issued. At the hearing, the court also directed the parties to identify other pending summary judgment motions that the court should next consider. There are no other hearing or trial dates set.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of 20 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. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS® operating system and Windows in the late 80s and early 90s — essentially the same complaints that



NOTES continued (in millions)

resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

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

| Year Ended June 30 | Windows<br>Platforms | Productivity<br>Applications<br>and<br>Developer | Consumer,<br>Commerce,<br>and Other | Reconciling<br>Amounts | Consolidated |
|--------------------|----------------------|--|-------------------------------------|------------------------|--------------|
| <b>1997</b>        |                      |  |                                     |                        |              |
| Revenue            | \$5,213              | \$5,992  | \$ 1,129                            | \$ (398)               | \$           |
|                    | 11,936               |  |                                     |                        |              |
| <b>1998</b>        |                      |  |                                     |                        |              |
| Revenue            | \$6,236              | \$7,458  | \$ 1,765                            | \$ (197)               | \$           |
|                    | 15,262               |  |                                     |                        |              |
| Operating income   | 3,661                | 4,824  | (1,050)                             | (1,021)                | 6,414        |
| <b>1999</b>        |                      |  |                                     |                        |              |
| Revenue            | \$8,590              | \$8,686  | \$ 1,784                            | \$ 687                 | \$           |
|                    | 19,747               |  |                                     |                        |              |
| Operating income   | 6,007                | 5,568  | (1,072)                             | (575)                  | 9,928        |

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, Commerce, and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and other Internet services. Assets of the segment groups are not relevant for management of the businesses nor for disclosure. In addition, it is not practicable to discern operating income for 1997 for the above segments due to previous internal reorganizations.

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 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 revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization, but do not reflect the charge for the ESO exercise price methodology previously employed by the Company.

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 \$7.8 billion, \$10.1 billion, and \$13.7 billion in 1997, 1998, and 1999. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled \$4.1 billion, \$5.2 billion, and \$6.0 billion in 1997, 1998, and 1999.

Long-lived assets totaled \$1.2 billion and \$1.5 billion in the United States in 1998 and 1999 and \$287 million and \$154 million in other countries in 1998 and 1999.

QUARTERLY INFORMATION (in millions, except per share amounts, unaudited)

|                               | Quarter Ended |         |         |         | Year     |
|-------------------------------|---------------|---------|---------|---------|----------|
|                               | Sept. 30      | Dec. 31 | Mar. 31 | June 30 |          |
| 1997                          |               |         |         |         |          |
| Revenue                       | \$2,405       | \$2,808 | \$3,365 | \$3,358 | \$11,936 |
| Gross profit                  | 1,923         | 2,250   | 2,782   | 2,811   | 9,766    |
| Net income                    | 614           | 741     | 1,042   | 1,057   | 3,454    |
| Basic earnings per share      | 0.13          | 0.15    | 0.22    | 0.22    | 0.72     |
| Diluted earnings per share    | 0.12          | 0.14    | 0.20    | 0.20    | 0.66     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 17.33         | 21.54   | 25.88   | 33.74   | 33.74    |
| Low                           | 13.44         | 16.36   | 20.19   | 22.44   | 13.44    |
| 1998                          |               |         |         |         |          |
| Revenue                       | \$3,334       | \$3,792 | \$3,984 | \$4,152 | \$       |
| 15,262                        |               |         |         |         |          |
| Gross profit                  | 2,800         | 3,179   | 3,344   | 3,479   | 12,802   |
| Net income                    | 663           | 1,133   | 1,337   | 1,357   | 4,490    |
| Basic earnings per share      | 0.14          | 0.24    | 0.27    | 0.27    | 0.92     |
| Diluted earnings per share    | 0.13          | 0.21    | 0.25    | 0.25    | 0.84     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 37.69         | 36.66   | 45.47   | 54.28   | 54.28    |
| Low                           | 30.82         | 29.50   | 31.10   | 40.94   | 29.50    |
| 1999                          |               |         |         |         |          |
| Revenue                       | \$4,193       | \$5,195 | \$4,595 | \$5,764 | \$       |
| 19,747                        |               |         |         |         |          |
| Gross profit                  | 3,544         | 4,407   | 3,887   | 5,095   | 16,933   |
| Net income                    | 1,683         | 1,983   | 1,917   | 2,202   | 7,780    |

**FINANCIAL STATEMENTS**

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**ACCOUNTING POLICIES**

> **ACCOUNTING PRINCIPLES** The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles.

> **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 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 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.

> **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. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

> **STOCK SPLIT** During March 1999, 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 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.

During June 1999, the Financial Accounting Standards Board (FASB) issued SFAS 137, Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement 133. The Statement defers the effective date of SFAS 133 to fiscal 2001. Management is evaluating SFAS 133 and does not believe that adoption of the Statement will have a material impact on its financial statements.

> **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.

> **RECLASSIFICATIONS** The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also 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 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. The impact on fiscal 1999 was to increase reported revenue \$170 million. In addition, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. The impact on fiscal 1999 was to decrease reported revenue \$90 million. 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, Windows platforms products unearned revenue was \$2.17 billion and unearned revenue associated with productivity applications and developer products totaled \$1.96 billion. Unearned revenue for other miscellaneous programs totaled \$116 million at June 30, 1999.

## 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's return with options in the event of a catastrophic increase in interest rates. At June 30, 1999, the notional amount of the options outstanding was \$4.0 billion. 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 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. 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. At June 30, 1999, the notional amount of options outstanding was \$662 million. 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 at June 30, 1999 was \$2.25 billion. The fair value and premiums paid for the options were not material.

At June 30, 1998 and 1999, approximately 40% and 50% of accounts receivable represented amounts due from 10 customers. One customer accounted for approximately 12%, 8%, and 11% of revenue in 1997, 1998, and 1999.

## NOTES continued (in millions)

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

## CASH AND SHORT-TERM INVESTMENTS

| June 30                               | 1998     | 1999   |
|---------------------------------------|----------|--------|
| Cash and equivalents:                 |          |        |
| Cash                                  | \$ 195   | \$ 635 |
| Commercial paper                      | 2,771    | 3,805  |
| Certificates of deposit               | 419      | 522    |
| Money market preferreds               | 454      | 13     |
| Cash and equivalents                  | 3,839    | 4,975  |
| Short-term investments:               |          |        |
| Commercial paper                      | 868      | 1,026  |
| U.S. government and agency securities | 3,511    | 3,592  |
| Corporate notes and bonds             | 3,998    | 6,996  |
| Municipal securities                  | 1,361    | 247    |
| Certificates of deposit               | 350      | 400    |
| Short-term investments                | 10,088   | 12,261 |
| Cash and short-term investments       | \$13,927 | \$     |
| <b>17,236</b>                         |          |        |

PROPERTY AND EQUIPMENT

| June 30                          | 1998     | 1999    |
|----------------------------------|----------|---------|
| Land                             | \$ 183   | \$ 158  |
| Buildings                        | 1,259    | 1,347   |
| Computer equipment               | 1,182    | 1,433   |
| Other                            | 428      | 578     |
| Property and equipment – at cost | 3,052    | 3,516   |
| Accumulated depreciation         | (1,547)  | (1,905) |
| Property and equipment – net     | \$ 1,505 | \$      |
| <b>1,611</b>                     |          |         |

During 1997, 1998, and 1999, depreciation expense, of which the majority related to computer equipment, was \$353 million, \$528 million, and \$483 million; disposals were not material.

NOTES continued (in millions)

EQUITY AND OTHER INVESTMENTS

| June 30, 1999   | Cost Basis | Net<br>Unrealized<br>Gains | Recorded<br>Basis |
|---|------------|----------------------------|-------------------|
| Debt securities recorded at market, maturing:         |            |                            |                   |
| Within one year                                       | \$ 682     | \$ 8                       | \$ 690            |
| Between 10 and 15 years                               | 533        | (3)                        | 530               |
| Beyond 15 years (AT&T)                                | 4,731      | 347                        | 5,078             |
| Debt securities recorded at market                    | 5,946      | 352                        | 6,298             |
| Equity securities recorded at market:                 |            |                            |                   |
| Comcast Corporation common stock                      | 500        | 1,394                      | 1,894             |
| MCI Worldcom, Inc. common stock                       | 14         | 1,088                      | 1,102             |
| Other   | 849        | 1,102                      | 1,951             |
| Unrealized hedge loss                                 | —          | (785)                      | (785)             |
| Equity securities recorded at market                  | 1,363      | 2,799                      | 4,162             |
| Equity securities and instruments recorded at cost:   |            |                            |                   |
| Nextel Communications, Inc. common stock              | 600        | —                          | 600               |
| Comcast Corporation convertible preferred stock       | 555        | —                          | 555               |
| NTL, Inc. convertible preferred stock                 | 511        | —                          | 511               |
| Other   | 2,179      | —                          | 2,179             |
| Equity securities and<br>instruments recorded at cost | 3,845      | —                          | 3,845             |
| Other investments                                     | 67         | —                          | 67                |
| Equity and other investments                          | \$11,221   | \$3,151                    | \$                |
| <b>14,372</b>   |            |                            |                   |

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. Unrealized gains on equity securities recorded at market were \$1.4 billion on June 30, 1998. Equity securities and instruments recorded at cost include primarily preferred stock, common stock, and warrants that are restricted or not publicly traded. At June 30, 1998 and 1999, the estimated fair value of these investments was \$2.4 billion and \$6.1 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, the notional amount of the options outstanding was \$2.1 billion; the fair value was \$1.0 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1997 and 1998 were not material; realized gains were \$623 million and losses were not material in 1999.

NOTES continued (in millions)

## INCOME TAXES

> The provision for income taxes consisted of:

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| Current taxes:             |         |         |              |
| U.S. and state             | \$1,710 | \$2,518 | \$           |
| <b>4,027</b>               |         |         |              |
| International              | 412     | 526     | <b>281</b>   |
| Current taxes              | 2,122   | 3,044   |              |
| <b>4,308</b>               |         |         |              |
| Deferred taxes             | (262)   | (417)   | <b>(202)</b> |
| Provision for income taxes | \$1,860 | \$2,627 | \$           |
| <b>4,106</b>               |         |         |              |

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

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| U.S.                       | \$3,775 | \$5,072 | \$           |
| <b>10,649</b>              |         |         |              |
| International              | 1,539   | 2,045   | <b>1,242</b> |
| Income before income taxes | \$5,314 | \$7,117 | \$           |
| <b>11,891</b>              |         |         |              |

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the non-deductible 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. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate were not significant.

Income taxes payable were:

| June 30                          | 1998     | 1999         |
|----------------------------------|----------|--------------|
| Deferred income tax assets:      |          |              |
| Revenue items                    | \$ 713   | \$ 1,145     |
| Expense items                    | 613      | <b>648</b>   |
| Deferred income tax assets       | 1,326    | <b>1,793</b> |
| Deferred income tax liabilities: |          |              |
| Unrealized gain on investments   | (479)    |              |
| <b>(1,046)</b>                   |          |              |
| International earnings           | (373)    | <b>(647)</b> |
| Other                            | (26)     | <b>(16)</b>  |
| Deferred income tax liabilities  | (878)    |              |
| <b>(1,709)</b>                   |          |              |
| Current income tax liabilities   | (1,363)  |              |
| <b>(1,691)</b>                   |          |              |
| Income taxes payable             | \$ (915) | \$           |
| <b>(1,607)</b>                   |          |              |

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. 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 \$1.1 billion in 1997, \$1.1 billion in 1998, and \$874 million in 1999.

NOTES continued (in millions)

#### CONVERTIBLE PREFERRED STOCK

> During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred stockholders 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, equivalent to \$19.97 and \$25.56 per common share. Net proceeds of \$980 million were used to repurchase common shares.

#### COMMON STOCK

> ISSUED AND OUTSTANDING      Shares of common stock outstanding were as follows:

| Year Ended June 30         | 1997  | 1998  | 1999  |
|----------------------------|-------|-------|-------|
| Balance, beginning of year | 4,776 | 4,816 | 4,940 |
| Issued                     | 188   | 202   | 213   |
| Repurchased                | (148) | (78)  | (44)  |
| Balance, end of year       | 4,816 | 4,940 | 5,109 |

> REPURCHASE PROGRAM      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 2000.

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

> To enhance its stock repurchase program, Microsoft 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, 1999, 163 million warrants were outstanding with strike prices ranging from \$59 to \$65 per share. The put warrants expire between September 1999 and March 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.



NOTES continued (in millions, except per share amounts)

#### 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 1997, 1998, and 1999, employees purchased 5.6 million, 4.4 million, and 2.7 million shares at average prices of \$14.91, \$27.21, and \$52.59 per share. At June 30, 1999, 70.9 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 \$28 million, \$39 million, and \$49 million in 1997, 1998, and 1999.

> **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 over seven and one-half years and expire after 10 years. At June 30, 1999, options for 406 million shares were vested and 998 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

|                        |        | Price per Share |           |                  |
|------------------------|--------|-----------------|-----------|------------------|
|                        | Shares | Range           |           | Weighted Average |
| Balance, June 30, 1996 | 952    | \$ 0.28         | – \$14.74 | \$ 5.52          |
| Granted                | 220    | 13.83           | – 29.80   |                  |
| 14.58                  |        |                 |           |                  |
| Exercised              | (180)  | 0.28            | – 14.74   | 3.32             |
| Canceled               | (36)   | 4.25            | – 24.29   | 9.71             |
| Balance, June 30, 1997 | 956    | 0.56            | – 29.80   | 7.86             |
| Granted                | 138    | 16.56           | – 43.63   |                  |
| 31.28                  |        |                 |           |                  |
| Exercised              | (176)  | 0.56            | – 31.24   | 4.64             |
| Canceled               | (25)   | 4.25            | – 41.94   |                  |
| 14.69                  |        |                 |           |                  |
| Balance, June 30, 1998 | 893    | 0.56            | – 43.63   |                  |
| 11.94                  |        |                 |           |                  |
| Granted                | 78     | 45.59           | – 83.28   |                  |
| 54.62                  |        |                 |           |                  |
| Exercised              | (175)  | 0.56            | – 53.63   | 6.29             |
| Canceled               | (30)   | 4.25            | – 74.28   |                  |
| 21.06                  |        |                 |           |                  |
| Balance, June 30, 1999 | 766    | 0.56            | – 83.28   |                  |
| 17.28                  |        |                 |           |                  |

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1999 were as follows:

| Range of<br>Exercise Prices | Outstanding Options |                              |                              | Exercisable Options |                              |
|-----------------------------|---------------------|------------------------------|------------------------------|---------------------|------------------------------|
|                             | Shares              | Remaining<br>Life<br>(Years) | Weighted<br>Average<br>Price | Shares              | Weighted<br>Average<br>Price |
| \$ 0.56 – \$ 5.97           | 242                 | 2.9                          | \$ 4.31                      | 230                 | \$ 4.24                      |
| 5.98 – 13.62                | 158                 | 3.9                          | 10.85                        | 89                  | 10.62                        |

|       |   |       |     |     |       |    |       |
|-------|---|-------|-----|-----|-------|----|-------|
| 13.63 | - | 29.80 | 173 | 4.7 | 14.92 | 66 | 14.67 |
| 29.81 | - | 43.62 | 117 | 5.5 | 32.06 | 21 | 31.83 |
| 43.63 | - | 83.28 | 76  | 6.2 | 55.04 | -  | -     |

NOTES continued (in millions, except per share amounts)

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of \$217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.

An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards, pro forma income statements for 1997, 1998, and 1999 would have been as follows:

| Year Ended June 30              | 1997     |           | 1998     |           | 1999     |           |
|---------------------------------|----------|-----------|----------|-----------|----------|-----------|
|                                 | Reported | Pro forma | Reported | Pro forma | Reported | Pro forma |
| Revenue                         | \$11,936 | \$11,936  | \$15,262 | \$15,262  | \$19,747 | \$19,747  |
| Operating expenses:             |          |           |          |           |          |           |
| Cost of revenue                 | 2,170    | 2,290     | 2,460    | 2,628     | 2,814    | 3,024     |
| Research and development        | 1,863    | 2,168     | 2,601    | 3,023     | 2,970    | 3,504     |
| Acquired in-process technology  | —        | —         | 296      | 296       | —        | —         |
| Sales and marketing             | 2,411    | 2,539     | 2,828    | 3,003     | 3,231    | 3,448     |
| General and administrative      | 362      | 424       | 433      | 520       | 689      | 822       |
| Other expenses                  | 259      | 259       | 230      | 230       | 115      | 115       |
| Total operating expenses        | 7,065    | 7,680     | 8,848    | 9,700     | 9,819    | 10,913    |
| Operating income                | 4,871    | 4,256     | 6,414    | 5,562     | 9,928    | 8,834     |
| Investment income               | 443      | 443       | 703      | 703       | 1,803    | 1,803     |
| Gain on sale of Softimage, Inc. | —        | —         | —        | —         | 160      | 160       |
| Income before income taxes      | 5,314    | 4,699     | 7,117    | 6,265     | 11,891   | 10,797    |
| Provision for income taxes      | 1,860    | 1,646     | 2,627    | 2,325     | 4,106    | 3,723     |
| Net income                      | 3,454    | 3,053     | 4,490    | 3,940     | 7,785    | 7,074     |
| Preferred stock dividends       | 15       | 15        | 28       | 28        | 28       | 28        |
| Net income available for        |          |           |          |           |          |           |
| Common shareholders             | \$ 3,439 | \$ 3,038  | \$ 4,462 | \$ 3,912  | \$ 7,757 | \$ 7,046  |
| Diluted earnings per share      | \$ 0.66  | \$ 0.58   | \$ 0.84  | \$ 0.73   | \$ 1.42  | \$ 1.29   |

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1997, 1998, and 1999, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been \$3,179 million, \$4,019 million, and \$7,109 million, and earnings per share would have been \$0.61, \$0.75, and \$1.30 for 1997, 1998, and 1999.

The weighted average Black-Scholes value of options granted under the stock option plans during 1997, 1998, and 1999 was \$5.86, \$11.81, and \$20.90. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1999 and 1998 and .30 in 1997, and risk-free interest rates of 6.5%, 5.7%, and 4.9% in 1997, 1998, and 1999.

NOTES continued (in millions, except per share amounts)

#### EARNINGS PER SHARE

> Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding preferred shares using the "if-converted" method, assumed net-share settlement of common stock structured repurchases, and outstanding stock options using the "treasury stock" method.

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

| Year Ended June 30                                  | 1997    | 1998    | 1999           |
|---|---------|---------|----------------|
| Net income  | \$3,454 | \$4,490 | \$             |
| <b>7,785</b>  |         |         |                |
| Preferred stock dividends                           | 15      | 28      | <b>28</b>      |
| Net income available for common shareholders        | \$3,439 | \$4,462 | \$             |
| <b>7,757</b>  |         |         |                |
| Weighted average outstanding shares of common stock | 4,782   | 4,864   | <b>5,028</b>   |
| Dilutive effect of:                                 |         |         |                |
| Common stock under structured repurchases           | —       | 6       | <b>13</b>      |
| Preferred stock                                     | 26      | 34      | <b>16</b>      |
| Employee stock options                              | 436     | 458     | <b>425</b>     |
| Common stock and common stock equivalents           | 5,244   | 5,362   | <b>5,482</b>   |
| Earnings per share:                                 |         |         |                |
| Basic   | \$ 0.72 | \$ 0.92 | <b>\$ 1.54</b> |
| Diluted   | \$ 0.66 | \$ 0.84 | <b>\$ 1.42</b> |

#### 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, Inc. 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. During fiscal 1999, 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.

In July 1999, Ticketmaster Online CitySearch, Inc. agreed to purchase certain online properties of Sidewalk in exchange for stock and warrants at a price to be determined upon closing.

#### 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 \$92 million, \$95 million, and \$135 million in 1997, 1998, and 1999. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2000, \$133; 2001, \$121; 2002, \$97; 2003, \$83; 2004, \$75; and thereafter, \$194.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 2000, \$125 and 2001, \$22. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed \$275 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

## NOTES continued

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. 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. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java compatibility logo, and against distributing Internet Explorer 4.0 browser technology unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary, and punitive damages, and liquidated damages of \$35 million for the alleged source code disclosure.

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 on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On July 23, 1999 the court also granted Microsoft's motion to increase the bond on the preliminary injunction from \$15 million to \$35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the court issued tentative rulings on three of the motions. In the preliminary rulings, the court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++® 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the court heard oral argument on the three tentative rulings. No final orders have been issued. At the hearing, the court also directed the parties to identify other pending summary judgment motions that the court should next consider. There are no other hearing or trial dates set.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of 20 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. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS® operating system and Windows in the late 80s and early 90s — essentially the same complaints that

NOTES continued (in millions)

resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

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

| Year Ended June 30 | Windows<br>Platforms | Productivity<br>Applications<br>and<br>Developer | Consumer,<br>Commerce,<br>and Other | Reconciling<br>Amounts | Consolidated |
|--------------------|----------------------|--|-------------------------------------|------------------------|--------------|
| <b>1997</b>        |                      |  |                                     |                        |              |
| Revenue            | \$5,213              | \$5,992  | \$ 1,129                            | \$ (398)               | \$           |
|                    | 11,936               |  |                                     |                        |              |
| <b>1998</b>        |                      |  |                                     |                        |              |
| Revenue            | \$6,236              | \$7,458  | \$ 1,765                            | \$ (197)               | \$           |
|                    | 15,262               |  |                                     |                        |              |
| Operating income   | 3,661                | 4,824  | (1,050)                             | (1,021)                | 6,414        |
| <b>1999</b>        |                      |  |                                     |                        |              |
| Revenue            | \$8,590              | \$8,686  | \$ 1,784                            | \$ 687                 | \$           |
|                    | 19,747               |  |                                     |                        |              |
| Operating income   | 6,007                | 5,568  | (1,072)                             | (575)                  | 9,928        |

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, Commerce, and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and other Internet services. Assets of the segment groups are not relevant for management of the businesses nor for disclosure. In addition, it is not practicable to discern operating income for 1997 for the above segments due to previous internal reorganizations.

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 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 revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization, but do not reflect the charge for the ESO exercise price methodology previously employed by the Company.

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 \$7.8 billion, \$10.1 billion, and \$13.7 billion in 1997, 1998, and 1999. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled \$4.1 billion, \$5.2 billion, and \$6.0 billion in 1997, 1998, and 1999.

Long-lived assets totaled \$1.2 billion and \$1.5 billion in the United States in 1998 and 1999 and \$287 million and \$154 million in other countries in 1998 and 1999.

QUARTERLY INFORMATION (in millions, except per share amounts, unaudited)

|                               | Quarter Ended |         |         |         | Year     |
|-------------------------------|---------------|---------|---------|---------|----------|
|                               | Sept. 30      | Dec. 31 | Mar. 31 | June 30 |          |
| 1997                          |               |         |         |         |          |
| Revenue                       | \$2,405       | \$2,808 | \$3,365 | \$3,358 | \$11,936 |
| Gross profit                  | 1,923         | 2,250   | 2,782   | 2,811   | 9,766    |
| Net income                    | 614           | 741     | 1,042   | 1,057   | 3,454    |
| Basic earnings per share      | 0.13          | 0.15    | 0.22    | 0.22    | 0.72     |
| Diluted earnings per share    | 0.12          | 0.14    | 0.20    | 0.20    | 0.66     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 17.33         | 21.54   | 25.88   | 33.74   | 33.74    |
| Low                           | 13.44         | 16.36   | 20.19   | 22.44   | 13.44    |
| 1998                          |               |         |         |         |          |
| Revenue                       | \$3,334       | \$3,792 | \$3,984 | \$4,152 | \$       |
| 15,262                        |               |         |         |         |          |
| Gross profit                  | 2,800         | 3,179   | 3,344   | 3,479   | 12,802   |
| Net income                    | 663           | 1,133   | 1,337   | 1,357   | 4,490    |
| Basic earnings per share      | 0.14          | 0.24    | 0.27    | 0.27    | 0.92     |
| Diluted earnings per share    | 0.13          | 0.21    | 0.25    | 0.25    | 0.84     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 37.69         | 36.66   | 45.47   | 54.28   | 54.28    |
| Low                           | 30.82         | 29.50   | 31.10   | 40.94   | 29.50    |
| 1999                          |               |         |         |         |          |
| Revenue                       | \$4,193       | \$5,195 | \$4,595 | \$5,764 | \$       |
| 19,747                        |               |         |         |         |          |
| Gross profit                  | 3,544         | 4,407   | 3,887   | 5,095   | 16,933   |
| Net income                    | 1,683         | 1,983   | 1,917   | 2,202   | 7,785    |
| Basic earnings per share      | 0.34          | 0.40    | 0.38    | 0.43    | 1.54     |
| Diluted earnings per share    | 0.31          | 0.36    | 0.35    | 0.40    | 1.42     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 59.81         | 72.00   | 94.63   | 95.63   | 95.63    |

**STATEMENTS**

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ACCOUNTING POLICIES

> **ACCOUNTING PRINCIPLES** The financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles.

> **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 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 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.

> **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. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

> **STOCK SPLIT** During March 1999, 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 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.

During June 1999, the Financial Accounting Standards Board (FASB) issued SFAS 137, Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement 133. The Statement defers the effective date of SFAS 133 to fiscal 2001. Management is evaluating SFAS 133 and does not believe that adoption of the Statement will have a material impact on its financial statements.

> **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.

> **RECLASSIFICATIONS** The Company changed the way it reports revenue and costs associated with product support, consulting, MSN Internet access, and certification and training of system integrators. Amounts received from customers for these activities have been classified as revenue in a manner more consistent with Microsoft's primary businesses. Direct costs of these activities are classified as cost of revenue. Prior financial statements have been reclassified for consistent presentation. Certain other reclassifications have also 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 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. The impact on fiscal 1999 was to increase reported revenue \$170 million. In addition, the Company extended the life cycle of Windows from two to three years based upon management's review of product shipment cycles. The impact on fiscal 1999 was to decrease reported revenue \$90 million. 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, Windows platforms products unearned revenue was \$2.17 billion and unearned revenue associated with productivity applications and developer products totaled \$1.96 billion. Unearned revenue for other miscellaneous programs totaled \$116 million at June 30, 1999.

#### 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's return with options in the event of a catastrophic increase in interest rates. At June 30, 1999, the notional amount of the options outstanding was \$4.0 billion. 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 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. 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. At June 30, 1999, the notional amount of options outstanding was \$662 million. 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 at June 30, 1999 was \$2.25 billion. The fair value and premiums paid for the options were not material.

At June 30, 1998 and 1999, approximately 40% and 50% of accounts receivable represented amounts due from 10 customers. One customer accounted for approximately 12%, 8%, and 11% of revenue in 1997, 1998, and 1999.

#### NOTES continued (in millions)

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

#### CASH AND SHORT-TERM INVESTMENTS

| June 30                               | 1998   | 1999   |
|---------------------------------------|--------|--------|
| Cash and equivalents:                 |        |        |
| Cash                                  | \$ 195 | \$ 635 |
| Commercial paper                      | 2,771  | 3,805  |
| Certificates of deposit               | 419    | 522    |
| Money market preferreds               | 454    | 13     |
| Cash and equivalents                  | 3,839  | 4,975  |
| Short-term investments:               |        |        |
| Commercial paper                      | 868    | 1,026  |
| U.S. government and agency securities | 3,511  | 3,592  |
| Corporate notes and bonds             | 3,998  | 6,996  |
| Municipal securities                  | 1,361  | 247    |
| Certificates of deposit               | 350    | 400    |

|                                 |          |               |
|---------------------------------|----------|---------------|
| Short-term investments          | 10,088   | <b>12,261</b> |
| Cash and short-term investments | \$13,927 | <b>\$</b>     |
| <b>17,236</b>                   |          |               |

**PROPERTY AND EQUIPMENT**

|                                  |          |                |
|----------------------------------|----------|----------------|
| June 30                          | 1998     | <b>1999</b>    |
| Land                             | \$ 183   | <b>\$ 158</b>  |
| Buildings                        | 1,259    | <b>1,347</b>   |
| Computer equipment               | 1,182    | <b>1,433</b>   |
| Other                            | 428      | <b>578</b>     |
| Property and equipment – at cost | 3,052    | <b>3,516</b>   |
| Accumulated depreciation         | (1,547)  | <b>(1,905)</b> |
| Property and equipment – net     | \$ 1,505 | <b>\$</b>      |
| <b>1,611</b>                     |          |                |

During 1997, 1998, and 1999, depreciation expense, of which the majority related to computer equipment, was \$353 million, \$528 million, and \$483 million; disposals were not material.

NOTES continued (in millions)

EQUITY AND OTHER INVESTMENTS

| June 30, 1999   | Cost Basis | Net<br>Unrealized<br>Gains | Recorded<br>Basis |
|---|------------|----------------------------|-------------------|
| Debt securities recorded at market, maturing:         |            |                            |                   |
| Within one year                                       | \$ 682     | \$ 8                       | \$ 690            |
| Between 10 and 15 years                               | 533        | (3)                        | 530               |
| Beyond 15 years (AT&T)                                | 4,731      | 347                        | 5,078             |
| Debt securities recorded at market                    | 5,946      | 352                        | 6,298             |
| Equity securities recorded at market:                 |            |                            |                   |
| Comcast Corporation common stock                      | 500        | 1,394                      | 1,894             |
| MCI Worldcom, Inc. common stock                       | 14         | 1,088                      | 1,102             |
| Other   | 849        | 1,102                      | 1,951             |
| Unrealized hedge loss                                 | —          | (785)                      | (785)             |
| Equity securities recorded at market                  | 1,363      | 2,799                      | 4,162             |
| Equity securities and instruments recorded at cost:   |            |                            |                   |
| Nextel Communications, Inc. common stock              | 600        | —                          | 600               |
| Comcast Corporation convertible preferred stock       | 555        | —                          | 555               |
| NTL, Inc. convertible preferred stock                 | 511        | —                          | 511               |
| Other   | 2,179      | —                          | 2,179             |
| Equity securities and<br>instruments recorded at cost | 3,845      | —                          | 3,845             |
| Other investments                                     | 67         | —                          | 67                |
| Equity and other investments                          | \$11,221   | \$3,151                    | \$                |
| <b>14,372</b>   |            |                            |                   |

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. Unrealized gains on equity securities recorded at market were \$1.4 billion on June 30, 1998. Equity securities and instruments recorded at cost include primarily preferred stock, common stock, and warrants that are restricted or not publicly traded. At June 30, 1998 and 1999, the estimated fair value of these investments was \$2.4 billion and \$6.1 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, the notional amount of the options outstanding was \$2.1 billion; the fair value was \$1.0 billion; and premiums paid for the options were not material. Realized gains and losses of equity and other investments in 1997 and 1998 were not material; realized gains were \$623 million and losses were not material in 1999.

NOTES continued (in millions)

## INCOME TAXES

> The provision for income taxes consisted of:

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| Current taxes:             |         |         |              |
| U.S. and state             | \$1,710 | \$2,518 | \$           |
| <b>4,027</b>               |         |         |              |
| International              | 412     | 526     | <b>281</b>   |
| Current taxes              | 2,122   | 3,044   |              |
| <b>4,308</b>               |         |         |              |
| Deferred taxes             | (262)   | (417)   | <b>(202)</b> |
| Provision for income taxes | \$1,860 | \$2,627 | \$           |
| <b>4,106</b>               |         |         |              |

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

| Year Ended June 30         | 1997    | 1998    | 1999         |
|----------------------------|---------|---------|--------------|
| U.S.                       | \$3,775 | \$5,072 | \$           |
| <b>10,649</b>              |         |         |              |
| International              | 1,539   | 2,045   | <b>1,242</b> |
| Income before income taxes | \$5,314 | \$7,117 | \$           |
| <b>11,891</b>              |         |         |              |

The effective income tax rate was 35.0% in 1997 and increased to 36.9% in 1998 due to the non-deductible 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. The components of the differences between the U.S. statutory tax rate and the Company's effective tax rate were not significant.

Income taxes payable were:

| June 30                          | 1998     | 1999         |
|----------------------------------|----------|--------------|
| Deferred income tax assets:      |          |              |
| Revenue items                    | \$ 713   | \$ 1,145     |
| Expense items                    | 613      | <b>648</b>   |
| Deferred income tax assets       | 1,326    | <b>1,793</b> |
| Deferred income tax liabilities: |          |              |
| Unrealized gain on investments   | (479)    |              |
| <b>(1,046)</b>                   |          |              |
| International earnings           | (373)    | <b>(647)</b> |
| Other                            | (26)     | <b>(16)</b>  |
| Deferred income tax liabilities  | (878)    |              |
| <b>(1,709)</b>                   |          |              |
| Current income tax liabilities   | (1,363)  |              |
| <b>(1,691)</b>                   |          |              |
| Income taxes payable             | \$ (915) | \$           |
| <b>(1,607)</b>                   |          |              |

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991, which the Company is contesting in U.S. 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 \$1.1 billion in 1997, \$1.1 billion in 1998, and \$874 million in 1999.

NOTES continued (in millions)

#### CONVERTIBLE PREFERRED STOCK

> During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred stockholders 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, equivalent to \$19.97 and \$25.56 per common share. Net proceeds of \$980 million were used to repurchase common shares.

#### COMMON STOCK

> ISSUED AND OUTSTANDING      Shares of common stock outstanding were as follows:

| Year Ended June 30         | 1997  | 1998  | 1999  |
|----------------------------|-------|-------|-------|
| Balance, beginning of year | 4,776 | 4,816 | 4,940 |
| Issued                     | 188   | 202   | 213   |
| Repurchased                | (148) | (78)  | (44)  |
| Balance, end of year       | 4,816 | 4,940 | 5,109 |

> REPURCHASE PROGRAM      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 2000.

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

> To enhance its stock repurchase program, Microsoft 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, 1999, 163 million warrants were outstanding with strike prices ranging from \$59 to \$65 per share. The put warrants expire between September 1999 and March 2002. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

NOTES continued (in millions, except per share amounts)

#### 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 1997, 1998, and 1999, employees purchased 5.6 million, 4.4 million, and 2.7 million shares at average prices of \$14.91, \$27.21, and \$52.59 per share. At June 30, 1999, 70.9 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 \$28 million, \$39 million, and \$49 million in 1997, 1998, and 1999.

> **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 over seven and one-half years and expire after 10 years. At June 30, 1999, options for 406 million shares were vested and 998 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

|                        |        | Price per Share |           |                  |
|------------------------|--------|-----------------|-----------|------------------|
|                        | Shares | Range           |           | Weighted Average |
| Balance, June 30, 1996 | 952    | \$ 0.28         | – \$14.74 | \$ 5.52          |
| Granted                | 220    | 13.83           | – 29.80   |                  |
| 14.58                  |        |                 |           |                  |
| Exercised              | (180)  | 0.28            | – 14.74   | 3.32             |
| Canceled               | (36)   | 4.25            | – 24.29   | 9.71             |
| Balance, June 30, 1997 | 956    | 0.56            | – 29.80   | 7.86             |
| Granted                | 138    | 16.56           | – 43.63   |                  |
| 31.28                  |        |                 |           |                  |
| Exercised              | (176)  | 0.56            | – 31.24   | 4.64             |
| Canceled               | (25)   | 4.25            | – 41.94   |                  |
| 14.69                  |        |                 |           |                  |
| Balance, June 30, 1998 | 893    | 0.56            | – 43.63   |                  |
| 11.94                  |        |                 |           |                  |
| Granted                | 78     | 45.59           | – 83.28   |                  |
| 54.62                  |        |                 |           |                  |
| Exercised              | (175)  | 0.56            | – 53.63   | 6.29             |
| Canceled               | (30)   | 4.25            | – 74.28   |                  |
| 21.06                  |        |                 |           |                  |
| Balance, June 30, 1999 | 766    | 0.56            | – 83.28   |                  |
| 17.28                  |        |                 |           |                  |

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1999 were as follows:

| Range of<br>Exercise Prices | Outstanding Options |                              |                              | Exercisable Options |                              |
|-----------------------------|---------------------|------------------------------|------------------------------|---------------------|------------------------------|
|                             | Shares              | Remaining<br>Life<br>(Years) | Weighted<br>Average<br>Price | Shares              | Weighted<br>Average<br>Price |
| \$ 0.56 – \$ 5.97           | 242                 | 2.9                          | \$ 4.31                      | 230                 | \$ 4.24                      |
| 5.98 – 13.62                | 158                 | 3.9                          | 10.85                        | 89                  | 10.62                        |

|       |   |       |     |     |       |    |       |
|-------|---|-------|-----|-----|-------|----|-------|
| 13.63 | - | 29.80 | 173 | 4.7 | 14.92 | 66 | 14.67 |
| 29.81 | - | 43.62 | 117 | 5.5 | 32.06 | 21 | 31.83 |
| 43.63 | - | 83.28 | 76  | 6.2 | 55.04 | -  | -     |



NOTES continued (in millions, except per share amounts)

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. Historically, exercise prices of grants of ESOs were struck at the lowest price in the 30 days following July 1 for annual grants and the 30 days after the start date for new employees. In connection with this practice, which is no longer employed, a charge of \$217 million was recorded in the fourth quarter for fiscal 1999 compensation expense.

An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards, pro forma income statements for 1997, 1998, and 1999 would have been as follows:

| Year Ended June 30              | 1997     |           | 1998     |           | 1999     |           |
|---------------------------------|----------|-----------|----------|-----------|----------|-----------|
|                                 | Reported | Pro forma | Reported | Pro forma | Reported | Pro forma |
| Revenue                         | \$11,936 | \$11,936  | \$15,262 | \$15,262  | \$19,747 | \$19,747  |
| Operating expenses:             |          |           |          |           |          |           |
| Cost of revenue                 | 2,170    | 2,290     | 2,460    | 2,628     | 2,814    | 3,024     |
| Research and development        | 1,863    | 2,168     | 2,601    | 3,023     | 2,970    | 3,504     |
| Acquired in-process technology  | —        | —         | 296      | 296       | —        | —         |
| Sales and marketing             | 2,411    | 2,539     | 2,828    | 3,003     | 3,231    | 3,448     |
| General and administrative      | 362      | 424       | 433      | 520       | 689      | 822       |
| Other expenses                  | 259      | 259       | 230      | 230       | 115      | 115       |
| Total operating expenses        | 7,065    | 7,680     | 8,848    | 9,700     | 9,819    | 10,913    |
| Operating income                | 4,871    | 4,256     | 6,414    | 5,562     | 9,928    | 8,834     |
| Investment income               | 443      | 443       | 703      | 703       | 1,803    | 1,803     |
| Gain on sale of Softimage, Inc. | —        | —         | —        | —         | 160      | 160       |
| Income before income taxes      | 5,314    | 4,699     | 7,117    | 6,265     | 11,891   | 10,797    |
| Provision for income taxes      | 1,860    | 1,646     | 2,627    | 2,325     | 4,106    | 3,723     |
| Net income                      | 3,454    | 3,053     | 4,490    | 3,940     | 7,785    | 7,074     |
| Preferred stock dividends       | 15       | 15        | 28       | 28        | 28       | 28        |
| Net income available for        |          |           |          |           |          |           |
| Common shareholders             | \$ 3,439 | \$ 3,038  | \$ 4,462 | \$ 3,912  | \$ 7,757 | \$ 7,046  |
| Diluted earnings per share      | \$ 0.66  | \$ 0.58   | \$ 0.84  | \$ 0.73   | \$ 1.42  | \$ 1.29   |

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1997, 1998, and 1999, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been \$3,179 million, \$4,019 million, and \$7,109 million, and earnings per share would have been \$0.61, \$0.75, and \$1.30 for 1997, 1998, and 1999.

The weighted average Black-Scholes value of options granted under the stock option plans during 1997, 1998, and 1999 was \$5.86, \$11.81, and \$20.90. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1999 and 1998 and .30 in 1997, and risk-free interest rates of 6.5%, 5.7%, and 4.9% in 1997, 1998, and 1999.

NOTES continued (in millions, except per share amounts)

#### EARNINGS PER SHARE

> Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding preferred shares using the "if-converted" method, assumed net-share settlement of common stock structured repurchases, and outstanding stock options using the "treasury stock" method.

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

| Year Ended June 30                                  | 1997    | 1998    | 1999           |
|---|---------|---------|----------------|
| Net income  | \$3,454 | \$4,490 | \$             |
| <b>7,785</b>  |         |         |                |
| Preferred stock dividends                           | 15      | 28      | <b>28</b>      |
| Net income available for common shareholders        | \$3,439 | \$4,462 | \$             |
| <b>7,757</b>  |         |         |                |
| Weighted average outstanding shares of common stock | 4,782   | 4,864   | <b>5,028</b>   |
| Dilutive effect of:                                 |         |         |                |
| Common stock under structured repurchases           | —       | 6       | <b>13</b>      |
| Preferred stock                                     | 26      | 34      | <b>16</b>      |
| Employee stock options                              | 436     | 458     | <b>425</b>     |
| Common stock and common stock equivalents           | 5,244   | 5,362   | <b>5,482</b>   |
| Earnings per share:                                 |         |         |                |
| Basic   | \$ 0.72 | \$ 0.92 | <b>\$ 1.54</b> |
| Diluted   | \$ 0.66 | \$ 0.84 | <b>\$ 1.42</b> |

#### 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, Inc. 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. During fiscal 1999, 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.

In July 1999, Ticketmaster Online CitySearch, Inc. agreed to purchase certain online properties of Sidewalk in exchange for stock and warrants at a price to be determined upon closing.

#### 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 \$92 million, \$95 million, and \$135 million in 1997, 1998, and 1999. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 2000, \$133; 2001, \$121; 2002, \$97; 2003, \$83; 2004, \$75; and thereafter, \$194.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 2000, \$125 and 2001, \$22. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed \$275 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

## NOTES continued

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. 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. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java compatibility logo, and against distributing Internet Explorer 4.0 browser technology unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary, and punitive damages, and liquidated damages of \$35 million for the alleged source code disclosure.

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 on December 16, 1998. Oral argument on that appeal was held on June 16, 1999. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. The court granted that motion. On July 23, 1999 the court also granted Microsoft's motion to increase the bond on the preliminary injunction from \$15 million to \$35 million.

On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. On May 20, 1999, the court issued tentative rulings on three of the motions. In the preliminary rulings, the court (1) granted Sun's motion for summary judgment that prior versions of Internet Explorer 4.0, Windows 98, Windows NT, Visual J++® 6.0 development system, and the SDK for Java infringe Sun's copyrights, because they contain Sun's program code but do not pass Sun's compatibility tests and, therefore, Microsoft's use of Sun's technology is outside the scope of the Agreement and unlicensed; (2) granted Microsoft's motion that the Agreement authorizes Microsoft to distribute independently developed Java technology that is not subject to the compatibility obligations in the Agreement; and (3) denied Sun's motion for summary judgment on the meaning of certain provisions of the Agreement, tentatively adopting Microsoft's interpretation that Sun is required to deliver certain new Java technology, called "Supplemental Java Classes," in working order on Microsoft's then existing and commercially distributed virtual machine. On June 24, 1999, the court heard oral argument on the three tentative rulings. No final orders have been issued. At the hearing, the court also directed the parties to identify other pending summary judgment motions that the court should next consider. There are no other hearing or trial dates set.

On May 18, 1998, the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of 20 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. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of the MS-DOS® operating system and Windows in the late 80s and early 90s — essentially the same complaints that

NOTES continued (in millions)

resulted in the 1994 DOJ consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research, Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Trial is scheduled for January 2000. Some partial summary judgment motions are pending. Microsoft believes the claims are without merit and is vigorously defending the case.

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

| Year Ended June 30 | Windows<br>Platforms | Productivity<br>Applications<br>and<br>Developer | Consumer,<br>Commerce,<br>and Other | Reconciling<br>Amounts | Consolidated |
|--------------------|----------------------|--|-------------------------------------|------------------------|--------------|
| <b>1997</b>        |                      |  |                                     |                        |              |
| Revenue            | \$5,213              | \$5,992  | \$ 1,129                            | \$ (398)               | \$           |
|                    | 11,936               |  |                                     |                        |              |
| <b>1998</b>        |                      |  |                                     |                        |              |
| Revenue            | \$6,236              | \$7,458  | \$ 1,765                            | \$ (197)               | \$           |
|                    | 15,262               |  |                                     |                        |              |
| Operating income   | 3,661                | 4,824  | (1,050)                             | (1,021)                | 6,414        |
| <b>1999</b>        |                      |  |                                     |                        |              |
| Revenue            | \$8,590              | \$8,686  | \$ 1,784                            | \$ 687                 | \$           |
|                    | 19,747               |  |                                     |                        |              |
| Operating income   | 6,007                | 5,568  | (1,072)                             | (575)                  | 9,928        |

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, Commerce, and Other. Windows Platforms includes the Business and Enterprise Division, which is primarily responsible for Windows NT and developing Windows 2000. Windows Platforms also includes the Consumer Windows Division, which oversees Windows 98 and Windows 95. Productivity Applications and Developer includes the Business Productivity Division, which is responsible for developing and marketing desktop applications, server applications, and developer tools. Consumer, Commerce, and Other products and services include primarily learning, entertainment, and PC input device products; WebTV and PC online access; and portal and other Internet services. Assets of the segment groups are not relevant for management of the businesses nor for disclosure. In addition, it is not practicable to discern operating income for 1997 for the above segments due to previous internal reorganizations.

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 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 revenue from product support, consulting, and training and certification of system integrators. Additionally, the internal P&Ls use accelerated methods of depreciation and amortization, but do not reflect the charge for the ESO exercise price methodology previously employed by the Company.

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 \$7.8 billion, \$10.1 billion, and \$13.7 billion in 1997, 1998, and 1999. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled \$4.1 billion, \$5.2 billion, and \$6.0 billion in 1997, 1998, and 1999.

Long-lived assets totaled \$1.2 billion and \$1.5 billion in the United States in 1998 and 1999 and \$287 million and \$154 million in other countries in 1998 and 1999.

QUARTERLY INFORMATION (in millions, except per share amounts, unaudited)

|                               | Quarter Ended |         |         |         | Year     |
|-------------------------------|---------------|---------|---------|---------|----------|
|                               | Sept. 30      | Dec. 31 | Mar. 31 | June 30 |          |
| 1997                          |               |         |         |         |          |
| Revenue                       | \$2,405       | \$2,808 | \$3,365 | \$3,358 | \$11,936 |
| Gross profit                  | 1,923         | 2,250   | 2,782   | 2,811   | 9,766    |
| Net income                    | 614           | 741     | 1,042   | 1,057   | 3,454    |
| Basic earnings per share      | 0.13          | 0.15    | 0.22    | 0.22    | 0.72     |
| Diluted earnings per share    | 0.12          | 0.14    | 0.20    | 0.20    | 0.66     |
| Common stock price per share: |               |         |         |         |          |
| High                          | 17.33         | 21.54   | 25.88   | 33.74   | 33.74    |
| Low                           | 13.44         | 16.36   | 20.19   | 22.44   | 13.44    |

|                               |         |         |         |         |        |
|-------------------------------|---------|---------|---------|---------|--------|
| 1998                          |         |         |         |         |        |
| Revenue                       | \$3,334 | \$3,792 | \$3,984 | \$4,152 | \$     |
| 15,262                        |         |         |         |         |        |
| Gross profit                  | 2,800   | 3,179   | 3,344   | 3,479   | 12,802 |
| Net income                    | 663     | 1,133   | 1,337   | 1,357   | 4,490  |
| Basic earnings per share      | 0.14    | 0.24    | 0.27    | 0.27    | 0.92   |
| Diluted earnings per share    | 0.13    | 0.21    | 0.25    | 0.25    | 0.84   |
| Common stock price per share: |         |         |         |         |        |
| High                          | 37.69   | 36.66   | 45.47   | 54.28   | 54.28  |
| Low                           | 30.82   | 29.50   | 31.10   | 40.94   | 29.50  |

|                               |         |         |         |         |        |
|-------------------------------|---------|---------|---------|---------|--------|
| 1999                          |         |         |         |         |        |
| Revenue                       | \$4,193 | \$5,195 | \$4,595 | \$5,764 | \$     |
| 19,747                        |         |         |         |         |        |
| Gross profit                  | 3,544   | 4,407   | 3,887   | 5,095   | 16,933 |
| Net income                    | 1,683   | 1,983   | 1,917   | 2,202   | 7,785  |
| Basic earnings per share      | 0.34    | 0.40    | 0.38    | 0.43    | 1.54   |
| Diluted earnings per share    | 0.31    | 0.36    | 0.35    | 0.40    | 1.42   |
| Common stock price per share: |         |         |         |         |        |
| High                          | 59.81   | 72.00   | 94.63   | 95.63   | 95.63  |
| Low                           | 47.25   | 48.13   | 68.00   | 75.50   | 47.25  |

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1999, there were 92,169 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

|     |       |       |       |       |       |
|-----|-------|-------|-------|-------|-------|
| .63 |       |       |       |       |       |
| Low | 47.25 | 48.13 | 68.00 | 75.50 | 47.25 |

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|                               |       |       |       |       |       |
|-------------------------------|-------|-------|-------|-------|-------|
| 5                             |       |       |       |       |       |
| Basic earnings per share      | 0.34  | 0.40  | 0.38  | 0.43  | 1.54  |
| Diluted earnings per share    | 0.31  | 0.36  | 0.35  | 0.40  | 1.42  |
| Common stock price per share: |       |       |       |       |       |
| High                          | 59.81 | 72.00 | 94.63 | 95.63 | 95.63 |
| Low                           | 47.25 | 48.13 | 68.00 | 75.50 | 47.25 |

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1999, there were 92,169 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

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