# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIESEXCHANGE ACT OF 1934**

**For the Quarterly Period Ended March 31, 2004**

**or**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIESEXCHANGE ACT OF 1934**

**For the Transition Period From to**

**Commission File Number 0-14278**

# MICROSOFT CORPORATION
**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Washington**<br>(State or other jurisdiction of incorporation or organization) | **91-1144442**<br>(I.R.S. Employer Identification No.) |
| **One Microsoft Way, Redmond, Washington**<br>(Address of principal executive office) | **98052-6399**<br>(Zip Code) |

**Registrant's telephone number, including area code: (425) 882-8080**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐

The number of shares outstanding of the registrant's common stock as of April 23, 2004 was 10,794,692,690.

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**FORM 10-Q**

**For the Quarter Ended March 31, 2004**

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## Part I. Financial Information

### Item 1. Financial Statements

**MICROSOFT CORPORATION**

**INCOME STATEMENTS**
**(In millions, except earnings per share)(Unaudited)**

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| | 2003(1) | 2004 | 2003(1) | 2004 |
| Revenue | $ 7,835 | $ 9,175 | $ 24,122 | $ 27,543 |
| Operating expenses: | | | | |
| Cost of revenue | 1,274 | 1,411 | 4,755 | 5,235 |
| Research and development | 1,692 | 1,538 | 4,914 | 6,120 |
| Sales and marketing | 1,700 | 1,928 | 5,274 | 5,900 |
| General and administrative | 425 | 3,020 | 1,174 | 4,387 |
| Total operating expenses | 5,091 | 7,897 | 16,117 | 21,642 |
| Operating income | 2,744 | 1,278 | 8,005 | 5,901 |
| Losses on equity investees and other | (19) | (11) | (53) | (26) |
| Investment income | 472 | 1,012 | 888 | 2,617 |
| Income before income taxes | 3,197 | 2,279 | 8,840 | 8,492 |
| Provision for income taxes | 1,055 | 964 | 2,792 | 3,014 |
| Net income | $ 2,142 | $ 1,315 | $ 6,048 | $ 5,478 |
| Earnings per share: | | | | |
| Basic | $ 0.20 | $ 0.12 | $ 0.56 | $ 0.51 |
| Diluted | $ 0.20 | $ 0.12 | $ 0.55 | $ 0.50 |
| Weighted average shares outstanding: | | | | |
| Basic | 10,715 | 10,785 | 10,720 | 10,796 |
| Diluted | 10,837 | 10,856 | 10,930 | 10,899 |

(1) The three and nine months ended March 31, 2003 results have been restated for retroactive adoption of the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation,* as discussed in Note 2.

See accompanying notes.

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**MICROSOFT CORPORATION**

**BALANCE SHEETS**
**(In millions)(Unaudited)**

| | June 30 2003(1) | March 31 2004 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and equivalents | $ 6,438 | $ 9,348 |
| Short-term investment | 42,610 | 47,059 |
| Total cash and short-term investments | 49,048 | 56,407 |
| Accounts receivable, net of allowance for doubtful accounts of $242 and $157 | 5,196 | 4,937 |
| Inventories | 640 | 542 |
| Deferred income taxes | 2,506 | 1,748 |
| Other | 1,583 | 1,636 |
| Total current assets | 58,973 | 65,270 |
| Property and equipment, net | 2,223 | 2,258 |
| Equity and other investments | 13,692 | 15,155 |
| Goodwill | 3,128 | 3,110 |
| Intangible assets, net | 384 | 599 |
| Deferred income taxes | 2,161 | 1,583 |
| Other long-term assets | 1,171 | 1,792 |
| Total assets | $ 81,732 | $ 89,767 |
| **Liabilities and stockholders' equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,573 | $ 1,412 |
| Accrued compensation | 1,416 | 1,224 |
| Income taxes | 2,044 | 3,175 |
| Short-term unearned revenue | 7,225 | 5,949 |
| Other | 1,716 | 4,224 |
| Total current liabilities | 13,974 | 15,984 |
| Long-term unearned revenue | 1,790 | 1,577 |
| Other long-term liabilities | 1,056 | 1,626 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock and paid-in capital—shares authorized 24,000; outstanding 10,771 and 10,777 | 49,234 | 53,975 |
| Retained earnings, including accumulated other comprehensive income of $1,840 and $2,025 | 15,678 | 16,605 |
| Total stockholders' equity | 64,912 | 70,580 |
| Total liabilities and stockholders' equity | $ 81,732 | $ 89,767 |

(1) The June 30, 2003 balance sheet has been restated for retroactive adoption of the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, as discussed in Note 2.

See accompanying notes.

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**MICROSOFT CORPORATION**

**CASH FLOWS STATEMENTS**
**(In millions)(Unaudited)**

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| | 2003(1) | 2004 | 2003(1) | 2004 |
| **Operations** | | | | |
| Net income | $ 2,142 | $ 1,315 | $ 6,048 | $ 5,478 |
| Depreciation, amortization, and other noncash items | 383 | 249 | 931 | 877 |
| Stock-based compensation | 978 | 748 | 3,084 | 4,995 |
| Net recognized (gains)/losses on investments | (17) | (512) | 598 | (1,112) |
| Stock option income tax benefits | 329 | 135 | 990 | 772 |
| Deferred income taxes | 169 | 54 | (1,362) | (925) |
| Unearned revenue | 2,463 | 2,793 | 9,056 | 7,781 |
| Recognition of unearned revenue | (2,770) | (3,119) | (8,308) | (9,268) |
| Accounts receivable | 823 | 697 | 1,225 | 369 |
| Other current assets | 51 | 63 | 418 | 356 |
| Other long-term assets | (9) | (6) | (31) | 35 |
| Other current liabilities | (384) | 1,951 | 38 | 2,931 |
| Other long-term liabilities | 11 | 602 | 421 | 679 |
| Net cash from operations | 4,169 | 4,970 | 13,108 | 12,968 |
| **Financing** | | | | |
| Common stock issued | 485 | 568 | 1,389 | 1,452 |
| Common stock repurchased | (839) | (1,608) | (5,272) | (3,383) |
| Common stock dividend | (857) | — | (857) | (1,729) |
| Net cash used for financing | (1,211) | (1,040) | (4,740) | (3,660) |
| **Investing** | | | | |
| Additions to property and equipment | (182) | (213) | (618) | (552) |
| Acquisition of companies, net of cash acquired | (12) | — | (891) | (4) |
| Purchases of investments | (25,106) | (19,580) | (71,197) | (66,555) |
| Maturities of investments | 710 | 361 | 7,242 | 3,836 |
| Sales of investments | 20,383 | 18,694 | 58,341 | 56,840 |
| Net cash used for investing | (4,207) | (738) | (7,123) | (6,435) |
| Net change in cash and equivalents | (1,249) | 3,192 | 1,245 | 2,873 |
| Effect of exchange rates on cash and equivalents | (3) | 7 | 39 | 37 |
| Cash and equivalents, beginning of period | 5,552 | 6,149 | 3,016 | 6,438 |
| Cash and equivalents, end of period | $ 4,300 | $ 9,348 | $ 4,300 | $ 9,348 |

(1) The three and nine months ended March 31, 2003 cash flows statements have been restated for retroactive adoption of SFAS 123, *Accounting for Stock-Based Compensation*, as discussed in Note 2.

See accompanying notes.

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**MICROSOFT CORPORATION**

**STOCKHOLDERS' EQUITY STATEMENTS**

**(In millions)(Unaudited)**

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| | **2003(1)** | **2004** | **2003(1)** | **2004** |
| **Common stock and paid-in capital** | | | | |
| Balance, beginning of period | $ 45,860 | $ 52,676 | $ 41,845 | $ 49,234 |
| Common stock issued | 485 | 580 | 2,190 | 1,449 |
| Common stock repurchased | (85) | (150) | (542) | (375) |
| Stock based compensation expense | 978 | 748 | 3,084 | 4,995 |
| Stock option income tax benefits/(deficiency) | 329 | 121 | 990 | (1,328) |
| Balance, end of period | 47,567 | 53,975 | 47,567 | 53,975 |
| **Retained earnings** | | | | |
| Balance, beginning of period | 13,299 | 16,667 | 12,997 | 15,678 |
| Net income | 2,142 | 1,315 | 6,048 | 5,478 |
| Other comprehensive income: | | | | |
| Net gains/(losses) on derivative instruments | (36) | 33 | 10 | 46 |
| Net unrealized investments gains/(losses) | 473 | (212) | 333 | 55 |
| Translation adjustments and other | 18 | 9 | 49 | 84 |
| Comprehensive income | 2,597 | 1,145 | 6,440 | 5,663 |
| Common stock dividend | (857) | — | (857) | (1,729) |
| Common stock repurchased | (649) | (1,207) | (4,190) | (3,007) |
| Balance, end of period | 14,390 | 16,605 | 14,390 | 16,605 |
| Total stockholders' equity | $ 61,957 | $ 70,580 | $ 61,957 | $ 70,580 |

(1) The three and nine months ended March 31, 2003 stockholders' equity statements have been restated for retroactive adoption of SFAS 123, *Accounting for Stock-Based Compensation*, as discussed in Note 2.

See accompanying notes.

**MICROSOFT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**
***(Unaudited)***

**Note 1 – Accounting Policies**

***Basis of Presentation***

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include estimates of loss contingencies and product life cycles, and assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/enhancements and new products; when technological feasibility is achieved for the Company's products; the potential outcome of future tax consequences of events that have been recognized in the Company's financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 2003 Form 10-K.

Certain reclassifications have been made to prior period amounts to conform with current period presentation.

**Note 2 – Accounting Changes**

Effective July 1, 2003, we adopted the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, using the retroactive restatement method described in SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*. Under the fair value recognition provisions of SFAS 123, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. The June 30, 2003 balance sheet has been restated for the retroactive adoption of the fair value recognition provisions of SFAS 123 which resulted in a $13.89 billion increase in common stock and paid-in capital, a $10.00 billion decrease in retained earnings, and a $3.89 billion increase in deferred income taxes.

Stock-based employee compensation expense was $978 million ($655 million after-tax or $0.06 per diluted share) and $3.08 billion ($2.07 billion after-tax or $0.19 per diluted share) for the three and nine months ended March 31, 2003, respectively, and $748 million ($501 million after-tax or $0.05 per diluted share) and $5.00 billion ($3.35 billion after-tax or $0.31 per diluted share) for the three and nine months ended March 31, 2004, respectively. The amounts for the nine months ended March 31, 2004 include $2.21 billion ($1.48 billion after-tax or $0.14 per diluted share) due to the completion of the employee stock option transfer program, which is described in the following footnote.

**Note 3 – Stock-Based Compensation**

In fiscal year 2004, we implemented changes in employee compensation designed to help us continue to attract and retain the best employees, and to better align employee interests with those of our shareholders. Employees are now granted stock awards instead of stock options. The stock award program offers employees the opportunity to earn shares of our stock over time, rather than options that give employees the right to purchase stock at a set price. We also completed an employee stock option transfer program in the second quarter of fiscal 2004 whereby employees could elect to transfer all of their vested and unvested stock options with a strike price of $33 or higher ("eligible options") to JPMorgan Chase Bank (JPMorgan). The unvested eligible options that were transferred to JPMorgan became vested upon the transfer. The price paid by JPMorgan for the transferred options was determined by reference to the arithmetic average of the closing prices of Microsoft common stock during the period from November 14, 2003 to December 8, 2003, which was $25.5720.

A total of 18,503 (51%) of the 36,539 eligible Microsoft employees elected to participate in the stock option transfer program and 344.6 million (55%) of the 621.4 million eligible options were tendered. Under the terms of the program, JPMorgan paid Microsoft $382 million for the transferred options. Microsoft made an initial payment of $219 million to participating employees for the transferred options, with a remaining portion to be paid in one or more payments that are subject to participating employees' continued employment over the next two or three years. The options that were transferred to JPMorgan resulted in stock-based compensation expense of $2.21 billion ($1.48 billion after-tax or $0.14 per diluted share). This expense consists of the unrecognized compensation costs of the options that were transferred, less the amounts payable applicable to those previously unvested options for which payment is contingent upon continued employment of participating employees. The contingent payments applicable to unvested eligible options that are subject to continued employment of participating employees will be recognized as compensation expense over the vesting period of the contingent payments.

The stock option transfer program also resulted in a decrease to our long term deferred tax assets due to the excess of recorded compensation expense for these options over the related tax deduction reported on our tax return. For the nine months ended March 31, 2004, deferred tax assets were reduced by approximately $2.01 billion with an offsetting reduction in paid-in capital, reflecting the reduction of previously recorded deductions reported on our tax return in excess of stock-based compensation expense. Following is a description of our stock plans.

We have stock plans for directors and for officers and employees. The plans provide for awards of stock options and stock awards. At March 31, 2004, an aggregate of 797 million shares were available for future grant under our stock plans. In addition, awards that expire or are cancelled without delivery of shares generally become available for issuance under the plans. The options transferred to JPMorgan have been removed from our plans; any options transferred to JPMorgan that expire without being exercised will not become available for grant under any of our plans.

*Stock Awards*

Stock Awards are grants that entitle the holder to shares of common stock as the award vests. A total of 30 million stock awards with a weighted-average fair value of $26.11 per share were granted during the first nine months of fiscal 2004, generally vesting over a five year period.

*Shared Performance Stock Awards*

Shared Performance Stock Awards are a form of stock award in which the number of shares ultimately received depends on Microsoft's performance against specified performance targets. Shared Performance Stock Awards for 30 million shares at target with a weighted-average fair value of $26.08 per share were made during the first nine months of fiscal 2004 for the fiscal 2004-2006 performance period. At the end of the performance period, the number of shares of stock and stock awards issued will be determined by adjusting upward or downward from the target in a range between 33% and 150% (0% to 150% for certain executive officers). The

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**NOTES TO FINANCIAL STATEMENTS—(Continued)**
***(Unaudited)***

final performance percentage on which the payout will be based, considering company performance metrics established for the performance period, will be determined by the board of directors or a committee of the board in its sole discretion. Shares of stock are issued at the end of the performance period and as the stock awards vest over the following two years.

*Stock Options*

Nonqualified stock options have been granted to our directors under the director stock plan. Nonqualified and incentive stock options have been granted to our officers and employees under the employee stock plan. Options granted before 1995 generally vest over four and one-half years and expire ten years from the date of grant. Options granted between 1995 and 2001 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire ten years from the date of grant. Options granted after 2001 vest over four and one-half years and expire ten years from the date of grant. At March 31, 2004, stock options for 629 million shares were vested.

Stock options outstanding under our stock-based compensation plans were as follows:

**(In millions, except per share amounts)**

| | | Price per Share | |
|---|---|---|---|
| | **Shares** | **Range** | **Weighted Average** |
| Balance, June 30, 2003 | 1,549 | 0.40 – 59.56 | 29.30 |
| Granted | 2 | 25.46 – 29.96 | 26.76 |
| Exercised | (119) | 0.51 – 29.38 | 10.02 |
| Stock option transfer program | (345) | 33.03 – 59.56 | 38.70 |
| Canceled | (48) | 2.31 – 58.28 | 31.99 |
| Balance, March 31, 2004 | 1,039 | 0.40 – 59.56 | 28.20 |

For various price ranges, weighted average characteristics of outstanding stock options under our stock-based compensation plans at March 31, 2004 were as follows:

**(In millions, except per share amounts)**

| | Outstanding Options | | | Exercisable Options | |
|---|---|---|---|---|---|
| **Range of Exercise Prices** | **Shares** | **Remaining Life (Years)** | **Weighted Average Price** | **Shares** | **Weighted Average Price** |
| $ 0.40 – $15.00 | 45 | 1.9 | $ 6.84 | 44 | $ 6.79 |
| 15.01 – 25.00 | 315 | 6.0 | 21.76 | 141 | 18.98 |
| 25.01 – 33.00 | 397 | 5.9 | 28.23 | 235 | 28.16 |
| 33.01 – 41.00 | 170 | 4.4 | 34.22 | 116 | 34.31 |
| 41.01 – 59.56 | 112 | 4.6 | 44.80 | 93 | 44.65 |

The information presented differs from the information presented in Microsoft’s 2003 10-K primarily due to the impact of the stock option transfer program as well as to correctly calculate the weighted average remaining life of outstanding options.

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**NOTES TO FINANCIAL STATEMENTS—(Continued)**
***(Unaudited)***

**Note 4 – Inventories**

The components of inventories were as follows:

| (In millions) | June 30 2003 | March 31 2004 |
|---|---|---|
| Finished goods | $ 393 | $ 340 |
| Raw materials and work in process | 247 | 202 |
| Inventories | $ 640 | $ 542 |

**Note 5 – 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 stock options, stock awards and shared performance stock awards using the "treasury stock" method. The components of basic and diluted earnings per share were as follows:

**Earnings Per Share**

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| (In millions, except earnings per share) | 2003 | 2004 | 2003 | 2004 |
| Net income available for common shareholders (A) | $ 2,142 | $ 1,315 | $ 6,048 | $ 5,478 |
| Weighted average outstanding shares of common stock (B) | 10,715 | 10,785 | 10,720 | 10,796 |
| Dilutive effect of employee stock based compensation | 122 | 71 | 210 | 103 |
| Common stock and common stock equivalents (C) | 10,837 | 10,856 | 10,930 | 10,899 |
| Earnings per share: | | | | |
| Basic (A/B) | 0.20 | 0.12 | 0.56 | 0.51 |
| Diluted (A/C) | 0.20 | 0.12 | 0.55 | 0.50 |

For the three months ended March 31, 2003 and 2004, 1,386 million and 1,225 million shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive. For the nine months ended March 31, 2003 and 2004, 1,182 million and 1,152 million shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive. For the nine months ended March 31, 2004, 20 million shared performance stock awards, out of 30 million granted, have been excluded from the calculation of diluted earnings per share because the number of shares ultimately received will be determined by the board of directors or a committee of the board in its sole discretion, considering company performance against metrics established for the performance period, as discussed in Note 3.

Diluted earnings per share the for the nine months ended March 31, 2003 has been revised from the previously disclosed pro-forma amount of $0.56 as a result of the refinement of our treasury stock method calculation.

**Note 6 – Unearned Revenue**

Unearned revenue from volume licensing programs represents customer billings, paid either upfront or annually at the beginning of each billing coverage period, which are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. For certain licensing arrangements, revenue attributable to

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
*(Unaudited)*

undelivered elements, including free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis, is based on the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the related product's life cycle. The percentage of revenue recorded as unearned due to undelivered elements ranges from approximately 15% to 25% of the sales price for Windows XP Home, approximately 5% to 15% of the sales price for Windows XP Professional, and approximately 1% to 15% of the sales price for desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three and one half years for Windows operating systems and two years for desktop applications. Unearned revenue also includes payments for online advertising for which the advertisement has yet to be displayed and payments for post-delivery support services to be performed in the future.

The components of unearned revenue were as follows:

| (In millions) | June 30 2003 | March 31 2004 |
|---|---|---|
| Volume licensing programs | $ 5,472 | **$ 4,331** |
| Undelivered elements | 2,847 | **2,501** |
| Other | 696 | **694** |
| Unearned revenue | $ 9,015 | **$ 7,526** |

Unearned revenue by segment was as follows:

| (In millions) | June 30 2003 | March 31 2004 |
|---|---|---|
| Client | $ 3,165 | **$ 2,829** |
| Server and Tools | 2,185 | **2,019** |
| Information Worker | 3,305 | **2,341** |
| Other segments | 360 | **337** |
| Unearned revenue | $ 9,015 | **$ 7,526** |

The expected earn-out of unearned revenue by period is as follows:

| (In millions) | Amount Expected to be Recognized |
|---|---|
| Fourth Quarter Fiscal 2004 | $ 2,598 |
| First Quarter Fiscal 2005 | 1,660 |
| Second Quarter Fiscal 2005 | 1,085 |
| Third Quarter Fiscal 2005 | 606 |
| Thereafter | 1,577 |
| Unearned revenue | $ 7,526 |

**Note 7 – Stockholders' Equity**

As discussed in Note 3 – Stock-Based Compensation, 344.6 million options were transferred to JPMorgan under the stock option transfer program. The options transferred to JPMorgan were amended and restated upon

**MICROSOFT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**
***(Unaudited)***

transfer to contain terms and conditions typical of equity option transactions entered into between sophisticated financial counterparties at arm's-length using standard terms and definitions for equity derivatives. The options have strike prices ranging from $33.03 to $59.56 per share and expire between February 2004 and December 2006.

We repurchase our common shares primarily to manage the dilutive effects of our stock-based compensation plans and other issuances of common shares. During the third quarter, we repurchased 49.9 million shares of common stock for $1.35 billion, compared to 30.7 million shares for $734 million in the comparable quarter of the prior year. For the first nine months of fiscal 2004, we repurchased 123.7 million shares of common stock for $3.4 billion, compared to 190.1 million shares of common stock for $4.7 billion in the comparable period of the prior year. In any period, cash used in financing activities related to common stock repurchased may differ from the comparable change in Stockholders' Equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

**Note 8 – Investment Income**

The components of investment income are as follows:

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| **(In millions)** | **2003** | **2004** | **2003** | **2004** |
| Dividends and interest | $ 455 | $ 500 | $ 1,486 | $ 1,505 |
| Net gains (losses) on investments | 2 | 419 | (230) | 974 |
| Net gains (losses) on derivatives | 15 | 93 | (368) | 138 |
| Investment income | $ 472 | $ 1,012 | $ 888 | $ 2,617 |

Net gains (losses) on investments includes other-than-temporary impairments of $5 million in the third quarter of fiscal 2004 compared to $234 million in the third quarter of the prior year, and $66 million for the nine months ended March 31, 2004 compared to $1.09 billion in the nine months ended March 31, 2003.

**Note 9 – Contingencies**

We are a defendant in *U.S. v. Microsoft* and *New York v. Microsoft*, companion lawsuits filed by the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of eighteen state Attorneys General alleging violations of the Sherman Act and various state antitrust laws. After the trial, the District Court entered Findings of Fact and Conclusions of Law stating that we had violated Sections 1 and 2 of the Sherman Act and various state antitrust laws. A Judgment was entered on June 7, 2000 ordering, among other things, our breakup into two companies. On June 28, 2001, the U.S. Court of Appeals for the District of Columbia Circuit affirmed in part, reversed in part, and vacated the Judgment in its entirety and remanded the case to the District Court for a new trial on one Section 1 claim and for entry of a new judgment consistent with its ruling. In its ruling, the Court of Appeals substantially narrowed the bases of liability found by the District Court, but affirmed some of the District Court's conclusions that we had violated Section 2. We entered into a settlement with the United States on November 2, 2001. Nine states (New York, Ohio, Illinois, Kentucky, Louisiana, Maryland, Michigan, North Carolina and Wisconsin) agreed to settle on substantially the same terms on November 6, 2001. On November 1, 2002, the Court approved the settlement as being in the public interest, conditioned upon the parties' agreement to a modification to one provision related to the Court's ongoing jurisdiction. Two trade groups unsuccessfully sought to intervene to challenge the approval of the settlement and have appealed. Nine states and the District of Columbia continued to litigate the remedies phase of *New York v. Microsoft*. On November 1, 2002, the Court entered a Final Judgment in

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**NOTES TO FINANCIAL STATEMENTS—(Continued)**
***(Unaudited)***

this part of the litigation that largely mirrored the settlement between us, the DOJ and the settling states, with some modifications and a different regime for enforcing compliance. The Court declined to impose other and broader remedies sought by the non-settling states. Two states, Massachusetts and West Virginia, appealed from this decision. West Virginia dismissed its appeal as part of a settlement with us of several other cases. Oral argument on both appeals was heard by the U.S. Court of Appeals for the D.C. Circuit on November 4, 2003.

On March 25, 2004 the European Commission announced a decision in its competition law investigation of Microsoft. The Commission concluded that we infringed European competition law by refusing to provide our competitors with licenses to certain protocol technology in the Windows server operating systems and by including streaming media playback functionality in Windows desktop operating systems. The Commission ordered us to make the relevant licenses to our technology available to our competitors and to develop and make available a version of the Windows desktop operating system that does not include specified software relating to media playback. The decision also imposed a fine of €497 million, for which we recorded an accrual of €497 million ($605 million). We intend to appeal to the Court of First Instance and to seek interim measures suspending the operation of certain provisions of the Decision. We contest the conclusion that European competition law was infringed and will defend our position vigorously. In other ongoing investigations, various foreign governments and several state Attorneys General have requested information from us concerning competition, privacy, and security issues.

A large number of antitrust and unfair competition class action lawsuits have been filed against us in various state and federal courts. The federal cases have been consolidated in the U.S. District Court for Maryland. These cases allege that we have competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications, and they seek to recover on behalf of variously defined classes of direct and indirect purchasers overcharges we allegedly charged for these products. To date, courts have dismissed all claims for damages against us by indirect purchasers under federal law and in 14 states. Nine of those state court decisions have been affirmed on appeal. Claims on behalf of foreign purchasers have also been dismissed. An appeal of one of these rulings is still pending and the plaintiffs in a second state have sought a further appeal. Courts in eleven states have ruled that these cases may proceed as class actions, while courts in two states have denied class certification. The Maryland federal District Court has certified a class of direct purchasers of certain of our operating system software that acquired the software from the shop.Microsoft.com web site or pursuant to a direct marketing campaign and otherwise denied certification of the proposed classes. Members of the certified class licensed fewer than 550,000 copies of at-issue operating system software from Microsoft. In September 2003, we reached an agreement with plaintiffs' counsel to settle this action, which received final approval in April 2004. In 2003, we reached an agreement with counsel for the California plaintiffs to settle all claims in 27 consolidated cases in that state. Under the proposed settlement, class members will be able to obtain vouchers on a claims made basis that entitle the class members to be reimbursed up to the face value of their vouchers for purchases of a wide variety of platform-neutral computer hardware and software. The total amount of vouchers issued will depend on the number of class members who claim and are issued vouchers. Two-thirds of the amount of vouchers unissued or unredeemed by class members will be made available to certain schools in California in the form of vouchers that also may be redeemed for cash against purchases of a wide variety of platform-neutral computer hardware, software and related services. The court in California preliminarily approved this proposed settlement, and has held a hearing on final approval with a ruling anticipated in May 2004. Since the beginning of 2003, we also reached similar agreements to settle all claims in Montana, Florida, West Virginia, North Carolina, the District of Columbia, North Dakota, Kansas, Tennessee, South Dakota and Minnesota. The proposed settlements in these states are structured similarly to the California settlement, except that, among other differences, one-half of the amounts of vouchers unissued to class members will be made available to certain schools in the relevant states. The maximum amount of vouchers to be issued in these settlements, including the California settlement, is $1.55 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools who are issued and redeem vouchers. The settlements in Montana, Florida and West Virginia have received final approval by the relevant court. The proposed settlements in North Carolina, the District of Columbia, North Dakota, Kansas, Tennessee and South Dakota have received preliminary approval by the courts in those states, but still require final approval. We estimate the total cost to resolve all of these cases will range between $1.0 billion and $1.2 billion with the actual cost dependent upon many unknown factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims process. In accordance with SFAS 5, *Accounting for Contingencies*, and FIN 14, *Reasonable Estimation of the Amount of a Loss*, we have recorded a contingent liability of $972 million, net of administrative expenses paid.

On December 18, 2003, RealNetworks, Inc. filed suit against us alleging violations of federal and state antitrust and unfair competition laws, related to streaming media features of Windows and related technologies. RealNetworks seeks damages and injunctive relief, including a permanent injunction requiring Microsoft to offer a version of Windows products with no streaming media features. We deny the allegations and will vigorously defend the action. RealNetworks filed the case in federal court in San Jose, California. It has been consolidated for pretrial purposes with other cases pending in the U.S. District Court in Baltimore.

We are the defendant in more than 30 patent infringement cases that we are defending vigorously. In the case of *Eolas Technologies, Inc. and University of California v. Microsoft*, filed in the U.S. District Court for the Northern District of Illinois on February 2, 1999, the plaintiffs accused the browser functionality of Windows of infringement. On August 11, 2003, the jury awarded the plaintiffs approximately $520 million in damages for infringement from the date the plaintiffs' patent issued through September 2001. The plaintiffs are seeking an equitable accounting for damages from September 2001 to the present. On January 14, 2004, the trial court entered final judgment of $565 million, including post-trial interest of $45 million, and entered an injunction against distribution of any new products, but stayed execution of the judgment and the injunction pending our appeal. We filed our notice of appeal on February 12, 2004. On October 30, 2003, the U.S. Patent Office issued a letter stating that it has initiated a Director-ordered re-examination of the Eolas patent. On February 26, 2004, pursuant to this re-examination proceeding, the Patent Office issued an Office Action rejecting the claims of the Eolas patent. We believe the total cost to resolve this case will not be material to our financial position or results of operations. The actual costs are dependent upon many unknown factors such as success on appeal and the events of a retrial of the case should the case be remanded to trial following appeal. In *Research Corporation Technologies, Inc. v. Microsoft*, filed in U.S. District Court for the District of Arizona, plaintiff has asserted a family of six patents relating to halftoning which it believes are infringed by certain printing and display functionality allegedly present in different versions of Windows and Office. Plaintiff seeks an as yet unspecified amount of damages in the form of "reasonable royalties" on various Microsoft products dating as far back as Windows and Office 2000. The case is scheduled for trial in April of 2005. In *TVI v. Microsoft*, filed in U.S. District Court for the Northern District of California, plaintiff accuses the Autoplay feature of Windows of infringement. This case is scheduled for trial in September 2004. Adverse outcomes in some or all of the pending cases may result in significant monetary damages or injunctive relief against us adversely affecting distribution of our operating system or application products. The risks associated with an adverse decision may result in material settlements.

We are also subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business.

While management currently believes that resolving all of these matters, individually or in aggregate, will not have a material adverse impact on our financial position or our results of operations, the litigation and other claims noted above are subject to inherent uncertainties and management's view of these matters may change in the future. Were an unfavorable final outcome to occur, there exists the possibility of a material adverse impact on our financial position and the results of operations for the period in which the effect becomes reasonably estimable.

On April 1, 2004, we entered into a series of agreements with Sun Microsystems, Inc. that resulted in dismissal of the previously reported suit by Sun and resolved other legal claims between the companies. Pursuant to the agreements, we made payments totaling $1.95 billion to Sun subsequent to March 31, 2004, of which $29 million has been recorded as an intellectual property asset and the balance has been recorded as an expense in the three months ended March 31, 2004.

On April 3, 2004, the previously reported case of *InterTrust v. Microsoft* was settled by agreement of the parties. Under the terms of this agreement, we have taken a comprehensive license to InterTrust's patent portfolio, including pending patent applications, and agreed to make a one-time payment to InterTrust of $440 million. The agreement involved a combination of a license of intellectual property assets for which we recorded an intangible asset of $266 million and a payment of $174 million for settlement of legal claims. Of the total payment, $174 million will be recovered through insurance and had no impact on our results of operations for the three months ended March 31, 2004. The agreement resolves all outstanding litigation between the parties.

**Note 10 – Guarantees**

We have unconditionally guaranteed the repayment of certain Japanese Yen denominated bank loans and related interest and fees of Jupiter Telecommunication, Ltd., a Japanese cable company (Jupiter). These guarantees arose on February 1, 2003 in conjunction with the expiration of prior financing arrangements, including previous guarantees by us. The financing arrangements were entered into by Jupiter as part of financing its operations. As part of Jupiter's new financing agreement, we agreed to guarantee repayment by Jupiter of the loans of approximately $55 million. The estimated fair value and the carrying value of the guarantees was $10.5 million and did not result in a charge to operations. The guarantees are in effect until the earlier of repayment of the loans, including accrued interest and fees, or February 1, 2009. The maximum amount of the guarantees is limited to the sum of the total due and unpaid principal amounts, accrued and unpaid interest, and any other related expenses. Additionally, the maximum amount of the guarantees, denominated in Japanese yen, will vary based on fluctuations in foreign exchange rates. If we were required to make payments under the guarantees, we may recover all or a portion of those payments upon liquidation of Jupiter's assets. The proceeds from such liquidation cannot be accurately estimated due to the multitude of factors that would affect the valuation and realization of the proceeds in the event of liquidation.

In connection with various operating leases, we issued residual value guarantees, which provide that if we do not purchase the leased property from the lessor at the end of the lease term, then we are liable to the lessor for an amount equal to the shortage (if any) between the proceeds from the sale of the property and an agreed value. As of March 31, 2004, the maximum amount of the residual value guarantees was approximately $271 million. We believe that proceeds from the sale of properties under operating leases would exceed the payment obligation and therefore no liability to us currently exists.

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. In addition, we also provide indemnification against credit risk in several geographical locations to our volume license resellers in case the resellers fail to collect from the end user. Due to the nature of the indemnification provided to our resellers, we can not estimate the fair value, nor determine the total nominal amount of the indemnification. We evaluate estimated losses for such indemnifications under SFAS 5 as interpreted by FASB Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45).

**MICROSOFT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**
***(Unaudited)***

We consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnifications in our financial statements.

Our product warranty accrual reflects management's best estimate of probable liability under our product warranties (primarily relating to the Xbox console). We determine the warranty accrual based on known product failures (if any), historical experience, and other currently available evidence. Product warranty and changes to the accruals were not significant for any of the periods presented.

**Note 11 – Segment Information**

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| **(In millions)** | **2003** | **2004** | **2003** | **2004** |
| **Revenue** | | | | |
| Client | $ 2,485 | $ 2,791 | $ 7,787 | $ 8,464 |
| Server and Tools | 1,640 | 2,029 | 4,898 | 5,755 |
| Information Worker | 2,440 | 2,799 | 7,168 | 8,070 |
| Microsoft Business Solutions | 129 | 154 | 401 | 467 |
| MSN | 630 | 621 | 1,744 | 1,822 |
| Mobile and Embedded Devices | 47 | 64 | 111 | 173 |
| Home and Entertainment | 492 | 519 | 2,281 | 2,353 |
| Reconciling Amounts | (28) | 198 | (268) | 439 |
| Consolidated | $ 7,835 | $ 9,175 | $ 24,122 | $ 27,543 |
| **Operating Income/(Loss)** | | | | |
| Client | $ 2,002 | $ 2,223 | $ 6,434 | $ 6,866 |
| Server and Tools | 428 | 565 | 1,437 | 1,613 |
| Information Worker | 1,938 | 2,074 | 5,746 | 6,026 |
| Microsoft Business Solutions | (58) | (52) | (161) | (146) |
| MSN | (87) | 117 | (334) | 326 |
| Mobile and Embedded Devices | (40) | (24) | (108) | (71) |
| Home and Entertainment | (203) | (182) | (717) | (598) |
| Reconciling Amounts | (1,236) | (3,443) | (4,292) | (8,115) |
| Consolidated | $ 2,744 | $ 1,278 | $ 8,005 | $ 5,901 |

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 our internal organization and reporting of revenue and operating income based upon internal accounting methods. Our financial reporting systems present various data for management to run the business, including internal profit and loss statements (P&Ls) prepared on a basis not consistent with U.S. GAAP. Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each segment and it is impracticable for the Company to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

Our segments are designed to promote better alignment of strategies and objectives between development, sales, marketing, and services organizations; provide for more timely and rational allocation of development, sales, and marketing resources within businesses; and focus long-term planning efforts on key objectives and

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
*(Unaudited)*

initiatives. Our seven segments are: Client; Server and Tools; Information Worker; Microsoft Business Solutions; MSN; Mobile and Embedded Devices; and Home and Entertainment.

The segments are used to allocate resources internally and provide a framework to determine management responsibility. Due to our integrated business structure, operating costs included in one segment may benefit other segments, and therefore the segments are not designed to measure operating income or loss directly related to the products included in each segment. Inter-segment sales cost commissions are estimated by management and used to compensate or charge each segment for such shared costs, and to incent shared efforts. Management will continually evaluate the alignment of development, sales organizations, and inter-segment commissions for segment reporting purposes, which may result in changes to segment allocations in future periods.

The Company retroactively adopted the fair value recognition provisions of SFAS 123 on July 1, 2003. For internal management reporting, the stock-based compensation expense for stock awards, shared performance-based stock awards, and the employee stock purchase plan have been allocated to the segments, using a non-GAAP accelerated amortization method in the case of stock awards and shared performance-based stock awards. For example, the compensation expense for stock award grants will be expensed in the fiscal year of grant and the compensation expense for performance-based stock award grants will be expensed over three years. Costs related to options granted in prior years, including the costs associated with the stock option transfer program discussed in Note 3, were not allocated to segments by management and therefore are not included in segment operating income and are included as reconciling items. Additionally, as the broad use of stock awards and performance-based awards began in the current year, there is no comparable expense included in the corresponding period of the prior year. The following table outlines the stock-based compensation expense included in segment operating income for the three and the nine months ended March 31, 2004.

| (In millions) | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Client | $ — | $ 38 | $ — | $ 109 |
| Server and Tools | — | 100 | — | 281 |
| Information Worker | — | 46 | — | 131 |
| Microsoft Business Solutions | — | 10 | — | 29 |
| MSN | — | 22 | — | 61 |
| Mobile and Embedded Devices | — | 9 | — | 26 |
| Home and Entertainment | — | 19 | — | 55 |
| Reconciling Amounts | 978 | 504 | 3,084 | 4,303 |
| Consolidated | $ 978 | $ 748 | $ 3,084 | $ 4,995 |

**MICROSOFT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**
***(Unaudited)***

Client includes revenue and operating expenses associated with Windows XP Professional and Home, Windows 2000 Professional, and other standard Windows operating systems. Server and Tools consists of revenue and operating expenses associated with server software licenses and client access licenses (CALs) for Windows Server, SQL Server, Exchange Server, and other servers. It also includes developer tools, training, certification, Microsoft Press, Premier product support services, and Microsoft consulting services. Information Worker includes Microsoft Office, Microsoft Project, Microsoft Visio, SharePoint Portal Server CALs, other information worker products including LiveMeeting and OneNote, an allocation for CALs, and professional product support services. Microsoft Business Solutions includes Microsoft Great Plains, Microsoft Navision, Microsoft Axapta, Microsoft Solomon, Microsoft CRM, bCentral and other business applications and services. MSN includes MSN subscriptions, the MSN network of Internet products and services, and Microsoft's participation in certain joint ventures including MSNBC Cable L.L.C., MSNBC Interactive News L.L.C., ninemsn Pty Ltd, and T1MSN, Corp. Mobile and Embedded Devices includes Windows Mobile™ software, Windows Embedded device operating systems, MapPoint, and Windows Automotive. Home and Entertainment includes the Xbox video game system, PC games, consumer software and hardware, and TV platform.

Corporate and reconciling amounts include adjustments to state revenue and operating income in accordance with U.S. GAAP and corporate level expenses not specifically attributed to a segment. For revenue, reconciling items include certain undelivered elements of unearned revenue and allowances for certain sales returns and rebates. Corporate and reconciling items for operating income/(loss) for the third quarter include general and administrative expenses ($397 million in the third quarter of fiscal year 2003 and $472 million in 2004), broad-based research and development expenses ($58 million in the third quarter of fiscal year 2003 and $78 million in 2004), and certain corporate level sales and marketing costs ($160 million in the third quarter of fiscal year 2003 and $238 million in 2004), $1.92 billion of accrued legal settlement expenses related to the Sun Microsystems litigation, $605 million accrual for the European Commission fine, and other reconciling items, including stock based compensation expense ($621 million in the third quarter of fiscal year 2003 and $129 million in 2004).

Corporate and reconciling items for operating income/(loss) for the first nine months include general and administrative expenses ($1.10 billion in the first nine months of fiscal 2003 and $1.51 billion in 2004), broad-based research and development expenses ($169 million in the first nine months of fiscal 2003 and $245 million in 2004), and certain corporate level sales and marketing costs ($427 million in the first nine months of fiscal 2003 and $628 million in 2004), $2.21 billion in stock-based compensation related to the employee stock option transfer program, $1.92 billion of accrued legal settlement expenses related to the Sun Microsystems litigation, $605 million accrual for the European Commission fine, and other reconciling items, including additional stock-based compensation expense ($2.59 billion in the first nine months of fiscal 2003 and $1.00 billion in 2004). The internal segment operating income or loss also includes non-GAAP accelerated methods of depreciation and amortization, and accelerated amortization of stock awards and performance-based stock awards. Additionally, losses on equity investees and minority interest are classified in operating income for internal reporting presentations.

**INDEPENDENT ACCOUNTANTS' REPORT**

To the Board of Directors and Stockholders of Microsoft Corporation
Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Company) as of March 31, 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for the three-month and nine-month periods ended March 31, 2004 and 2003. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2003, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended prior to restatement for the adoption of SFAS No. 123, *Accounting for Stock-Based Compensation* (not presented herein); and in our report dated July 17, 2003 (September 3, 2003 as to certain information in Note 20), we expressed an unqualified opinion on those consolidated financial statements. We also audited the adjustments described in Note 2 that were applied to restate the June 30, 2003 consolidated balance sheet of Microsoft Corporation and subsidiaries (not presented herein). In our opinion, such adjustments are appropriate and have been properly applied and the information set forth in the accompanying consolidated balance sheet as of June 30, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/S/ DELOITTE & TOUCHE LLP

**Seattle, Washington**
**April 30, 2004**

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### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This document Management's Discussion and Analysis (MD&A) contains statements that are forward-looking. 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 "Issues and Uncertainties" and elsewhere in this report. We undertake no duty to update any forward-looking statement to conform the statement to actual results or changes in our expectations. The revenue and operating income/(loss) amounts in this MD&A are presented in accordance with U.S. GAAP. Segment Information appearing in Note 11 of the Notes to Financial Statements are presented in accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*.

#### Management Summary

#### Overview

The state of the global economy is an important factor in evaluating our third quarter results. Growth in major world economies has led to an increase in demand and spending for information technology products and services, including increased demand for personal computers, server hardware, software and gaming consoles compared to a year ago. In the third quarter of fiscal 2004, we also benefited from an increase in spending on Internet-based advertising as well as the decline in the value of the U.S. dollar versus major foreign currencies over the prior year period. While we expect these improvements to continue through our fiscal fourth quarter, competition remains intense from both commercial and non-commercial software products and litigation remains a general risk in the intellectual property business, and a specific risk for Microsoft.

#### Third Quarter and Nine Months Summary

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| | | | Percentage | | | Percentage |
| (In millions, except percentages) | 2003 | 2004 | Inc./ (Dec.) | 2003 | 2004 | Inc./ (Dec.) |
| Revenue | $ 7,835 | **$ 9,175** | 17% | $ 24,122 | **$ 27,543** | 14% |
| Operating Income | $ 2,744 | **$ 1,278** | (53%) | $ 8,005 | **$ 5,901** | (26%) |

The revenue growth for the third quarter of fiscal 2004 resulted primarily from increased licensing of Windows operating systems through OEMs, Office 2003 and Server products, and MSN advertising revenue. Foreign exchange rates also contributed nearly 5% growth in total revenue for the quarter due to generally stronger foreign currency rates versus the U.S. dollar.

During the third quarter, continued strong PC and Server shipment growth and improved IT spending compared to fiscal 2003 contributed to our overall revenue growth. We estimate that total PC shipments grew approximately 14% from the third quarter of the prior year driven by strong business demand in both mature and emerging markets with consumer shipments growth of approximately 10% for the quarter. Total server hardware shipments have grown 17% in the third quarter of fiscal 2004 per our internal projections, with Windows Server shipments growing faster than the overall sector at 25% compared to the prior year's third quarter. The net impact of foreign exchange rates on revenue was positive in the third quarter compared to a year ago, primarily due to a stronger Euro and Japanese yen versus the U.S. dollar. Had the rates from the prior year's third quarter been in effect in the third quarter of fiscal 2004, translated international revenue earned in local currencies would have been approximately $350 million lower. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

The revenue growth for the first nine months of fiscal 2004 was driven partly by revenue recognized from multi-year licensing that occurred prior to the Company's transition to a new licensing program (Licensing 6.0) in the first quarter of fiscal 2003 and strong OEM licensing of Microsoft Windows XP Home and Professional operating systems and Server products as a result of growth in PC and server hardware shipments. Prior to the July 31, 2002 transition date to Licensing 6.0, we experienced a significant increase in multi-year licensing arrangements as customers enrolled in the Company's maintenance programs, primarily Upgrade Advantage. The increase in revenue was also driven by a 14% growth in estimated PC shipments, reflecting strength in the consumer segment as well as global economic improvement driving enterprise segment replacement PC and notebook sales. We estimate that total server hardware shipments grew 15%, with Windows Server shipments growing faster than the overall sector at 19% in the first nine months of fiscal 2004. The net impact of foreign exchange rates on revenue was positive in the first nine months of fiscal 2004, primarily due to a stronger Euro and Japanese yen versus the U.S. dollar. Had the rates from the prior year's first nine months been in effect in the first nine months of fiscal 2004, translated international revenue earned in local currencies would have been approximately $830 million lower. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

For the full fiscal 2004, we expect PC shipments to grow at rates in the low teens, driven by both consumer and business demand for PCs. We believe the overall server hardware sector and IT spending outlook will continue to demonstrate improvement over fiscal 2003. Our enterprise server products revenue results should be positively affected by the continued shift to lower cost X86 server architecture. As a result, we expect overall server hardware shipment growth for fiscal 2004 to reach near mid-teens growth with Windows Server operating systems licenses growing faster than the overall sector. We believe foreign exchange rates will continue to stabilize during the last quarter of our fiscal year and we will continue to benefit from the U.S. dollar's position relative to the Euro and Japanese yen.

The operating income decline for the third quarter of fiscal 2004 was due primarily to a $1.92 billion charge related to settlement of the Sun Microsystems litigation and a €497 million ($605 million) accrual for the European Commission fine. Sun Microsystems and Microsoft entered into a series of agreements that settled Sun's suit against us and resolved other legal claims between the companies. The European Commission fine was imposed as part of its finding that Microsoft had infringed European competition law by refusing to supply work group server interoperability information and by including streaming media playback functioning in Windows desktop operating systems. We intend to appeal the European Commission's finding.

For the first nine months of fiscal 2004, the operating income decline was primarily driven by the $2.53 billion of charges related to the settlement of the Sun Microsystems litigation and an accrual for the fine imposed by the European Commission and $2.21 billion of stock-based compensation expense related to our employee stock option transfer program in the second quarter of fiscal 2004.

We adopted the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, on July 1, 2003 and restated prior periods to reflect compensation cost under the recognition provisions of SFAS 123 for all awards granted to employees after July 1, 1995. Stock-based compensation is included in operating expenses as part of headcount-related costs. Total stock-based compensation costs included in operating expenses for the third quarter of fiscal 2004 were $748 million, compared to $978 million in the prior year's comparable quarter. Total stock-based compensation costs included in operating expenses for the nine months ended March 31, 2004 were $5.00 billion, compared to $3.08 billion in the prior year's comparable period.

**SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)**

Our seven segments are: Client; Server and Tools; Information Worker; Microsoft Business Solutions; MSN; Mobile and Embedded Devices; and Home and Entertainment.

The revenue and operating income/(loss) amounts in this section MD&A are presented in accordance with U.S. GAAP applied at the segment level. Certain corporate level expenses (primarily general and administrative expenses, including the accrual for the imposed fine from the European Commission, and corporate level sales and marketing costs) have been excluded. Segment Information appearing in Note 11 of the Notes to Financial Statements is presented in accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*.

The following table presents our segment revenue and operating income, determined in accordance with U.S. GAAP:

***Client***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| **(In millions, except percentages)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** |
| Revenue | $ 2,527 | **$ 2,924** | 16% | $ 7,868 | **$ 8,792** | 12% |
| Operating Income | $ 1,901 | **$ 1,605** | (16%) | $ 6,136 | **$ 5,941** | (3%) |

Client includes revenue from Windows XP Professional and Home, Windows 2000 Professional, and other standard Windows operating systems. In the third quarter of fiscal year 2004 Windows OEM license units grew 16%, driving an 18% growth in OEM revenue compared to the prior year. Revenue from commercial and retail licensing grew 6% compared to the prior year's third quarter. The mix of Windows units shipped with the Professional version increased two percentage points to 58% of total Windows licenses compared to the prior year. Client operating income in the third quarter of fiscal 2004 declined primarily as a result of $700 million of legal settlement expenses related to the Sun Microsystems litigation, partially offset by growth in revenue.

The nine month revenue growth reflected Windows OEM license unit growth of 12%, driving a 16% growth in OEM revenue compared to the prior year. Revenue from commercial and retail licensing declined 1% compared to the prior year's first nine months. Client operating income for the first nine months of fiscal year 2004 declined due to growth in operating expenses, primarily related to legal settlement expenses of $700 million in the third quarter of fiscal 2004 and stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004, partially offset by growth in revenue.

We anticipate that total PC shipments will grow about 10% for the fourth quarter of fiscal 2004, continuing to influence our growth in Client revenue. Additionally, we do not expect significant future changes in the mix of Windows Home and the higher priced Windows Professional version.

***Server and Tools***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| **(In millions, except percentages)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** |
| Revenue | $ 1,827 | **$ 2,177** | 19% | $ 5,215 | **$ 6,177** | 18% |
| Operating Income/ (Loss) | $ 305 | **($ 635)** | nm | $ 831 | **($ 469)** | nm |

Server and Tools consists of server software licenses and client access licenses (CALs) for Windows Server, SQL Server, Exchange Server, and other servers. It also includes developer tools, training, certification, Microsoft Press, Premier product support services, and Microsoft consulting services. In the third quarter of fiscal 2004, Server revenue, including CALs, grew $445 million or 36%. The revenue increase was driven primarily by an estimated 25% increase in Windows-based server shipments resulting in 31% growth in new Windows Server license sales as well as growth in SQL Server and Core CAL revenue. Consulting and Premier product support services increased $30 million or 11% compared to the prior year's third quarter. Revenue from developer tools, training, certification, Microsoft Press and other services decreased $125 million or 38%, due to recognition of $128 million of previously deferred revenue in the prior year's comparable quarter. The third quarter of fiscal 2004 operating income declined $940 million primarily due to $1.22 billion of legal settlement expenses related to the Sun Microsystems litigation, partially offset by the increase in revenue.

In the first nine months of fiscal 2004, Server revenue, including CALs, grew $950 million or 25% driven primarily by an estimated 19% increase in Windows-based server shipments driving growth in new Windows Server license sales as well as growth in SQL Server and Exchange Server revenue. Consulting and Premier product support services increased $137 million or 19% compared to the prior year's first nine months. Revenue from developer tools, training, certification, Microsoft Press and other services declined $125 million or 17% compared to the prior year's first nine months. Server and Tools operating income for the first nine months of fiscal 2004 decreased primarily due to a legal settlement charge of $1.22 billion in the third quarter of fiscal 2004 and stock-based compensation costs from the employee stock option transfer program in the second quarter of fiscal 2004.

***Information Worker***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| | | | Percentage | | | Percentage |
| **(In millions, except percentages)** | **2003** | **2004** | **Inc./ (Dec.)** | **2003** | **2004** | **Inc./ (Dec.)** |
| Revenue | $ 2,327 | **$ 2,739** | 18% | $ 6,880 | **$ 7,921** | 15% |
| Operating Income | $ 1,696 | **$ 1,926** | 14% | $ 5,018 | **$ 5,191** | 3% |

Information Worker includes Microsoft Office, Microsoft Project, Microsoft Visio, SharePoint Portal Server CALs, other information worker products including Microsoft LiveMeeting and OneNote, and professional product support services. Revenue for the third quarter of fiscal 2004 reflected continued momentum from the Office 2003 launch. Benefiting from increased adoption of Office 2003 including penetration of the premium Small Business and Professional editions, OEM licensing revenue grew 35% compared to the prior year's third quarter. Revenue from volume licensing, retail packaged product and pre- installed versions of Office in Japan also grew 15% in aggregate as Office 2003 sales strength continued post launch. Contributing to the increase in revenue was previously deferred multi-year licensing arrangements revenue, including Upgrade Advantage, and a lower deferral rate for undelivered elements, partially offset by lengthened product lives. Information Worker operating income for the third quarter of fiscal year 2004 increased due to the growth in revenue, partially offset by an increase in operating expenses, primarily headcount-related costs and marketing expenses in the Small and Mid-Market Solutions and Partners group.

Revenue growth for the first nine months of fiscal 2004 from volume licensing, retail packaged product and pre installed versions of Office in Japan is 13% in aggregate, driven by recognitions of unearned revenue from a large increase in multi-year licenses signed prior to the transition to our Licensing 6.0 programs and the release of Office 2003. OEM licensing revenue grew 33%. Information Worker operating income in the first nine months of fiscal year 2004 increased from the prior year primarily due to growth in revenue, largely offset by an increase in operating expenses, primarily related to the stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004 and higher sales and marketing expenses.

***Microsoft Business Solutions***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| | | | Percentage | | | Percentage |
| **(In millions, except percentages)** | **2003** | **2004** | **Inc./ (Dec.)** | **2003** | **2004** | **Inc./ (Dec.)** |
| Revenue | $ 147 | **$ 153** | 4% | $ 388 | **$ 471** | 21% |
| Operating Loss | ($ 92) | **($ 65)** | (29%) | ($273) | **($213)** | (22%) |

Microsoft Business Solutions includes Microsoft Great Plains, Microsoft Navision, Microsoft Axapta, Microsoft Solomon, Microsoft CRM, bCentral and other business applications and services. The revenue increase in the third quarter of fiscal 2004 was primarily attributable to continued growth in licensing of Navision and Axapta products outside of the United States as well as the timing of licensing agreements. Microsoft Business Solutions operating loss for the third quarter of fiscal year 2004 declined due to growth in revenue and lower stock-based compensation expense partially offset by increased sales and marketing costs.

The revenue increase in the first nine months of fiscal 2004 was primarily attributable to continued growth in licensing of Navision and Axapta products. The operating loss for the first nine months of fiscal 2004 declined due to the increase in revenue, partially offset by a 3% increase in operating expenses primarily related to stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004.

***MSN***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| | | | Percentage | | | Percentage |
| **(In millions, except percentages)** | **2003** | **2004** | **Inc./ (Dec.)** | **2003** | **2004** | **Inc./ (Dec.)** |
| Revenue | $ 508 | **$ 591** | 16% | $ 1,394 | **$ 1,628** | 17% |
| Operating Income/ (Loss) | ($ 139) | **$ 107** | nm | ($ 483) | **$ 86** | nm |

MSN includes MSN subscriptions and the MSN network of Internet products and services. In the third quarter of fiscal 2004, MSN Network services revenue grew $100 million or 43% as a result of growth in paid search and growth in the overall Internet advertising market. MSN subscription revenue declined $17 million or 6% as the number of narrowband subscribers continued to migrate to competitively priced broadband or other ISPs. The number of total MSN subscriptions at the end of March 2004 was 8.2 million, slightly higher than at the end of December 2003, as the loss of narrowband subscribers was offset by the gain of other premium service subscriptions. Subscription revenue may decline in the fourth quarter of the fiscal year as the narrowband subscriber base is expected to continue to decline. The improvement in operating income/(loss) in the third quarter was due to strong advertising revenue and paid search, while operation costs remained flat and customer acquisition expenditures declined.

In the first nine months of fiscal 2004, MSN Network services grew $274 million or 47% as a result of increased Internet advertising revenue. MSN Subscription revenue declined $40 million or 5%, reflecting a decrease in the overall subscriber base. The improvement in operating results for the first nine months of fiscal 2004 was driven primarily by strong advertising revenue performance and lower operating expenses including a $48 million one-time refund of prior year taxes, partially offset by the costs related to the employee stock option transfer program which were recorded in the second quarter of fiscal 2004.

***Mobile and Embedded Devices***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| | | | Percentage | | | Percentage |
| **(In millions, except percentages)** | **2003** | **2004** | **Inc./ (Dec.)** | **2003** | **2004** | **Inc./ (Dec.)** |
| Revenue | $ 46 | **$ 61** | 33% | $ 112 | **$ 177** | 58% |
| Operating Income/ (Loss) | ($ 72) | **($ 38)** | (47%) | ($212) | **($182)** | (14%) |

Mobile and Embedded Devices includes Windows Mobile software, Windows Embedded device operating systems, MapPoint, and Windows Automotive. The increase in revenue in the third quarter of fiscal 2004 was driven by growth in all businesses. The revenue growth realized by MapPoint has slowed and is expected to grow at a continued slower pace in future quarters, as the first two quarters of fiscal 2004 growth rates reflected the acquisition of Vicinity Corporation toward the end of the second quarter of the prior fiscal year. Mobile and Embedded Devices operating loss was lower in the third quarter of fiscal 2004 compared to the prior year's third quarter, due to lower operating expenses and growth in revenue.

The increase in revenue for the first nine months of fiscal 2004 was driven by growth in all businesses and the acquisition of Vicinity at the end of the second quarter of fiscal 2003. Mobile and Embedded Devices operating loss was lower in the first nine months of fiscal 2004 compared to the prior year's first nine months, primarily driven by growth in revenue, partially offset by stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004.

***Home and Entertainment***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| **(In millions, except percentages)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** |
| Revenue | $ 453 | **$ 530** | 17% | $ 2,265 | **$ 2,377** | 5% |
| Operating Income/ (Loss) | ($ 277) | **($ 209)** | (25%) | ($ 933) | **($ 876)** | (6%) |

Home and Entertainment includes the Xbox video game system, PC games, consumer software and hardware, and TV platform. Xbox revenue increased $81 million or 35% from the prior year's third quarter, with $78 million related to higher volumes of Xbox software and $39 million due to higher Xbox console volumes, partially offset by a $36 million decline related to past price reductions of Xbox consoles and software. At the end of the third quarter of fiscal 2004, we announced a price reduction for the Xbox console in the United States. Overall, Xbox console volumes increased 30% in the third quarter compared to the prior year's comparable quarter. This increase was partially attributed to low inventory levels of competitive consoles. Xbox's life to date U.S. games attach rate according to NPD data was 6.8 games per console. Revenue from consumer hardware and software, PC games and TV platforms declined $4 million or 2% compared to the third quarter of fiscal 2003 due to lower PC games software and PC gaming devices sales.

Home and Entertainment operating loss for the third quarter of fiscal year 2004 improved from the third quarter of fiscal year 2003 driven by revenue growth and improved Xbox console and third party software margins as well as lower marketing costs.

Xbox revenue increased $149 million or 11% from the prior year's first nine months, with $255 million related to higher volumes of Xbox software and $85 million due to higher Xbox console volumes offset by a $191 million decrease related to price reductions of Xbox consoles and software. Xbox console volumes increased 9%. Revenue from consumer hardware and software, PC games and TV platforms declined $37 million or 4% compared to the prior year's first nine months due to a decline in revenue from PC gaming devices.

Home and Entertainment operating loss for the first nine months of fiscal year 2004 improved from the first nine months of fiscal year 2003 driven by growth in revenue and only a 2% growth in operating expenses, including stock-based compensation costs associated with the employee stock option transfer program in the second quarter of fiscal 2004.

***Cost of revenue***

| | Three Months Ended March 31 | | | Nine Months Ended March 31 | | |
|---|---|---|---|---|---|---|
| **(In millions, except percentages)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** | **2003** | **2004** | **Percentage Inc./ (Dec.)** |
| Cost of revenue | $ 1,274 | **$ 1,411** | 11% | $ 4,755 | **$ 5,235** | 10% |
| As a percent of revenue | 16.3% | **15.4%** | (0.9) pp | 19.7% | **19.0%** | (0.7) pp |

Cost of revenue includes manufacturing and distribution costs for products and programs sold, operation costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, and costs associated with the delivery of consulting services. The increase in absolute dollars in the third quarter of fiscal 2004 resulted from an increase in product support and consulting services costs and Home & Entertainment costs related to increased Xbox console units sold, partially offset by lower costs of producing the Xbox console. The absolute dollar cost of revenue growth in the first nine months of fiscal 2004 was primarily driven by stock-based compensation expense from the employee stock option transfer program and an increase in product support and consulting services.

***Research and development***

| (In millions, except percentages) | Three Months Ended March 31 2003 | 2004 | Percentage Inc./(Dec.) | Nine Months Ended March 31 2003 | 2004 | Percentage Inc./(Dec.) |
|---|---|---|---|---|---|---|
| Research and development | $ 1,692 | **$ 1,538** | (9%) | $ 4,914 | **$ 6,120** | 25% |
| As a percent of revenue | 21.6% | **16.8%** | (4.8) pp | 20.4% | **22.2%** | 1.8 pp |

Research and development expenses include payroll, employee benefits, stock-based compensation and other headcount-related costs associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. The decrease in the third quarter of fiscal 2004 was primarily due to lower headcount-related costs driven by reductions in stock-based compensation expense, partially offset by increased product development costs. The increase in the first nine months of fiscal 2004 was primarily due to stock-based compensation expenses including expenses related to the option transfer program recorded in the second quarter of fiscal 2004 and $164 million or 7% in other headcount-related costs.

***Sales and marketing***

| (In millions, except percentages) | Three Months Ended March 31 2003 | 2004 | Percentage Inc./(Dec.) | Nine Months Ended March 31 2003 | 2004 | Percentage Inc./(Dec.) |
|---|---|---|---|---|---|---|
| Sales and marketing | $ 1,700 | **$ 1,928** | 13% | $ 5,274 | **$ 5,900** | 12% |
| As a percent of revenue | 21.7% | **21.0%** | (0.7) pp | 21.9% | **21.4%** | (0.5) pp |

Sales and marketing expenses include payroll, employee benefits, stock-based compensation and other headcount-related costs associated with sales and marketing personnel and advertising, promotions, tradeshows, seminars, and other marketing-related programs. Sales and marketing costs increased in absolute dollars in the third quarter of fiscal 2004 due to marketing programs targeted toward the Small and Mid-Market Solutions and Partners group and $117 million or 13% growth in headcount-related costs. The sales and marketing increase in absolute dollars in the first nine months of fiscal 2004 was due to stock-based compensation expenses including expenses related to the option transfer program in the second quarter of fiscal 2004 and $354 million or a 17% increase in other headcount-related costs.

***General and administrative***

| (In millions, except percentages) | Three Months Ended March 31 2003 | 2004 | Percentage Inc./(Dec.) | Nine Months Ended March 31 2003 | 2004 | Percentage Inc./(Dec.) |
|---|---|---|---|---|---|---|
| General and administrative | $ 425 | **$ 3,020** | 611% | $ 1,174 | **$ 4,387** | 274% |
| As a percent of revenue | 5.4% | **32.9%** | 27.5 pp | 4.9% | **15.9%** | 11.0 pp |

General and administrative costs include payroll, employee benefits, stock-based compensation and other headcount-related costs associated with the finance, legal, facilities, certain human resources, and other administrative headcount, and legal costs and other administrative fees. General and administrative in the third quarter included $1.92 billion of charges related to the settlement of the Sun Microsystems litigation and a $605 million accrual for the European Commission fine. The increase in the first nine months of fiscal 2004 was primarily due to legal settlement expenses and stock-based compensation expense related to the employee stock option transfer program in the second quarter of fiscal 2004.

**INVESTMENT INCOME**

The components of investment income are as follows:

| (In millions) | Three Months Ended March 31 2003 | Three Months Ended March 31 2004 | Nine Months Ended March 31 2003 | Nine Months Ended March 31 2004 |
|---|---|---|---|---|
| Dividends and interest | $ 455 | **$ 500** | $ 1,486 | **$ 1,505** |
| Net gains (losses) on investments | 2 | **419** | (230) | **974** |
| Net gains (losses) on derivatives | 15 | **93** | (368) | **138** |
| Investment income | $ 472 | **$ 1,012** | $ 888 | **$ 2,617** |

Dividends and interest income was relatively consistent for the comparable three and nine month periods. Net gains (losses) on investments include other-than-temporary impairments of $5 million in the third quarter of fiscal 2004 compared to $234 million in the third quarter of the prior year, and $66 million for the nine month period ended March 31, 2004 compared to $1.09 billion in the prior year comparable period. The decline in impairments was mainly due to improved market conditions. Realized gains from investments increased to $424 million compared to $236 million in the third quarter of the prior year, and were $1.04 billion compared to $859 million in the nine month period of the prior year. Net losses on derivative instruments of $368 million for the nine month period ended March 31, 2003 were driven mainly by the impact of declining interest rates on interest rate sensitive instruments during the first quarter of fiscal 2003.

**INCOME TAXES**

The effective tax rate for the third quarter and the first nine months of fiscal 2004 is approximately 42% and 35%. The increase in the effective tax rate for the third quarter and for the full fiscal year 2004 reflects the impact of the accrual for the European Commission fine, which is not tax deductible. Excluding the effect of the European Commission fine, the tax rate for the quarter would have been 33%. The effective tax rate is expected to be approximately 35% for fiscal 2004. The effective tax rate for fiscal 2003 was 32%, reflecting a benefit in the second quarter of $126 million from the reversal of previously accrued taxes.

**STOCK-BASED COMPENSATION**

| (In millions, except earnings per share) | Three Months Ended March 31 2003 | Three Months Ended March 31 2004 | Nine Months Ended March 31 2003 | Nine Months Ended March 31 2004 |
|---|---|---|---|---|
| Stock-based employee compensation expense | $ 978 | **$ 748** | $ 3,084 | **$ 4,995** |
| After-tax stock-based employee compensation expense | $ 655 | **$ 501** | $ 2,066 | **$ 3,345** |
| Stock-based employee compensation expense per diluted share | 0.06 | **0.05** | 0.19 | **0.31** |

Effective July 1, 2003, we adopted the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, using the retroactive restatement method described in SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*. Under the fair value recognition provisions of SFAS 123, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. The June 30, 2003 balance sheet has been restated for the retroactive adoption of the fair value recognition provisions of SFAS 123 which resulted in a $13.89 billion increase in common stock and paid-in capital, a $10.00 billion decrease in retained earnings, and a $3.89 billion increase in deferred income taxes.

In fiscal year 2004, we implemented changes in employee compensation designed to help us continue to attract and retain the best employees, and to better align employee interests with those of our shareholders. Employees are now granted stock awards instead of stock options. The stock award program offers employees the opportunity to earn shares of our stock over time, rather than options that give employees the right to purchase stock at a set price. We also completed an employee stock option transfer program in the second quarter of fiscal 2004 whereby employees could elect to transfer all of their vested and unvested stock options with a strike price of $33 or higher ("eligible options") to JPMorgan. The unvested eligible options that were transferred to JPMorgan became vested upon the transfer. The price paid by JPMorgan for the transferred options was determined by reference to the arithmetic average of the closing prices of Microsoft common stock during the period from November 14, 2003 to December 8, 2003, which was $25.5720.

A total of 18,503 (51%) of the 36,539 eligible Microsoft employees elected to participate in the stock option transfer program and 344.6 million (55%) of the 621.4 million eligible options were tendered. Under the terms of the program, JPMorgan paid Microsoft $382 million for the transferred options. Microsoft made an initial payment of $219 million to participating employees for the transferred options, with a remaining portion to be paid in one or more payments that are subject to participating employees' continued employment over the next two or three years. The options that were transferred to JPMorgan resulted in stock-based compensation expense of $2.21 billion ($1.48 billion after-tax or $0.14 per diluted share) in the second quarter of fiscal 2004. This expense consists of the unrecognized compensation costs of the options that were transferred, less the amounts payable applicable to those previously unvested options that are subject to continued employment of participating employees. The contingent payments applicable to unvested eligible options that are subject to continued employment of participating employees will be recognized as compensation expense over the vesting period of the contingent payments.

The stock option transfer program also resulted in a decrease to our long-term deferred tax assets due to the excess of recorded compensation expense for these options over the related tax deduction reported on our tax return. For the nine months ended March 31, 2004, deferred tax assets were reduced by approximately $2.01 billion with an offsetting reduction in paid-in capital, reflecting the reduction of previously recorded deductions reported on our tax return in excess of stock-based compensation expense.

**FINANCIAL CONDITION**

Cash and short-term investments totaled $56.41 billion as of March 31, 2004 compared to $49.05 billion as of June 30, 2003. The portfolio consists primarily of fixed-income securities, diversified among industries and individual issuers. Our investments are generally liquid and investment grade securities. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions, in order to diversify financial risk.

Unearned revenue from volume licensing programs represents customer billings, paid either upfront or annually at the beginning of each billing coverage period, which are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. For certain other licensing arrangements revenue attributable to undelivered elements, including free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis, is based on the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the related product's life cycle. The percentage of revenue recorded as unearned due to undelivered elements ranges from approximately 15% to 25% of the sales price for Windows XP Home, approximately 5% to 15% of the sales price for Windows XP Professional, and approximately 1% to 15% of the sales price for desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three and a half years for Windows operating systems and two years for desktop applications. Unearned revenue also includes payments for online advertising for which the advertisement has yet to be displayed and payments for post-delivery support services to be performed in the future.

Unearned revenue as of March 31, 2004 decreased $326 million from December 31, 2003. The sequential decrease reflected a $123 million net decrease in unearned revenue related to undelivered elements as deferral rates were lower, partially offset by lengthened product life cycles for the underlying products licensed, resulting in a higher proportion of revenue earned. The sequential decline also reflects a net decrease of $248 million in unearned revenue from volume licensing programs as $261 million of revenue was earned from previously deferred revenue from Upgrade Advantage programs.

Unearned revenue as of March 31, 2004 decreased $1.49 billion from June 30, 2003. The sequential decrease reflected a $346 million net decrease in unearned revenue related to undelivered elements as deferral rates were lower, partially offset by lengthened product life cycles for the underlying products licensed, resulting in a higher proportion of revenue earned. The decline also reflects a net decrease of $1.14 billion in unearned revenue from volume licensing programs as $936 million of revenue was earned from previously deferred revenue from Upgrade Advantage programs.

The revenue earned from the Upgrade Advantage programs for fiscal years 2003 and 2004 was as follows (in millions):

| (In millions) | Revenue Earned |
|---|---|
| **Three months ended:** | |
| September 30, 2002 | $ 464 |
| December 31, 2002 | 480 |
| March 31, 2003 | 450 |
| June 30, 2003 | 421 |
| September 30, 2003 | 379 |
| December 31, 2003 | 296 |
| March 31, 2004 | 261 |

Cash flow from operations for the third quarter of fiscal 2004 was $4.97 billion, compared to $4.17 billion in the comparable quarter of the prior year. The increase reflects higher net income before non-cash items including stock-based compensation expense and legal charges, and other changes in working capital. Cash used for financing was $1.04 billion in the third quarter of fiscal 2004, compared to $1.21 billion in the comparable quarter of the prior year. Cash used in the prior year's comparable quarter included a cash dividend payment of $857 million. We also repurchased 49.9 million shares of common stock under our share repurchase program in the third quarter of fiscal 2004, compared to 30.7 million shares repurchased in the prior year's third quarter. Cash used for investing was $738 million in the third quarter of fiscal 2004, compared to $4.21 billion in the prior year's third quarter. The decrease reflects the decline in purchases of investments partially offset by impact of other investing activities.

Cash flow from operations in the fourth quarter of fiscal 2004 will be affected by the cash payment of certain legal charges accrued in the third quarter of fiscal 2004.

Cash flow from operations was $12.97 billion in the first nine months of fiscal 2004, a decrease of $140 million from the first nine months of the prior year. The decrease reflects the decline in net income due to stock-based compensation and accrued legal fees, the impact of net recognized gains on investments and the impact of accounts receivable, partially offset by the rise in other current and long-term liabilities. Cash used for financing was $3.66 billion in the first nine months of fiscal 2004, a decrease of $1.08 billion from the first nine months of the prior year, reflecting a decrease of approximately $1.89 billion in stock repurchases partially offset by an increase in cash dividends of $872 million. During the first nine months of fiscal 2004, we repurchased 123.7 million shares of common stock, compared to 190.1 million shares of common stock in the comparable period of the prior year. The decrease in net cash used for investing for the first nine months of fiscal 2004 reflects the impact of $891 million in cash acquisition costs in the prior year.

We have no material long-term debt. Stockholders' equity at March 31, 2004 was $70.58 billion. We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $148 million on March 31, 2004. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of or requirements for capital resources.

We believe existing cash and short-term investments together with funds generated from operations should be sufficient to meet operating requirements. Our philosophy regarding the maintenance of a balance sheet with a large component of cash and short-term investments, as well as equity and other investments, reflects our views on potential future capital requirements relating to research and development, creation and expansion of sales distribution channels, investments and acquisitions, share dilution management, legal risks, and challenges to our business model. We continuously assess our investment management approach in view of our current and potential future needs.

***Off-balance sheet arrangements***

We have unconditionally guaranteed the repayment of certain Japanese Yen denominated bank loans and related interest and fees of Jupiter Telecommunication, Ltd., a Japanese cable company (Jupiter). These guarantees arose on February 1, 2003 in conjunction with the expiration of prior financing arrangements, including previous guarantees by us. The financing arrangements were entered into by Jupiter as part of financing its operations. As part of Jupiter's new financing agreement, we agreed to guarantee repayment by Jupiter of the loans of approximately $55 million. The estimated fair value and the carrying value of the guarantees was $10.5 million and did not result in a charge to operations. The guarantees are in effect until the earlier of repayment of the loans, including accrued interest and fees, or February 1, 2009. The maximum amount of the guarantees is limited to the sum of the total due and unpaid principal amounts, accrued and unpaid interest, and any other related expenses. Additionally, the maximum amount of the guarantees, denominated in Japanese yen, will vary based on fluctuations in foreign exchange rates. If we were required to make payments under the guarantees, we may recover all or a portion of those payments upon liquidation of Jupiter's assets. The proceeds from such liquidation cannot be accurately estimated due to the multitude of factors that would affect the valuation and realization of the proceeds in the event of liquidation.

In connection with various operating leases, we issued residual value guarantees, which provide that if we do not purchase the leased property from the lessor at the end of the lease term, then we are liable to the lessor for an amount equal to the shortage (if any) between the proceeds from the sale of the property and an agreed value. As of March 31, 2004, the maximum amount of the residual value guarantees was approximately $271 million. We believe that proceeds from the sale of properties under operating leases would exceed the payment obligation and therefore no liability to us currently exists.

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. In addition, we also provide indemnification against credit risk in several geographical locations to our volume license resellers in case the resellers fail to collect from the end user. Due to the nature of the indemnification provided to our resellers, we can not estimate the fair value, nor determine the total nominal amount of the indemnification. We evaluate estimated losses for such indemnifications under SFAS 5 as interpreted by FASB Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of*

*Others* (FIN 45). We consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnifications in our financial statements.

**RECENTLY ISSUED ACCOUNTING STANDARDS**

In December 2003, the FASB issued Interpretation 46R (FIN 46R), a revision to Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities.* FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after March 15, 2004. Entities that have adopted FIN 46 prior to this effective date can continue to apply the provisions of FIN 46 until the effective date of FIN 46R or elect early adoption of FIN46R. Microsoft adopted FIN 46 on July 1, 2003 and FIN 46R for the quarter ended December 31, 2003 .and it did not have a material impact on our financial statements. The early adoption of FIN46R did not have a material impact on our financial statements.

**APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management’s application of accounting policies. Critical accounting policies for us include revenue recognition, accounting for stock-based compensation, impairment of investment securities, impairment of goodwill, accounting for research and development costs, accounting for legal contingencies, and accounting for income taxes.

We account for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. End users receive certain elements of our products over a period of time. These elements include free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis, the fair value of which is recognized over the product’s estimated life cycle. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product’s estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

We account for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123. The application of SFAS 123 requires judgment, including the expected life and stock price volatility for stock options and expected dividends and forfeitures for all stock-based awards. Changes in the expected or actual outcome of forfeitures due to service- and/or performance-related conditions could materially impact the amount of stock-based compensation expense recognized.

SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 59, *Accounting for Noncurrent Marketable Equity Securities*, provide guidance on determining when an investment is other-than-temporarily impaired. This determination requires significant judgment. In making this judgment, we evaluate, among other factors, the duration and extent to which the fair value of an investment is less than its cost; the financial health of and near-term business outlook for the investee, including factors such as industry and sector performance, changes in technology, and operational and financing cash flow; and our intent and ability to hold the investment.

SFAS 142, *Goodwill and Other Intangible Assets*, requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (July 1st for

Microsoft) and between annual tests in certain circumstances. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit.

We account for research and development costs in accordance with several accounting pronouncements, including SFAS 2, *Accounting for Research and Development Costs*, and SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. SFAS 86 specifies that costs incurred internally in creating a computer software product should be charged to expense when incurred as research and development until technological feasibility has been established for the product. Once technological feasibility is established, all software costs should be capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established are not material, and accordingly, we expense all research and development costs when incurred.

We are subject to various legal proceedings and claims, the outcomes of which are subject to significant uncertainty. SFAS 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial position or our results of operations.

SFAS 109, *Accounting for Income Taxes*, establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could materially impact our financial position or our results of operations.

**ISSUES AND UNCERTAINTIES**

This Quarterly Report on Form 10-Q contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of issues and uncertainties such as those listed below and elsewhere in this report, which, among others, should be considered in evaluating our financial outlook.

***Challenges to our Business Model***

Since our inception, our business model has been based upon customers agreeing to pay a fee to license software developed and distributed by us. Under this commercial software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. We believe the commercial software model has had substantial benefits for users of software, allowing them to rely on our expertise and the expertise of other software developers that have powerful incentives to develop innovative software that is useful, reliable, and compatible with other software and hardware. In recent years, there has been a growing challenge to the commercial software model, often referred to as the Open Source model. Under the Open Source model, software is produced by loosely associated groups of unpaid programmers, and the resulting software and the intellectual property contained therein is licensed to end users at substantially no cost. The most notable example of Open Source software is the Linux operating system. While we believe that our products provide customers with significant advantages in security and productivity, and generally have a lower total cost of ownership than Open Source software, the popularization of the Open Source model continues to pose a significant challenge to our business model, including recent efforts by proponents of the Open Source model to convince governments worldwide to mandate the use of Open Source software in their purchase and deployment of software products. To the extent the Open Source model gains increasing market acceptance, sales of our products may decline, we may have to reduce the prices we charge for our products, and revenue and operating margins may consequently decline.

***Intellectual Property Rights***

We defend our intellectual property rights, but unlicensed copying and use of software and intellectual property rights represents a loss of revenue to us. While this adversely affects U.S. revenue, the impact on revenue from outside the United States is more significant, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may not affect revenue positively and further deterioration in compliance with existing legal protections or reductions in the legal protection for intellectual property rights of software developers could adversely affect revenue.

From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. Responding to these claims may require us to enter into royalty and licensing agreements on unfavorable terms, require us to stop selling or to redesign affected products, or to pay damages or to satisfy indemnification commitments with our customers.

We have made and expect to continue making significant expenditures to acquire the use of technology and intellectual property rights, including via cross-licenses of broad patent portfolios.

***New Products and Services***

We have made significant investments in research, development and marketing for new products, services and technologies, including Longhorn, Microsoft .NET, Xbox, business applications, MSN, and mobile and wireless technologies. Significant revenue from new product and service investments may not be achieved for a number of years, if at all. Moreover, some of these products and services may not be profitable, and even if they are profitable, operating margins for these businesses may not be as high as the margins we have historically experienced.

***Litigation***

As discussed in Note 9 – Contingencies of the Notes to Financial Statements, we are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of the pending cases may result in significant monetary damages or injunctive relief against us. We are also subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. While management currently believes that resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial position or results of operations, the litigation and other claims noted above are subject to inherent uncertainties and management's view of these matters may change in the future. If an unfavorable final outcome occurs, there exists the possibility of a material adverse impact on our financial position and the results of operations for the period in which the effect becomes reasonably estimable.

***Security***

Maintaining the security of computers and computer networks is an issue of critical importance for Microsoft and our customers. There are individuals and groups who develop and deploy viruses, worms and other malicious software programs that attack our products. While this is an industry-wide phenomenon that affects computers across all platforms, Microsoft's customers have been victims of such attacks and will likely continue to be so. We are devoting significant resources to addressing these critical issues. We are focusing our efforts on engineering more secure products, optimizing security and reliability options and settings when we deliver products, and providing guidance to help our customers make the best use of our products and services to protect against computer viruses and other attacks on their computing environment. In addition, we are working to improve the deployment of software patches to address security vulnerabilities discovered after our products are released. We are also investing in mitigation technologies that secure customers from attacks even when such software patches are not deployed. We are also advising customers on how to help protect themselves from security threats through the use of our online automated security tools, our published security guidance and the deployment of security software such as firewalls, antivirus and other security software. These steps could adversely affect our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases or to purchase competitive products. Customers may also increase their expenditures on protecting their computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue.

***Declines in Demand for Software***

If overall market demand for PCs, servers and other computing devices declines significantly, or consumer or corporate spending for such products declines, our revenue will be adversely affected. Additionally, our revenue would be unfavorably impacted if customers reduce their purchases of new software products or upgrades to existing products because new product offerings are not perceived as adding significant new functionality or other value to prospective purchasers. A significant number of customers purchased license agreements providing upgrade rights to specific licensed products prior to the transition to Licensing 6.0 in July 2002. These agreements will expire in fiscal year 2004 and 2005 and the rate at which such customers renew these contracts could adversely affect future revenue. We are making significant investments in the next release of the Windows operating system, codenamed Longhorn. If this system is not perceived as offering significant new functionality or value to prospective purchasers, our revenue and operating margins could be adversely affected.

***Product Development Schedule***

The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products, particularly any delays in the Longhorn operating system, could adversely affect our revenue.

***General Economic and Geo-Political Risks***

Softness in corporate information technology spending or other changes in general economic conditions that affect demand for computer hardware or software could adversely affect our revenue. Terrorist activity and armed conflict pose the additional risk of general economic disruption and could require changes in our international operations and security arrangements, thus increasing our operating costs. These conditions lend additional uncertainty to the timing and budget for technology investment decisions by our customers.

***Competition***

We continue to experience intensive competition across all markets for our products and services. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins and operating income.

### *Taxation of Extraterritorial Income*

In August 2001, a World Trade Organization ("WTO") dispute panel determined that the tax provisions of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("ETI") constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures. The U.S. government appealed the panel's decision and lost its appeal. On March 1, 2004, the European Union began imposing retaliatory tariffs on a specified list of U.S.-source goods. In March, the U.S. Senate began floor debate of the Jumpstart our Business Strength (JOBS) Act that would repeal ETI, provide a three year phase-out of current ETI benefits, and would replace ETI with a phased in production activity exclusion that would not be fully effective until 2012. The U.S. House of Representatives has not acted on last year's ETI replacement legislation. While neither bill will fully replace our current ETI tax benefits, both bills must pass their respective chambers and be reconciled in conference, so we remain unable to assess the ultimate form and financial impact of this legislation, if enacted. If the ETI provisions are repealed and financially comparable replacement tax legislation is not enacted, the loss of the ETI tax benefit to us could be significant.

### *Other Potential Tax Liabilities*

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different than that which is reflected in historical income tax provisions and accruals. Should additional taxes be assessed as a result of an audit or litigation, a material effect on our income tax provision and net income in the period or periods for which that determination is made could result.

### *Insurance Programs*

In addition to conventional third party insurance arrangements, we have entered into captive insurance arrangements for the purpose of protecting against possible catastrophic and other risks not covered by traditional insurance markets. As of March 31, 2004, the face value of captive insurance arrangements was $2.0 billion. Actual value at any particular time will vary due to deductibles, exclusions, other restrictions and claims. While we believe these arrangements are an effective way to insure against such risks, the potential liabilities associated with certain of the issues and uncertainties discussed in this document or other events could exceed the coverage provided by such arrangements.

### *Business Disruptions in the Event of a Catastrophic Event*

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

### *Other*

Other issues and uncertainties may include: warranty and other claims for hardware products such as Xbox; the effects of the Consent Decree in *U.S. v. Microsoft* and Final Judgment in *State of New York v. Microsoft* on the Windows operating system and server business, including those associated with protocol and other disclosures required by the Decree and Final Judgment and the ability of PC manufacturers to hide end user access to certain new Windows features; the continued availability of third party distribution channels for MSN service and other online services; factors associated with our international operations, and financial market volatility or other changes affecting the value of our investments, such as the Comcast Corporation securities held by us, that may result in a reduction in carrying value and recognition of losses including impairment charges.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to foreign currency, interest rate, and fixed income and equity price risks. A portion of these risks is hedged, but fluctuations could impact our results of operations and financial position. We hedge a portion of anticipated revenue and accounts receivable exposure to foreign currency fluctuations, primarily with option contracts. We monitor our foreign currency exposures daily to maximize the overall effectiveness of our foreign currency hedge positions. Principal currencies hedged include the Euro, Japanese yen, British pound, and Canadian dollar. Fixed income securities are subject to interest rate risk. The portfolio is diversified and structured to minimize credit risk. Securities held in our equity and other investments portfolio are subject to price risk, and are generally not hedged. However, we use options to hedge our price risk on certain highly volatile equity securities that are held primarily for strategic purposes.

We use a value-at-risk (VAR) model to estimate and quantify our market risks. VAR is the expected loss, for a given confidence level, in fair value of our portfolio due to adverse market movements over a defined time horizon. The VAR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. The model used for currencies and equities is geometric Brownian motion, which allows incorporation of optionality with regard to these risk exposures. For interest rate risk, the mean reverting geometric Brownian motion is used to reflect the principle that fixed-income securities prices revert to maturity value over time.

Value-at-risk is calculated by, first, simulating 10,000 market price paths over 20 days for equities, interest rates and foreign exchange rates, taking into account historical correlations among the different rates and prices. Each resulting unique set of equities prices, interest rates, and foreign exchange rates is applied to substantially all individual holdings to re-price each holding. The $250^{th}$ worst performance (out of 10,000) represents the value-at-risk over 20 days at the $97.5^{th}$ percentile confidence level. Several risk factors are not captured in the model, including liquidity risk, operational risk, credit risk, and legal risk.

Certain securities in our equity portfolio are held for strategic purposes. We hedge the value of a portion of these securities through the use of derivative contracts such as put-call collars. In these arrangements, we hedge a security’s market risk below the purchased put strike and forgo most or all of the benefits of the security’s appreciation above the sold call strike, in exchange for premium received for the sold call. We also hold equity securities for general investment return purposes. We have incurred material impairment charges related to these securities in prior periods. The VAR amounts disclosed below are used as a risk management tool and reflect an estimate of potential reductions in fair value of our portfolio. Losses in fair value over a 20-day holding period can exceed the reported VAR by significant amounts and can also accumulate over a longer time horizon than the 20-day holding period used in the VAR analysis. VAR amounts are not necessarily reflective of potential accounting losses, including determinations of other-than-temporary losses in fair value in accordance with U.S. GAAP.

The VAR numbers are shown separately for interest rate, currency, and equity risks. These VAR numbers include the underlying portfolio positions and related hedges. We use historical data to estimate VAR. Given reliance on historical data, VAR is most effective in estimating risk exposures in markets in which there are no fundamental changes or shifts in market conditions. An inherent limitation in VAR is that the distribution of past changes in market risk factors may not produce accurate predictions of future market risk.

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The following table sets forth the VAR calculations for substantially all of the Company's positions:

| (In millions) | | | Three Months Ended March 31, 2004 | | |
|---|---|---|---|---|---|
| Risk Categories | June 30, 2003 | March 31, 2004 | Average | High | Low |
| Interest Rates | $ 448 | $ 598 | $ 693 | $ 759 | $ 594 |
| Currency Rates | 141 | 141 | 278 | 326 | 141 |
| Equity Prices | 869 | 1,058 | 1,087 | 1,174 | 1,024 |

The total VAR for the combined risk categories was $987 million at June 30, 2003 and $1.22 billion at March 31, 2004. The total VAR is 34% less at June 30, 2003 and 32% less at March 31, 2004 than the sum of the separate risk categories for each of those years in the above table, due to the diversification benefits of the combination of risks. The change in VAR is due primarily to asset allocation shifts, and portfolio growth.

**Item 4. Controls and Procedures**

Under the supervision and with the participation of our management, including Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2004 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**Part II. Other Information**

**Item 1. Legal Proceedings**

See notes to financial statements and Part II, Item 1 of our Quarterly Reports on Form 10-Q for the quarters ended September 30, 2003 and December 31, 2003.

On April 1, 2004 Sun Microsystems, Inc. and Microsoft entered into a series of agreements that resulted in dismissal of the previously reported suit by Sun against Microsoft and resolved other legal claims between the companies. Pursuant to the agreements, Microsoft has made payments totaling $1.95 billion to Sun, of which $29 million has been recorded as an intellectual property asset and the balance has been recorded as an expense in the third quarter.

The previously reported case of *InterTrust v. Microsoft* was settled by agreement of the parties on April 3, 2004. Microsoft has taken a comprehensive license to InterTrust's patent portfolio, including pending patent applications, and agreed to make a one-time payment to InterTrust of $440 million, for which we recorded an intangible asset of $266 million and a payment of $174 million for settlement of legal claims. The agreement resolves all outstanding litigation between the parties.

**Item 2. Changes in Securities and Use of Proceeds**

Items 2(a) through (d) are inapplicable.

(e) STOCK REPURCHASES

| Period | (a) Total Number of Shares Purchased(1) | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| Jan. 1, 2004—Jan. 31, 2004 | 18,829,363 | $ 28.01 | — | N/A |
| Feb. 1, 2004—Feb. 29, 2004 | 23,415,000 | $ 26.90 | — | N/A |
| Mar. 1, 2004—Mar. 31, 2004 | 7,650,000 | $ 25.70 | — | N/A |

(1) Of the total shares purchased 37,392,800 were purchased in open market transactions and 12,501,563 were purchased in a private transaction.

**Item 6. Exhibits and Reports on Form 8-K**

(a) EXHIBITS

| | |
|---|---|
| 15 | Letter re unaudited interim financial information |
| 31.1 | Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32 | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(b) REPORTS ON FORM 8-K

We furnished to the SEC reports on Form 8-K on January 22, 2004 and February 6, 2004. The January 22, 2004 Form 8-K was for the purpose of furnishing the press release announcing our financial results for the fiscal quarter ended December 31, 2003. The February 6, 2004 Form 8-K was for the purpose of furnishing our consolidated balance sheets as of June 30, 2003 and December 31, 2003, and the related consolidated statements of income, cash flows, and stockholders' equity for the three months ended December 31, 2002 and 2003 formatted in XBRL (Extensible Business Reporting Language) 2.0 format.

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

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**SIGNATURE**

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

Microsoft Corporation

Date: May 3, 2004

By: /s/ JOHN G. CONNORS

**John G. Connors**
**Senior Vice President; Chief Financial Officer**
**(Principal Financial and Accounting Officer**
**and Duly Authorized Officer)**