Presentation

Operator

Good afternoon and welcome to the Microsoft fourth quarter fiscal year 2007 earnings conference call. (Operator Instructions) I would now like to turn the call over to Ms. Colleen Healy, General Manager, Investor Relations. Please go ahead.

Colleen Healy

Good afternoon, everyone and thank you for joining us today. This afternoon I'm joined by Chris Liddell, Senior Vice President and Chief Financial Officer; Frank Brod, Corporate Vice President and Chief Accounting Officer; and John Seethoff, Deputy General Counsel.

Today's call will start with Chris providing some key takeaways for the fourth quarter of fiscal year 2007 and an overview of expectations for fiscal year 2008. I will then provide detail around our fourth quarter results, and then turn it back to Chris for a more detailed discussion of our guidance for the full year and first quarter of fiscal 2008. After that, we will take your questions.

Our earnings release includes an addendum of financial highlights which contains more detailed information about revenue, operating expenses and other items. We have also posted our quarterly financial summary slide deck, which is intended to follow the flow of our prepared remarks in order to assist you.

The slide deck offers highlights from the quarter, outlines our guidance, and provides a reconciliation of differences between GAAP and non-GAAP financial measures that we will talk about today. You can find the earnings release, the financial highlights and the quarterly financial summary slide deck on the investor relations website at www.Microsoft.com/msft.

Today's call will be recorded. Please be aware that if you decide to ask a question, it will be included in both our live transmission as well as any future use of the recording. As always, shareholders and analysts can listen to a live webcast of today's call at the Microsoft Investor Relations website. A replay of the call will be available at this same site through the close of business on July 19, 2008.

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We will make forward statements during this call. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings press release and the comments made during this conference call and in our 2006 Form 10-K, subsequent quarterly reports on Form 10-Q and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

With that, let me now turn it over to Chris.

Chris Liddell

Thanks Colleen, and good afternoon, everyone. Thanks for joining us today. I'll start today's call with highlights from last fiscal year's performance and then give you an overview of our expectations for fiscal 2008.

Our quarter 4 performance capped an extremely strong year for our company, and helped set the stage for fiscal 2008 to be another year of double-digit revenue, operating income and earnings per share growth.

I'm extremely pleased with the traction our sales force and partners are experiencing with business customers, evidenced by billings growth in the quarter for enterprise agreements in excess of 25%, and non-annuity licensing up of over 15%. When you combine those figures with billings for OEM and packaged products each growing 10% plus in the quarter, you'll see that demand was strong across all of our channels and customers.

Looking at our full year results, fiscal 2007 was a year of $7 billion of revenue growth, fueled by robust customer acceptance of products in both our emerging and mature businesses including Windows Vista, Microsoft Office 2007, SQL Server, Windows Server, and Xbox 360 consoles. Our core businesses accounted for $5 billion of absolute revenue growth, with the business division, client, and server and tools growing 13%, 14% and 16%, respectively for the year.

Operating income for the year also grew double-digits. We were able to achieve this while still be being able to make a number of significant investments in our businesses. For example, the launch of over 40 new products into the marketplace, as well as a number of updates and enhancements to our online service offerings, continued development of a number of upcoming products such as new versions of Windows Server, SQL Server, and Visual Studio, the enhancement of our online service infrastructure by continuing to refine adCenter; increasing our database capacity; and necessary investments in Xbox customer satisfaction.

We also announced eight strategic acquisitions including: aQuantive, to provide the advertising industry with a world-class, Internet-wide advertising platform; Tellme, for its voice response services; and Softricity for its application virtualization and streaming capabilities.

Earnings for the year came in at $1.42, up 18% over last year, which was faster than both revenue and operating income.

Finally, during fiscal ‘07 we made significant progress on our strategy of returning cash to shareholders. Last year at this time we announced authorization for programs to repurchase up to $40 billion worth of our stock over five years. Today, one year after that announcement, I am happy to say that we have passed the halfway mark on the program by repurchasing approximately $25 billion worth of our stock during the year.

When you combine the share repurchases we made this year with the $3.8 billion worth of dividends paid, we returned about 175% of operating cash flow to shareholders.

Now I would like to move to our outlook for fiscal ‘08. Given the good exit from fiscal ‘07 we are increasing our revenue, operating income and earnings per share guidance for next year on an absolute basis. We expect revenue growth of 11% to 13%, with operating income and earnings per share growing even faster than that.

I'm particularly pleased that the high end of our guidance reflects each of our businesses growing revenue at double-digit rates for the year, especially given our robust performance in fiscal ‘07.

Looking to our product lineup in ‘08, next year represents another significant launch year for the company. We will intensify our pursuit of important market opportunities for the company with product launches in business intelligence, unified communications, security and business applications.

By the time we exit next year, we will have refreshed a major portion of our server lineup within a period of 15 months with the addition of new versions of Windows Server and SQL. Additionally, the consumers will have a great lineup of first and third-party games heading into the holidays, led by the release of Halo 3, plus continuing enhancements to our Windows Live services.

With those high level themes for 2007 and 2008, I am going to turn the call over to Colleen now for more details on how we closed out last year.

Colleen Healy

Thanks, Chris. As Chris mentioned, the fourth quarter delivered a strong finish to the year with revenue near the high end of our guidance provided on the April earnings call. Specifically, demand for our offerings was excellent, with revenue growing 13% and core bookings increasing over 20%, characterized by high annuity revenue growth, driven by outstanding field sales force execution on enterprise agreement renewals. This speaks not only to the healthy customer acceptance of the products recently launched, but also to the anticipation of our offerings still to come.

Let me provide you with details of our financial performance, starting with revenue. I'll discuss top line, financial and business momentum points, and then follow-up with revenue performance for each of the business units. Then I'll review the rest of the income statement. All growth comparisons I mention relate to the comparable quarter of last year, unless otherwise specified.

As I mentioned, revenue grew 13% to $13.4 billion, driven by client, the Microsoft business division and server and tools. Online services also had a good quarter. Each of these four businesses grew in the mid to high teens, and collectively at 16%.

The underlying PC hardware market remained robust, with estimated growth of 11% to 13% during the quarter, about a point higher than our expectations. PC shipment growth rates in emerging markets continue to outpace that of mature markets, and consumer PC shipment growth outpaced that of the Business Segment. Every region, except the US and Japan, increased PC shipments at double-digit rates.

Our mix of product billings for the quarter was approximately 30% from OEMs, over 40% from multi-year licensing agreements, around 15% from license-only sales, and the balance from our other businesses.

Over the past couple of years we have seen a mix shift from license-only sales to annuity agreements, driven by standing adoption of enterprise agreements. Enterprise agreement renewal rates exceeded the high end of our historical range of 66% to 75%. We are delighted that the value proposition from our current product lineup and future roadmap -- beyond the recently launched flagship desktop product even -- are resonating with customers.

This strong annuity licensing performance drove our unearned revenue balance 16% higher to $12.6 billion and our contracted, not billed balance was driven higher on both a sequential and year-over-year basis, exceeding $10 billion at the end of June. As a result, total bookings grew over 15%, and core bookings of client, Microsoft business division and server and tools increased over 20%, as I previously mentioned.

I'll close out the revenue overview by adding that changes in foreign exchange rates added about 2 percentage points to our overall revenue growth. Now I will provide revenue highlights by business segment.

Client revenue grew 14% to $3.8 billion, characterized by strong OEM revenue growth, driven by continued demand for Windows Vista and a healthy PC hardware market. OEM revenue increased 15% and includes 3 points of revenue recognition from undelivered elements. Adjusting for this impact, OEM revenue grew roughly in line with OEM unit shipments at 11%.

OEM premium mix was 72%, a 17 percentage point increase over this period last year. This was driven by a 20 percentage point increase in the consumer element of premium mix, and around a 3 percentage point decline in the business element. Given the over 5:1 pricing uplift we received from the business premium SKUs over consumer premium SKUs, these changes within the premium mix have largely an offsetting impact to revenue.

For further background on this new disclosure, we have included a slide in the earnings deck on our website that illustrates these metrics, as well as lists of SKUs comprising each of the consumer and business premium mixes.

Client, commercial and retail licensing increased 7%. Businesses are recognizing the value that Windows Vista and Software Assurance provides them, as evidenced by high renewal and new annuity attach rates, driving about a 25% increase in the volume licensing portion of the unearned revenue balance.

Server and tools revenue grew 15% to $3.1 billion, driven by SQL Server, Windows Server, Visual Studio and consulting services revenue. Fiscal 2007 capped a decade of consecutive years of double-digit revenue growth for SQL Server. During the quarter, significant product development momentum was achieved with beta releases of the upcoming versions of Windows Server and Visual Studio, and a community technology preview of SQL Server 2008.

In our online services business we saw advertising revenue growth of 33%, exceeding our expectations. Search ad revenue benefited from both increased search queries and revenue per search, while display ad revenue enjoyed both increased number of page views and revenue per page view. Overall, online services business revenue grew 19% to $688 million.

Microsoft business division revenue grew 19% to $4.6 billion, beating high end guidance by over $150 million. Highlights in the quarter included solid revenue growth through enterprise agreements for Office, and continued momentum for Share Point. Enterprise agreement momentum continued after the launch of the Office 2007 system, and renewal rates are higher now than they were a year ago.

We are also pleased with the results of our Dynamic business, which showed healthy performance across both the ERP and CRM product lines, driving a 24% increase in dynamic customer billings. An impressive 85,000 new seats of our dynamic CRM offering were sold during the quarter.

Consistent with our guidance, entertainment and devices revenues decreased 10% to $1.2 billion as a result of lower Xbox 360 sales. Software and accessory attach rates remained at record levels, and we passed the 7 million member mark for Xbox Live.

During the quarter, Halo 3 concluded beta testing, and on September 25th will lead the charge of hotly anticipated game titles into this 2007 holiday season. Entertainment and devices achieved its goal of selling over 1 million Zune units on a sell-in basis in its first eight months in the market.

Licenses for Windows Mobile-based phones grew in excess of 75% to end the year with sales of over $11 million, and an increased unit market share in the smart phone category.

Now for the rest of the income statement. Positive revenue increased 52%, primarily driven by a charge relating to the current and enhanced Xbox 360 warranty policies that were announced earlier this month. At this time, let me provide you with the details of that charge, now that they have been finalized. First, the total amount was $1.06 billion, within the range we provided a couple of weeks ago.

Second, the makeup is largely consistent with the guidance we provided with about half of the total charge driven by existing warranty policies and the other half driven by the new warranty enhancements. Of the total amount of the charge, approximately 35% is attributable to inventory valuation adjustment. Before the Xbox 360 charge, cost of revenue would have increased 5% year over year.

Other operating expenses increased 13%, excluding legal charges of $351 million in the year-ago period. Expense growth was driven by headcount-related costs and sales support cost for our enterprise software advisory channel partners.

Operating income was $4 billion. Excluding the impact of the Xbox 360 charge and certain legal charges in the year-ago period, operating income for the quarter would have increased 19% to $5 billion. Investment income and other totaled $295 million for the quarter.

Our effective tax rate for the quarter was 29% to align to our annual effective tax rate of 30% for fiscal 2007. Before non-recurring items the effective tax rate for the year would have been 31%.

Cash flow from operations increased 34% to $4.4 billion. During the quarter we repurchased 243 million shares, or $7.4 billion of company stock, of which $7.2 billion settled in the quarter. We paid out $952 million in dividends to shareholders.

Diluted shares outstanding for the quarter were 9.7 billion, down 6% from the prior year as a result of share repurchases. Earnings per share for the quarter were $0.31, which included $0.08 related to the Xbox charge. Before this charge, earnings would have been $0.39 per share.

So in summary, during the quarter we made a needed investment into our Xbox business to assure customers that we fully stand behind our products. Before this charge, the fourth quarter was a strong end to fiscal 2007 with double-digit revenue, operating income and EPS growth, robust bookings and solid progress on the fiscal 2008 product pipeline.

With that, let me turn it back to Chris, who will provide you with our expectations for the first quarter and all of fiscal 2008.

Chris Liddell

Thanks, Colleen. I'm going to spend my remaining time on the call talking about what we see for the full year ahead and first quarter. Before we get into the specific guidance, let me outline some of our key assumptions.

The fiscal 2008 forecast generally assumed a continuation of the economic conditions and demand from where we exited in 2007. Our forecast did not include any significant unexpected impacts from foreign exchange rate movements.

We expect PC unit demand to continue to remain healthy with growth rates similar to what we saw in 2007. Specifically, we expect PC unit growth for fiscal 2008 to be 9% to 11% for the year and between 11% to 13% for the first quarter. We estimate that growth rates will continue to be higher in the consumer segment than in the business segment, and recent regional trends should continue with growth in emerging markets outpacing that of mature markets.

Now let me go through our detailed guidance. For the full year we expect our revenue to come in between $56.8 billion to $57.8 billion, growing 11% to 13%. This represents a 1 percentage point improvement on the high-end and is about $300 million better in absolute dollar terms from our April guidance. The $5.7 billion to $6.7 billion yearly represents yearly increases driven by expected solid performance across our five segments. In the first quarter, we expect revenue of $12.4 billion to $12.6 billion, which represents an increase of 15% to 17%.

With that revenue guidance in our divisions is as follows:

For client, we expect full year growth to be 9% to 10%, and quarter one growth to being 15% to 16%. For the first quarter we expect OEM revenue to grow faster than the PC hardware market due to a higher premium mix than the year-ago quarter and to be in line for the full year.

On the commercial and retail side of the business, we expect double-digit growth for both quarter one and the year from continued demand through our volume licensing channels. Combined growth rate benefits by 3 percentage points in Q1 and 2 percentage points for the full year from recognition of undelivered elements. As in our April call, we have included a slide in our slide deck containing additional information on the impact of client revenue.

Server and tools revenue should be 14% to 15% for the year and 11% to 12% for the first quarter. Coming off another impressive year in fiscal 2007, Server and tools is expected to again achieve double-digit revenue growth, while delivering the next wave of server innovation with the upcoming February launch of the new versions of Windows Server, SQL Server and Visual Studio. Together, these products form a highly reliable and secure next-generation enterprise platform, which will fuel growth in the server and tools business over the next several years.

We forecast revenue in the online services business to increase 10% to 13% for the year and 10% to 11% in Q1. This implies advertising growth in excess of 20% for the year and for the quarter. Fiscal 2008 will bring many important structural enhancements to our online services business.

First, we expect to close both of our recently announced acquisitions for ScreenTonic and aQuantive in the first quarter. These acquisitions represent important next steps as we continue building out our vision of a centralized advertising platform that allows advertisers exposure across the various IP-enabled media.

Second, we will be making usability improvements by providing better integration between our Windows Live services.

Third, we will continue to build out our data centers to provide capacity for online services that can be used across the company.

I mentioned our acquisition of aQuantive, and I want to clarify that the guidance we are giving you for the company and for OSB does not include the financial impact of aQuantive. We expect to close the aQuantive acquisition in August, sometime after the shareholder vote. Assuming a positive vote and a subsequent close, we plan to update our corporate guidance for the inclusion of that business on our next earnings call in October.

As we stated in May, the transaction will have revenue and operating expenses, but we do not expect a significant affect to fiscal 2008 operating income and earnings per share, excluding transaction costs.

Microsoft business division revenue should be 11% to 12% for the year and 14% to 15% in the first quarter. Q1 will continue to benefit from strong customer acceptance of the Microsoft Office system.

Fiscal 2008 represents another important launch year for the business division, with the impending releases of Office Communications Server, Performance Point Server and a new versions of Dynamic CRM. These products continue Microsoft's push into the field of unified communications, business intelligence and business applications. While overall revenue growth remained healthy, direct comparisons for the second half of 2008 are more difficult due to our out performance in 2007.

For the entertainment and devices division, we're forecasting revenue growth of 10% to 19% for the full year and 30% to 40% for Q1. Growth in our most profitable revenue streams will be a key driver in achieving our goal of segment profitability in fiscal 2008.

We had the best first and third-party software title lineup we have ever had, highlighted by the launch of Halo 3 this September. These games, combined with Xbox accessory attach and an expanding line of Xbox LIVE installed base, set us up for an excellent year in our Xbox business.

2008 will be another year of continued momentum for our mobile communications business as well. We expect to sell over 20 million licenses for Windows Mobile-based phone as our carrier and OEM partners roll out a broad and compelling lineup of devices based on Windows Mobile 6.

Getting back to companywide performance, operating income for the year is expected to be between $22.2 billion and $22.7 billion, increasing 20% to 22% and 12% to 15%, excluding certain charges in fiscal 2007. The higher revenue forecast is responsible for the improvement versus our April operating income guidance. For the first quarter, we expect operating income to be between $5 billion and $5.2 billion.

As a result of the higher operating income guidance, we have increased our full year earnings per share results by $0.01. Therefore diluted earnings per share for the year are expected to come in at $1.69 to $1.73. For the first quarter we expect $0.38 to $0.40. These earnings assume an effective tax rate of 30.5%.

From a balance sheet prospective, we expect total unearned revenue to finish fiscal 2008 up 7% to 10%. Excluding undelivered elements, the remaining portion of our unearned revenue should increase 13% to 16%. Contracted not billed should also finish 2008 up from current levels.

When thinking about sequential changes in unearned revenue from quarter four 2007 to quarter one 2008, we expect the sequential decrease from the fourth quarter to be about 10%, due to the large amount of billings in that fourth quarter.

When thinking about the guidance we just provided you, I would suggest that you consider some of the risks. These risks include competitive, legal, execution and general market risks, as well as customer acceptance of our new and existing products and fluctuations in PC and server hardware growth rates. Additionally, changes in the mix of our billings between and annuity and license-only can have an impact on GAAP revenue, operating income and earnings per share by delaying revenue recognition into future periods.

So to wrap up, fiscal 2007 was an excellent year from my perspective. Launches of Windows Vista, the 2007 Microsoft Office System, Exchange 2007, Zune, and Windows Mobile 6 have brought new capabilities into the marketplace so it is exciting to see them off to such strong starts.

Many of the same factors that helped us be successful in 2007, such as a healthy PC hardware market, customer acceptance of our new versions of Office and Windows, an impressive lineup of new product offerings, as well as solid execution by our R&D and sales and marketing teams will help propel us into the next fiscal year.

In ‘08 we're looking to deliver another year of double-digit revenue, operating income and earnings per share growth. Next year product releases represent significant improvements over our existing products, as well as a continued push into new areas for the company. Given the operational backdrop and our ability to generate meaningful free cash flow for the company, we will look to continue to execute on our strategy of returning cash to shareholders.

This brings me to the end of my financial comments. I'm very much looking forward to catching up with many of you at our financial analyst meeting next week. As a result of your feedback, we have made some slight adjustments to the overall flow of the day. There will still be presentations by Bill, Steve and the senior management team, but we have also allowed more executive interactions than in prior years, with Q&A sessions throughout the day with all the speakers.

We have left some time now for your questions. I will hand the call over to Colleen so we can get started. Thank you.

Colleen Healy
Great. Let's now proceed to questions. We want to accommodate questions from as many people as possible, so please avoid multi-part questions and limit yourselves to just one question. Operator, will you please repeat your instructions?

Question and Answer

Operator

(Operator Instructions) Your first question comes from Charlie DiBona - Sanford Bernstein.

Charlie DiBona
Sanford Bernstein

Thank you, operator. Chris, I guess it will come as no surprise that I have a question about the online services group. I know you promised more metrics next week, but more generally, you have had some solid results here and a good recovery of search share by all the independent metrics in the last month, both sequentially and year over year. But there has been some speculation that those gains were driven by special programs. Now your Q1 guidance points to a relatively significant deceleration of that business. Can you talk a little bit about the strategy here and about the sustainability of particularly last month's momentum?

Chris Liddell

Yes. Let me talk about the quarter and then how it flows through to the year. From the quarter point of view, the underlying advertising revenue was up 33%. The good news from my perspective was that really it was across the board. So we had good search volumes, we had good monetization of those search volumes. We are lapping the transition to adCenter so we're getting some benefit, if you like, from revenue per search uplift, as well as the overall volumes.

Better than that growth rate is also on our display business, which doesn't tend to get talked about as much. That was up a healthy number in terms of volume and monetization as well, so it was a good quarter all around.

Vis-a-vis next year, inside the guidance is revenue growth in advertising of greater than 20%. Now the comparables start to get harder because we're off a bigger base, obviously, and we don't have for the full year quite as strong a momentum in terms of the adCenter transition. I would just say mid 20s or higher is a good result for the business overall. I think that clearly if we can do better than that, that's great, but that's not a bad result.

In terms of the last part of your question on how much we were assisted in the fourth quarter by some of the one-off impacts, we were certainly helped by that but I think the interesting thing from my point of view is not necessarily the sustainability of that because that was one or two months. It’s just that when we put a new product into the marketplace, it is capable of shifting share. I am certainly not going to extrapolate that through next year but I think it is interesting from, if you like, an experiment point of view that when we try something different, we were able to get some movement in the market in a relatively short period of time.

I haven’t built a lot of that into next year and we’ll wait to see other more sustainable products have some influence but overall, I think next year, having revenue of advertising growing at greater than 20% off a higher base is at least a good starting point at this stage.

Colleen Healy

Thank you, Charlie. Next question, please.

Operator

Thank you. Our next question comes from Heather Bellini with UBS.

Heather Bellini
UBS

Thanks, Chris and Colleen. I was wondering if you could comment on two things; one, where do you think the premium mix could go? It went from 71, I believe to 72 this quarter. Again, that's much higher than what you had forecasted before you went into the Vista cycle but where do you think we could go, especially as we get into the heart of consumer spending maybe more around back to school and holiday?

Also, could you comment on the significance of SP1 for Vista adoption? Do you have any comments on timing? Thanks.

Chris Liddell

With the premium mix, we think that sort of level is sustainable through next year, so we would expect the same sort of premium mix next year as for this year. We will see a difference in business premium versus consumer premium. As we talked about last quarter, we thought we would give you more visibility into what's happening in those two different segments or those two different components of the premium mix because they have such different monetization impact, the business premium having much more significance than the consumer premium.

Colin shared with you the makeup of those numbers. In terms of next year, because we expect consumer growth to be higher than business growth in terms of PCs, we would still expect a mix shift in the premium segment towards the consumer premium but the overall premium mix for the company to be relatively healthy and high in the 70 odd percent range. So we think it's sustainable at that level but with a change inside business and consumer.

In terms of SP1, clearly there will be an SP1 but it looks like we're not talking about exactly when that is. We don't see it as a massive driver of uptake in its own right. It's early days yet and we are broadly happy with how we are seeing Vista adoption, both from a consumer and a business point of view.

We were always expecting, and I think we talked about this for the last two or three quarters, that the business uptake would be driven by their needs rather than the availability of Vista per se, so that's going to be progressive over the next 12 to 18 months and I think will be relatively independent of when the first service pack comes out.

Heather Bellini
UBS

Thank you.

Colleen Healy

Thanks a lot, Heather. Next question, please.

Operator

Thank you. Our next question comes from Sara Friar with Goldman Sachs.

Sara Friar
Goldman Sachs

Good afternoon, guys. In the entertainment and device area, that guidance for fiscal year '08 is quite a wide spread. Chris, could you just talk us through what the major swing factors will be? Also, you did say the profitability of the segment for FY08 but can you give us any sense on timing? Could Halo 3 launching at the end of September help drive profitability as early as December?

Chris Liddell

It's profitability overall for the year and that's the key from my point of view. Because of the seasonality in that business, you could see some quite different swings in profitability on a quarter by quarter basis, not only because of Halo that you mentioned but obviously the Christmas quarter is a substantial one from a console and gaming point of view. So it won't necessarily be a linear improvement during the course of the year, although in terms of COGS it will help. The COGS will progressively degrade through the year but the volumes will go up and down with the quarter.

So profitability overall for the year but it will be non-linear in the way that it rolls out during the course of the year.

In terms of the width of the guidance, I guess that is purposeful. It's one of those businesses which, from a demand point of view, is relatively hard to anticipate. Obviously console demand in itself is a big variable there but the other thing and better than that, to be honest, we have a pricing strategy for the next 12 to 24 months that's embedded in that and a console strategy as well, and those two are related to each other.

At this stage, we're keeping relatively quiet about that from a competitive point of view. We really don't want to signal anything, so that will become more clear as the year comes through. But at this stage we're keeping, if you like, a relatively wide range to accommodate that.

Sara Friar
Goldman Sachs

Could I ask one more quick follow-up? On the macro environment, a number of other tech and others have alluded to a much better spending backdrop. I would just love to hear your quick thoughts on any changes you are seeing in the various geographic areas, where you are seeing strength and weakness.

Chris Liddell

We are certainly seeing strength in all of the emerging markets. For example, countries like Russia which has just had a phenomenal year for us, so some of those Eastern Europe countries, South America and obviously the Asian countries are very strong form our perspective, albeit off a relatively small basis.

In terms of overall level of spending, we aren't seeing a significant positive there. The thing that we believe that we are seeing is a higher share of the wallet from some of our customers and that's reflected in the relatively higher renewals that we are getting and people's uptake of the products.

So from our fields point of view, we are seeing a really healthy and encouraging trend from just being a desktop software provider to being much more of an infrastructure provider to enterprises. So we aren't necessarily seeing the amount of their spending going up but we believe that the amount that they are spending with us on the suite of products that we've got, not only the ones obviously that we've launched in the last couple of years but the ones that are coming up, is increasing in what we consider to be a promising way.

Sara Friar
Goldman Sachs

Got it. Thanks a lot.

Colleen Healy

Thanks, Sara. Next question, please.

Operator

Thank you. Our next question comes from Brent Thill with Citigroup.

Brent Thill
Citigroup

Thanks. Chris, on the client guidance for fiscal '08, it seems it's fairly prudent considering the industry is expecting a reacceleration in PC unit growth for the second-half of this year. Can you just talk to some of the characteristics and why you are expecting that line to slow down more than any of the other lines that you've given guidance for the year?

Chris Liddell

If you start with PC unit growth rates, and that's clearly the main driver inside there, we are expecting for next year, as I mentioned on the call, around 9% to 11%, so we're sticking pretty much in line with industry expectations.

We think we can grow OEM units at the top end of that range because of our continued progress that we make in piracy, so we think we can grow units at the top end of that range. And then we'll be assisted to some extent by the Vista revenue recognition that we talked about on the last couple of calls.

But because of the premium mix change, and this is something that Steve obviously alluded to in February and we talked a bit about on the last few calls, we will lose a couple of percentage points between OEM unit growth and OEM revenue growth, you know, the strong drive in emerging markets, growth in emerging markets, and consumers will take a little bit of a shaving relative from revenue relative to units.

Lastly, from our perspective in terms of revenue growth, the commercial and retail will have a strong comparable in FY07, so the growth rate will be relatively hard to repeat, given the FTP spike that we had in fiscal year '07.

So there's a lot of moving parts in the way that we look at it, but if you start with PC unit growth, we think we can grow OEM units at the top end of that and we think we can grow client revenue overall broadly equal to OEM units at around that 9% to 10% mark.

So we think that will be a good healthy result from our perspective, but in order to get out-performance on that, we'd have to see PC units at stronger levels than that.

Brent Thill
Citigroup

Just a quick follow-up; Longhorn is still on track for a calendar year '07 ship?

Colleen Healy

No update on the Longhorn. You can expect second-half calendar '07 for RTM.

Brent Thill
Citigroup

Thanks.

Colleen Healy

Thanks a lot, Brent. Next question, please.

Operator

Thank you. Our next question comes from John DiFucci with Bear Stearns.

John DiFucci
Bear Stearns

Thank you. I have a question, Chris, on cash flow. It looks like other current assets are down a little bit and there's a note right at the end of the press release, or the report on your website. I just want to make sure I understood it. It looks like this year relative to a year ago benefited by about $1.2 billion because you were not building X-Box inventory, so just I guess confirm that that's actually true.

We know that you had some channel issues where there was an over supply to the channel in the December quarter, but this 35% of that $1 billion charge due to inventory valuation adjustments, is this at all related to that? What exactly are you adjusting here? I mean, does that in any way allude to what you were talking about as far as your pricing strategy going forward or do you have to go in and fix all these things? And does that have to do with the three flashing light issue or just any issue? Sorry for such a long one there.

Chris Liddell

Let me try and strike all the components and hopefully I get them all. In terms of the cash flow impact, yes, there is a difference between our billed inventory a year ago and a declining inventory situation this year, so that is certainly true from a cash flow point of view.

In terms of the write-down component of the charge associated with X-Box, that is a write-down on the balance sheet of the holding costs of those X-Box, so that's a non-cash charge clearly but it does have an influence on the overall carrying costs of the boxes that are associated with that, a direct charge to that.

In terms of the linkage between that and the three flashing red lights, it is not so much a direct linkage. There's obviously an indirect linkage in the sense that because of that, as people return them we need to repair them, but this is very much, the inventory write-down is very much a write-down of the inventory that we have had returned to date that we believe that we will not be able to sell as a repaired unit, and hence it's impaired from a valuation perspective.

It is clearly all part of the same manufacturing issue but it is slightly different from a physical and hence an accounting perspective.

Did I grab all the parts to your question?

John DiFucci
Bear Stearns

I think you did but one of the things here with this write-down and some of those other components, other 15% -- I'm having a hard time understanding why this is like a special charge and it's taken out of this non-GAAP, the non-GAAP numbers for you.

Chris Liddell

I think the important thing from my point of view is the visibility of what we did and what we tried to do a couple of weeks ago -- I'd be happy to go over it again -- is give people all of the components of the charge and what they were and then obviously people can treat them as they see appropriate.

I think the important thing is that they relate effectively to boxes that have already been produced, so have been produced in the fiscal year '06 or fiscal year '07 area. From a GAAP point of view, it is clearly a charge and the important thing from my perspective is that people understand the magnitude of the charge and the major components of it in terms of what they -- what people can expect in the future will be a cash cost and what is simply an accounting charge against balance sheet items now. So people, depending on whether they are looking at cash flow as it sounds like you are or balance sheet or overall GAAP accounting, they've got hopefully all the major components to slice and dice the way they want to.

John DiFucci
Bear Stearns

Thanks a lot, Chris.

Colleen Healy

Thank you, John. Next question, please.

Operator

Thank you. Our next question comes from Adam Holt with JP Morgan.

Adam Holt
JP Morgan

Good afternoon. I have two questions about expenses and operating margins. You had relatively significant growth in headcount related expenses, both in the quarter as well as for the year. Could you talk a little bit about what we should expect for headcount growth as we look into next year?

Secondly, if you look at the midpoint of the guidance for next year, you're looking at maybe 60, 70 basis points of operating margin expansion year on year. How should we think about your strategy or your medium term margin expansion goals say over the next several years? Thanks.

Chris Liddell

We'll talk more extensively in terms of years other than next year at FAM, so if I can leave the longer term picture until then and then talk to last year and this year and hopefully that will give you some flavor.

In terms of headcount growth, from my point of view, the good trend that we are seeing is a slowing of the headcount growth so I am certainly keen to see us grow from lower rates of headcount growth than we have seen in the last couple of years. We got down on a year-on-year basis in the last quarter to around 10%. Now that's still relatively high but relative to our level of revenue growth. I'm much more comfortable with that than the mid-teen levels that we were seeing six to 12 months ago.

Headcount growth is in a better shape than it has been from my perspective. In terms of next year, embedded inside the guidance, as you can imagine, is both headcount growth and cost per head at those more moderated levels. That is going to vary quite differently between the different divisions, though.

For example, we are building headcount in our online business and headcount is relatively flat in our client business, so you are seeing quite different trends in where the heads are being added, adding up to the overall picture.

It's a little similar comment to the margin structure. From my perspective in terms of margins, I think of the business in three parts. There's our core businesses of client, MBD and server and tools, and next year collectively you should expect their margins to be broadly equal to this year, which I think is a good result when you see what the growth rates are inherent in those businesses.

You see EDD moving to profitability, so clearly that's a margin improvement but obviously still being very much in the investment phase, so it will be in a loss position and hence a negative margin next year and some of the improvement that we are making in EDD effectively we are reinvesting in [OSD]. But net overall, as you say, midpoint of the guidance will be a slight improvement in margins next year and I'll talk a little bit more next week about how I feel overall for margins longer term.

Adam Holt
JP Morgan

Great. Thank you.

Colleen Healy

Thanks a lot, Adam. Next question, please.

Operator

Thank you. Our next question comes from Jason Maynard with Credit Suisse.

Jason Maynard
Credit Suisse

Good afternoon. Chris, client and server and tools both came in a little bit lower than your guidance range. I was just curious if you would attribute that maybe to the stronger-than-expected strength in the EAs, or if you think some of the chatter around the timing of SP1 might have had an impact? Or any commentary on what virtualization is doing to the server market?

Chris Liddell

Client was very much in line with our guidance. It might have been a shave off and to the extent that the Vista revenue recognition was a little lower than what we had indicated, but that was in the $20 million to $30 million category. Other than that, it was very much in line.

Server and tools, you are correct, was a little light and was for the reasons that you mentioned, that we had a very strong annuity mix of revenue inside server and tools which helped us obviously from an un-earned perspective. That's one of the reasons why our unearned was so strong and also one of the reasons consequently why we flowed that through the higher revenues the next year.

But in the quarter, it hurts us in the sense that when we ship license only that we recognize all up front to annuity that we recognize over the length of the contract, we don't get quite as much of a pop. That was the principal reason why server and tools was at the light end of what we guided.

Jason Maynard
Credit Suisse

Maybe just a follow-up on that then; when you take into consideration your guidance around unearned for next year, are you assuming more normal historical type of EA mix rates or do you think it is going to continue on this path that you saw in Q4?

Chris Liddell

I think it could well continue. I think that the really interesting trend underlying this and the strength of the product suite and offering that we have to customers and their desire and willingness to stay on enterprise agreements for all sorts of reasons.

Firstly, obviously the product that we have; secondly, the ones that we have coming out; and people clearly focused on Vista and Office as the big products that we've launched but when you look at next year, which most people would not have thought was a big launch year and you think of new versions of Visual Studio, new versions of Window Server, new versions of SQL Server. You have Performance Point, our business intelligence coming out. CRM Live. There's a lot of different products that are appealing from a customer point of view and staying on annuity also helps them from an administration and cost perspective.

I think there's lots of good reasons to think that we are seeing a potentially more sustainable trend on annuity mix, which hurts us a little bit in terms of up-front revenue recognition but in terms of the overall health of the business, is very positive from my perspective.

Jason Maynard
Credit Suisse

Thank you. Very helpful.

Colleen Healy

Thanks, Jason. Next question, please.

Operator

Thank you. Our next question comes from Kash Rangan with Merrill Lynch.

Kash Rangan
Merrill Lynch

Thank you very much, Chris and Colleen. Just an observation; I'm just looking to get your explanation behind this -- the rev rec positive change to the client business seems to have changed relative to your earlier guidance. In looking at the presentation, it says $540 million. The previous guidance was for $660 million of positive change in the rev rec. Does that mean that you've made any changes in your assumptions of Vista relative to XP in your mix for fiscal 2008 client guidance?

As it relates to that, maybe if you could comment on, Chris, how are you seeing adoption of Vista in the enterprise? Because it occurs to me that I think you have given us a very neat explanation as to how you get to the client guidance. You have parsed out different elements.

But the one piece that could be a swing factor is the business adoption seems like if we get better business adoption going into 2008, you might have a positive swing factor. I just was wondering if you had any comments on what kind of update we should expect that could cause the business premium mix to shift towards the positive. So it is really a two-part question there. Sorry about that.

Chris Liddell

I'll cover both of them, if I can. In terms of the unearned, you're absolutely right. As we went from target seating, which we do around the March timeframe, the budgeting which we did last month, we fine-tuned the Vista/XP mix for next year. We changed it from 85% to 78%. Now it's a lower number, but it's still a very high number overall from our perspective, so 78% Vista mix in terms of sales next year.

Because of that change, then the amount of undelivered element that comes from Vista is slightly lower than it would be otherwise. The underlying sales are still exactly the same, but that accounting impact, as you correctly say, decreases from $660 million to $540 million.

So from our point of view, it's good that our outlook has pretty much exactly the same revenue overall, but the composition as a result of the accounting recognition is slightly different.

In terms of the adoption from business, that is a slightly different parameter. Obviously, those two are linked to each other. It's early days here, We are seeing what we consider to be good customer response. But the next 12 to 18 months is really going to be the time when people are going to be looking seriously to roll it out.

Looking out at the first stage we think it's early days, but it's good. Could there be some upside there if we see businesses adopt it? Not necessarily earlier, but have a refresh cycle which is a bit stronger than it is and hence we get a bit more business premium relative to customer premium? Yes. That's not so much a rollout then because we tend to get paid either way for XP or Vista, but it could help with the overall premium mix that I talked about a few minutes ago.

Kash Rangan
Merrill Lynch

That's the fiscal 2008 forecast, right?

Chris Liddell

Correct, yes.

Kash Rangan
Merrill Lynch

Okay, great. Thanks.

Operator

Your final question comes from Kirk Materne - Banc of America.

Kirk Materne
Banc of America

This is a little bit of a follow-up on Kash's question. Chris, on the business premium mix can you give us an idea of what is in your forecast? It seems that your assumptions for the actual unit side of the business are pretty conservative in light of what you all have seen. Have you made any assumptions in terms of the premium mix getting better? I think it was down 3% this quarter. Is that forecasted to get a little better as we head into fiscal '08 or are you assuming it stays at the same rate? And if it does get better that is upside to what you are looking for?

Chris Liddell

In terms of the overall premium mix, I'd say it's going to be in line with fiscal year 2007, which was 68% for the year. So plus or minus a percent here or there, I think it's going to be broadly in line next year with what it was this year.

As we have with our forecasts, and clearly external ones may differ, in terms of the business and consumer mix we would see business premium being down slightly and consumer premium being up, so it's the same trend that we saw this year. That's entirely driven by the fact that we expect the consumer segment to grow faster than the business segment, so therefore by definition the percentage will increase in favor relative to the customers.

That could change around a bit. We're relatively conservative, I think, on business growth overall, but I think it's appropriately conservative. We are seeing consumer sales consistently outpacing business sales for a number of years now, and I think that's the right starting place.

Now obviously I would love to see some upside there, to the extent that we get a good price for business premium, but we have built in what I think is an appropriate mix going forward.

Kirk Materne
Banc of America

Maybe just one follow-up on that. In terms of the business premium, is there any gating factors from say a technology or cost standpoint, meaning I think the enterprise edition comes along with Software Assurance. Is there anything structurally that's keeping people from going to a higher premium mix on the business side, or is it simply just an adoption issue?

Chris Liddell

Well, you have two impacts. Consumers tend to buy consumer, and businesses tend to buy business SKUs. So you've got that mix impact. Inside businesses, there's nothing structurally which is stopping them from buying one particular SKU or another. You are right, the Software Assurance gets you the enterprises edition, which most large businesses would favor. But it's about the features; it's not about the technology that probably drives the decision as to which SKU to take.

Kirk Materne
Banc of America

Thanks very much.

Colleen Healy

Thanks a lot, Kirk. Thanks to everyone for your participation in today's call. If you have any further questions, please feel free to call me or my team directly. As I mentioned at the beginning of this call, this conference call will be available on replay at our Investor Relations website through close of business July 19, 2008.
In addition, you can hear the replay by dialing 866-517-3727 or for international calls dial 203-369-2039. The dial-in replay will be available through the close of business July 27, 2007. Thanks again for joining us today and we look forward to seeing you next week at the financial analyst meeting.