

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934

FOR THE FISCAL YEAR ENDED JUNE 30, 1998

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION

WASHINGTON
(STATE OF INCORPORATION)

91-1144442
(I.R.S. ID)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

(425) 882-8080

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

COMMON STOCK

2 3/4% CONVERTIBLE EXCHANGEABLE PRINCIPAL-PROTECTED PREFERRED STOCK

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 if disclosure of delinquent filers pursuant to Item
405 of Regulation S-K is not contained herein, and will not be contained, to
the best of registrant's knowledge, in definitive proxy or information
statements incorporated by reference in Part III of this Form 10-K or any
amendment to this Form 10-K.

The aggregate market value of common stock held by non-affiliates of the
registrant as of September 11, 1998 was \$176,181,694,460.

The number of shares outstanding of the registrant's common stock as of
September 11, 1998 was 2,484,635,670.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 1998 Annual Report to Shareholders are incorporated by
reference into Parts I, II and IV. Portions of the definitive Proxy Statement
dated September 25, 1998 to be delivered to shareholders in connection with
the Annual Meeting of Shareholders to be held November 11, 1998 are
incorporated by reference into Part III.

MICROSOFT CORPORATION

FORM 10-K

FOR THE FISCAL YEAR ENDED JUNE 30, 1998

INDEX

PART I

Item 1. Business.....	1
Item 2. Properties.....	12
Item 3. Legal Proceedings.....	13
Item 4. Submission of Matters to a Vote of Security Holders.....	13

PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters.....	14
Item 6. Selected Financial Data.....	14
Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition.....	14
Item 7a. Quantitative and Qualitative Disclosures about Market Risk.....	14
Item 8. Financial Statements and Supplementary Data.....	14
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures.....	14

PART III

Item 10. Directors and Executive Officers of the Registrant.....	15
Item 11. Executive Compensation.....	16
Item 12. Security Ownership of Certain Beneficial Owners and Management..	16
Item 13. Certain Relationships and Related Transactions.....	16

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K.	17
Signatures.....	18

PART I

ITEM 1. BUSINESS

GENERAL

Microsoft Corporation (the "Company" or "Microsoft") was founded as a partnership in 1975 and incorporated in 1981. Microsoft develops, manufactures, licenses, and supports a wide range of software products, including scalable operating systems for intelligent devices, personal computers (PCs) and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company's interactive efforts include entertainment and information software programs, MSN(TM), the Microsoft Network online service; Internet-based services; and alliances with companies involved with other forms of digital interactivity. Microsoft also sells personal computer input devices and books, and researches and develops advanced technologies for future software products.

Microsoft's business strategy emphasizes the development of a broad line of software products for business and personal use, marketed through multiple channels of distribution. The Company is divided into three main areas: the Product Group, the Sales and Support Group, and the Operations Group.

The Platforms and Applications Product Group is comprised of three primary divisions, each responsible for a particular area of platform software development and marketing. The Platforms Group develops PC and server operating systems. The Applications and Tools Group creates server and desktop productivity applications and software development products. The Consumer Platforms Group develops system software for intelligent devices.

The Interactive Media Product Group creates and markets productivity programs, interactive entertainment and information products, desktop finance products, and hardware peripherals. Interactive Media offerings include children's titles, games, reference sources, online informational services, and MSN. The Desktop Finance Division develops personal finance products. The Hardware Division develops PC peripherals such as the keyboard and mouse.

Microsoft has a research lab dedicated to creating new technology in support of the Company's vision for the evolution of personal computing.

The Sales and Support Group is responsible for building long-term business relationships with customers. This group is organized to serve various customer types, including original equipment manufacturers (OEMs), end-users, organizations, enterprises, application developers, Internet content providers (ICPs) and infrastructure owners. Large enterprises are offered tailored license programs, enterprise-wide support, consulting services, and other specialized services. The group manages the channels that serve customers by working with OEMs, distributors, and resellers. In addition to the OEM channel, Microsoft has three major geographic sales organizations: the South Pacific and the Americas; Europe, the Middle East and Africa; and Asia. The group also supports the Company's products with technical support for end-users, developers, and organizations.

The Operations Group is responsible for managing business operations and overall business planning. This includes the process of manufacturing and delivering finished goods and licenses; corporate functions such as finance, administration, human resources, and legal; and the publishing efforts of Microsoft Press.

PRODUCTS

PLATFORMS

The Platforms Group is responsible for development of the Microsoft(R) Windows(R) and Windows NT(R) operating systems including Microsoft Internet Explorer browsing software. PC operating systems perform a variety of functions, such as allocating computer memory, scheduling applications software execution, managing information and communication flow among the various PC components, and enabling end-users to access files and information from a variety of sources. The Windows NT operating system for servers is an enterprise-wide

platform for building and deploying distributed applications for networked PCs. It also provides products for developing, running, and managing Internet and intranet applications and content. Component Object Model (COM) underlies a large majority of the new code developed for Windows and Windows NT operating systems. COM+, an extension of COM, builds on COM's integrated services and features, making it easier for developers to create and use software components in any language, using any tool.

Windows PC Platforms

Windows 98. The successor to Windows 95, Windows 98 is a personal computer operating system which provides a Web-oriented user interface, better system performance along with easier system diagnostics and maintenance. Windows 98 supports current graphics, sound, and multimedia technologies, provides the ability to easily add and remove peripheral devices with support for Universal Serial Bus (USB), and also enables the convergence of the PC and television. Windows 98 was released in June 1998.

Windows 95. The successor to MS-DOS(R) and Windows 3.1, Windows 95 was released in August 1995; periodic service releases, system updates, and new device drivers have been made available to PC OEMs and end-users via the Internet on the Company's web site, <http://www.microsoft.com>. Windows 95 is a fully integrated, multitasking 32-bit operating system, designed to be compatible with Intel microprocessor-based PCs, most hardware devices, and applications for Windows 3.x and MS-DOS.

Windows 3.x. Microsoft Windows 3.1 provides a graphical user interface and other enhancements for MS-DOS, a single-user, single-tasking operating system. Windows 3.1 supports 16-bit Windows-based applications, and offers ease of use, aesthetic appeal, and straightforward integration into corporate computing environments. Windows for Workgroups 3.11 integrates network and workgroup functionality directly into the Windows operating system.

Windows NT Platforms

Windows NT Workstation. A fully integrated, multitasking 32-bit PC operating system, Windows NT Workstation provides superior security, robustness, and portability. Windows NT Workstation is a multithreaded operating system for mission critical computing which provides the same features and applications programming interfaces (APIs) for Intel and Alpha AXP microprocessors. Microsoft Windows NT Workstation 4.0 features the Windows 95 interface and combines the ease of use of the Windows 95 operating system with the reliability and security of Windows NT.

Windows NT Server. Windows NT Server is a powerful operating system foundation for both server applications and file and print sharing, with extensive network management features, administration tools, security, and high availability. Windows NT Server provides a scalable platform for business critical applications and databases, connectivity, system management, and e-mail servers. The operating system integrates Web services such as Microsoft Internet Information Server, a service used to manage intranet and Internet functionality and Microsoft FrontPage(R) Web site creation and management tool. Windows NT Server, Terminal Server Edition, an extension to the Windows NT Server product line, offers the application support of the Windows operating system platform with the existing low cost, centrally managed environment of the mainframe with terminal. Windows NT Server also includes Microsoft Transaction Server, a component-based transaction processing system for developing, deploying, and managing scalable enterprise, Internet and intranet server applications.

APPLICATIONS AND TOOLS

The Applications and Tools Group is responsible for desktop applications, application oriented server applications, developer tools, and web authoring tools.

Desktop Applications

The Desktop Applications Division develops applications software, which provides the PC with instructions for the performance of productivity tasks such as manipulating text, numbers, or graphics. The Company's

desktop applications software is designed for use by a broad class of end-users, regardless of business, industry, or market segment. Primary examples of desktop applications software are word processing, spreadsheet, and presentation graphics programs. The Company's desktop applications programs are developed principally for Windows and Macintosh operating systems.

Microsoft Office. Microsoft Office is a suite of software programs featuring seamless integration of the most commonly used desktop applications. Microsoft Office is based upon a document-centric concept, with common commands and extensive use of cross-application capabilities. Microsoft Office is available in several versions, with certain combinations of products available for the various operating system platforms. The most recent version for Windows, Microsoft Office 97, has enhanced Internet features such as integration with Microsoft Internet Explorer, a Web toolbar, the ability to save as an HTML format, connectivity to other Office documents or web sites via hyperlinks, and support for ActiveX(R) controls. Products offered in the various versions include the word processor Microsoft Word, Microsoft Excel spreadsheet, Microsoft PowerPoint(R) presentation graphics program, Microsoft Outlook(TM) messaging and collaboration client, Microsoft Access database, Microsoft Bookshelf(R) CD-ROM reference library, and others. The Microsoft Home Essentials(R) suite is marketed primarily toward users in the home.

Microsoft Word. The Company's principal word processing program is Microsoft Word. Versions of Microsoft Word provide graphical word processing features, plus the ability to handle graphics, tables, spreadsheet data, charts, and images imported from other software programs.

Microsoft Excel. The Company's spreadsheet program is Microsoft Excel. It is an integrated spreadsheet with PivotTable(R) dynamic views, database, and business graphics capabilities. Microsoft Excel allows full linking and embedding of objects that permits users to view and edit graphics or charts from other programs in the worksheet in which the object is stored. Microsoft Excel graphics capabilities can be linked to its spreadsheets to allow simultaneous changes to charts as changes are made to the spreadsheets.

Microsoft PowerPoint. Microsoft PowerPoint is a presentation graphics program for producing transparencies, slides, overheads, and prints.

Microsoft Access. Microsoft Access is a relational database management application that provides access to structured business data. Database products control the maintenance and utilization of structured data organized into a set of records or files.

Microsoft Outlook. The Company's premier collaboration and messaging client is Microsoft Outlook. Outlook combines support for Internet standards-based messaging systems--including Microsoft Exchange Server--with integrated calendar, contact, and task-management features.

Microsoft Project. Microsoft Project is a critical path project scheduling and resource allocation program. The product can perform as a budgeting, monitoring, and cost estimating tool for large business projects and as a critical path and schedule planning tool.

Other Productivity Products. The Company also offers other productivity products. Microsoft Publisher is an easy-to-use, entry-level desktop publishing program. Microsoft FrontPage is a Web site creation and management tool for Web sites on the Internet or intranets.

Server Applications

Based on Windows NT Server, the Microsoft BackOffice(R) family of server applications is an integrated suite of software products that include file and print services, applications, database, messaging, groupware, desktop management, Internet access, transaction processing, and host connectivity. BackOffice enables organizations to share information, collaborate, and manage and deploy business-critical applications. Microsoft

BackOffice Small Business Server is designed for smaller companies of 25 users or less as an integrated solution for sharing files, databases, printers, electronic mail, fax services, applications, and other resources.

Microsoft Exchange Server. The Company's messaging and collaboration server is Microsoft Exchange Server, which provides e-mail, group scheduling, task management, and document routing capabilities. Exchange Server offers a scalable, reliable, and secure environment for multiple clients and Internet protocols are part of the core server architecture. It also includes tools to create rich collaboration applications.

Microsoft SQL Server. Microsoft SQL Server(TM) version is a scalable, high-performance database management system designed specifically for distributed client/server computing. Its built-in data replication, management tools, Internet integration, and open system architecture provide a Windows NT-based platform for delivering cost-effective information solutions.

Other Servers. Microsoft Proxy Server creates a single, secure gateway to the Internet; Microsoft SNA Server provides connectivity to host data and applications; and Microsoft Systems Management Server centrally manages this distributed environment. Microsoft Site Server allows a comprehensive management of sophisticated Web sites and their content. Microsoft Site Server Commerce helps businesses engage customers and partners with the creation of cost-effective commerce sites and applications, targeted online advertising and marketing, and personalized promotion.

Developer Tools

The Developer Tools Division provides software development tools and technical information to Internet applications developers and developers for Windows. These products and services empower independent software developers, corporate developers, solutions developers, and Webmasters to create a broad spectrum of applications, primarily for Windows 32-bit operating systems, but also for the platform-independent Internet and intranets.

Software development tools and computer languages allow software developers to write programs in a particular computer language and translate programs into a binary machine-readable set of commands that activate and instruct PC hardware. The Company develops and markets a number of software development environments, and language compilers. Microsoft Visual C++(R) is the Company's development system for Windows-based application development. The Microsoft Visual Basic(R) development system provides easy access to a wide variety of data sources by integrating the Microsoft Access database engine and the ability to take advantage of investments in commercial applications through ActiveX controls. The Visual InterDev(TM) Web Development System includes integrated, team-based development tools for building data-driven Web applications based on HTML, Script, and components written in any language. Microsoft Visual J++(TM) development system for Java contains a high productivity Integrated Development Environment and a collection of integrated components to create, test, tune, and deploy Java code on multiple platforms using ActiveX controls. Microsoft Visual Studio(R) development system is a suite of developer tools enabling developers to build components and applications using Visual Basic, Visual C++, Visual FoxPro(R) database development system, Visual InterDev, and Visual J++.

The Company provides third-party software developers with a wide range of technical and support information that assists them in developing software products intended to run on Windows operating systems, taking advantage of key technologies such as ActiveX controls and Windows 32-bit APIs. Developers can subscribe to the Microsoft Developer Network (MSDN(TM)) information service and receive periodic updates via CD-ROMs, magazines, and several on-line information services.

CONSUMER PLATFORMS

The Consumer Platforms Group delivers software and platform technologies that extend the benefits of Windows and Windows-compatible solutions for a broad range of intelligent business and consumer devices, including handheld PCs, Palm-sized PCs, wireless-communication devices such as digital information pagers and cellular smart phones, next-generation entertainment and multimedia consoles including game players, and purpose-built Internet access devices such as Internet TVs, digital set-top boxes and Internet "Web phones."

The Consumer Platforms Group also is responsible for systems integration of products and technologies that public network operators and corporate customers need for a variety of Internet and intranet-based applications.

Windows CE. Microsoft develops Windows CE, a scaleable Windows platform for a broad range of communications, entertainment, and mobile computing devices. The Windows CE operating system is built around an API that is consistent with other 32-bit Windows-based operating systems, which allows developers and programmers to use the same development tools and communication protocols to create applications for Windows CE-powered devices. Windows CE allows information appliances to communicate with each other, share information with Windows-based PCs, and connect to the Internet. Windows CE is developed for PC companions, including handheld PCs, palm-size PCs, and auto PCs, vertical market devices, and home products. Microsoft teams up with hardware companies that build Windows CE-based devices and who understand the needs of vertical markets such as automotive, retail, manufacturing, education, healthcare, telecommunications, or broadcast.

WebTV. In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on WebTV(TM) technologies. WebTV operates the WebTV Network Service and develops the WebTV Internet Terminal and WebTV Plus Receiver, which are available through the company's licensees. Future versions of the set-top terminals will use the Windows CE operating system.

INTERACTIVE MEDIA

The Interactive Media Group develops and markets interactive entertainment and information products across a variety of media, including the Internet, MSN, the Microsoft Network, and CD-ROM.

Learning, Entertainment and Productivity. Reference titles include Microsoft Encarta(R) and Microsoft Bookshelf. The Encarta multimedia encyclopedia database blends text in articles with innovative, interactive information presented through animations, videos, maps, charts, sounds, and pictures. Bookshelf is a multimedia reference library that integrates a dictionary, world atlas, world almanac, thesaurus, concise encyclopedia, and two books of quotations. The Expedia(R) travel series product line offers global positioning system (GPS)-compatible maps and travel planning in an easy-to-use format.

Titles for children include My Personal Tutor, a comprehensive three CD-ROM learning suite, and a series of products based on the popular children's book and television series, Scholastic's The Magic School Bus(TM).

The Company offers a line of entertainment products. Microsoft Flight Simulator is a popular aircraft flight simulation product available for Windows, MS-DOS, and Macintosh operating systems. Other games include Age of Empires(R), Monster Truck Madness(TM), Microsoft Golf, and other sports and action titles. Most games are available for the Windows 32-bit environment. The Microsoft Internet Gaming Zone is a gaming community on the Internet allowing multiplayer gaming competitions of popular CD-ROM games and classic card, board, and puzzle games.

Microsoft's productivity offerings include Microsoft Works, an integrated software program that contains basic word processing, spreadsheet, and database capabilities that allows the easy exchange of information from one tool to another. Home Essentials, an integrated software program, allows consumers to complete home PC tasks using Microsoft Word, Microsoft Encarta, Microsoft Money, Microsoft Works, Microsoft Greetings Workshop, Microsoft Internet Explorer, and the Microsoft Entertainment Pack-The Puzzle Collection.

Interactive Service Media. The Company is developing an online decision support infrastructure for end-users in such fields as automobiles, retail, entertainment, and travel. Microsoft CarPoint(TM) online automotive service provides current and objective information for new car purchases, including test drive reviews, dealer invoices, and surround videos. Additionally, CarPoint features interactive classifieds for used car purchasing and a new car buying service. Comprised of a national network of dealers, this service refers customers to nearby dealers. Microsoft Sidewalk(TM) online city guide is a personalized city guide to local entertainment. The Sidewalk

editorial team provides previews, reviews and even customized suggestions about entertainment events in Seattle, New York, Boston, Minneapolis/St. Paul, Washington, D.C., San Diego, Denver, Houston, San Francisco, and Sydney, Australia, with city guides scheduled to launch in additional cities. Microsoft Expedia(TM) travel service is a free service on the Web and MSN, which enables users to find low fares, book flights, make hotel reservations, and rent cars. Expedia also offers a comprehensive source of information for more than 330 destinations including photos, historical information, and local details. Microsoft HomeAdvisor online real estate service is a complete guide to the home-buying process and provides comprehensive tools for finding homes and loans on the Internet. With HomeAdvisor(R), users can find a home, qualify and apply for a loan online, calculate financing options, and gain real estate industry knowledge.

The Microsoft Network. MSN is a Web-based interactive online service. MSN provides easy and inexpensive access for users to a wide range of graphically rich online content. The online service provides access to the Internet, a free Web-based electronic mail account through Hotmail, bulletin boards, and a myriad of additional services offered by Microsoft and by ICPs.

Joint Ventures. The Company has entered into joint venture arrangements to take advantage of creative talent and content from other organizations. Microsoft owns 50 percent of DreamWorks Interactive L.L.C., a software company that develops interactive and multimedia products. DreamWorks SKG owns the remaining 50 percent. Microsoft owns 50 percent of MSNBC Cable L.L.C., a 24-hour cable news and information channel; and 50 percent of MSNBC Interactive News L.L.C., an interactive online news service. National Broadcasting Company (NBC) owns the remaining 50 percent of these two joint ventures. Microsoft is an investor in MSFDC L.L.C., a joint venture between Microsoft and First Data Corp. MSFDC has announced that it is changing its name to TransPoint and Citibank will make an equity investment in the venture. The venture is developing an Internet bill delivery and payment service called TransPoint E-Bills.

Desktop Finance. Desktop Finance develops and markets consumer finance products and manages relationships with financial institutions to develop online deliver systems for customers. Microsoft Money is a financial organization product that allows users to computerize their household finances. Microsoft Money is available for systems running Microsoft Windows 32-bit operating systems and provides online home-banking services with numerous different banks in the U.S.

Microsoft Investor is an online investing site that provides a comprehensive offering of information and services designed to help personal investors make investment decisions, track their securities and understand the market. A blend of free and subscription-based services, Investor provides portfolio tracking and analysis, company and mutual fund research, an investment finder, daily editorial and market summaries, electronic mail notifications and alerts, and access to online trading through leading financial services firms.

Hardware Peripherals. The Company's major PC input device is the Microsoft Mouse, a hand-held pointing device that facilitates use of a PC. The Microsoft IntelliMouse(R) pointing device is a mouse with a center positioned wheel which provides transfer zooming, scrolling and data zooming in Microsoft Windows 32-bit operating systems, Microsoft Internet Explorer, and Microsoft Office 97. Microsoft also offers a mouse designed for the home and a mouse for young children. The Company also markets the Microsoft Natural(R) Keyboard, an ergonomically designed keyboard. Additionally, Microsoft sells various Microsoft Sidewinder(R) Game Controllers and Force Feedback joysticks with realistic performance technology for use with PC games. ActiMates(TM) Interactive Barney is a two-way interactive, talking and moving, wireless plush character peripheral for young children that operates via programming from CD-ROM (PC mode) or a VHS (TV mode) and on-board ROM chip (Standalone mode).

MICROSOFT PRESS

Microsoft Press publishes books about software products from Microsoft and other software developers and about current developments in the industry. Books published by Microsoft Press typically are written and copyrighted by independent authors who submit their manuscripts to the Company for publication and who receive royalties based on revenue generated by the book.

Microsoft Press contracts with an independent commercial printer for the manufacturing of its books. Publisher's Resources, Inc. acts as the Company's main fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press(R) books. Books are marketed by independent sales representatives and by Microsoft Press sales personnel. Internationally, Microsoft Press has numerous international agreements with publishers for the worldwide distribution of its books. Microsoft Press has granted a publisher in England the right to distribute English language versions of its books in all countries except the United States, Canada, Central and South America, and certain Asian countries. In most cases, Microsoft Press provides each publisher with a book's manuscript, and the publisher arranges for its translation and the printing, marketing, and distribution of the translated version.

PRODUCT DEVELOPMENT

The PC software industry is characterized by extremely rapid technological change, which requires constant attention to software technology trends and shifting consumer demand, and rapid product innovation. The pace of change has recently become even greater due to the surge of interest in the Internet, other forms of online services, PC server-based networking, and new programming languages, such as Java.

Most of the Company's software products are developed internally. The Company also purchases technology, licenses intellectual property rights, and oversees third-party development and localization of certain products. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved development methodologies for creating and enhancing its products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, or computers. Product documentation is generally created internally.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to new user needs or advances in PCs, servers, peripherals, and the Internet, without compromising product quality. The Company strives to become informed at the earliest possible time about changing usage patterns and hardware advances that may affect software design.

In order to best serve the needs of users around the world, Microsoft "localizes" many of its products to reflect local languages and conventions. In French versions, for example, all user messages and documentation are in French with monetary references in French francs. Various Microsoft products have been localized into more than 30 languages.

During fiscal years 1996, 1997, and 1998, the Company spent \$1.43 billion, \$1.93 billion, and \$2.50 billion, respectively, on product research and development activities. Those amounts represented 16.5%, 16.9%, and 17.3%, respectively, of revenue in each of those years, excluding funding of joint venture activity. The Company is committed to continue high expenditures for research and product development.

MANUFACTURING

Microsoft contracts most of its manufacturing activity with third parties. Outside manufacturers produce various retail software packaged products and hardware such as mouse pointing devices, keyboards, and joysticks. There are other custom manufacturers in the event that outsourced manufacturing becomes unavailable from current sources.

The Company's manufacturing facilities are located in Puerto Rico and Ireland. The Irish facility and the Puerto Rico facilities replicate disks. Microsoft outsources its manufacturing of packaged products. Quality control tests are performed on purchased parts, finished disks and CD-ROMs, and other products. The chief materials and components used in Microsoft products include disks or CD-ROMs, books, and multicolor printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.

In recent years the Company's sales mix has shifted to OEM and organizational licenses from packaged products. Also, online distribution of software may increase in the future.

OPERATIONS

Microsoft manages all product fulfillment, licensing, and logistic services. The company has regional operation centers in Ireland and the Greater Seattle area. The regional centers support all operations activities, including information processing, vendor management, logistics, and related supporting functions by geographical regions. The regional center in Dublin, Ireland supports the European, African and Middle East regions, and the center in the Greater Seattle area supports North and South America. The company is establishing a regional operations center in Singapore for the Asia Pacific region and plans to consolidate its sales operation. The company established Microsoft Licensing Incorporated (MSLI) in Reno, Nevada, a wholly owned subsidiary, which manages the company's OEM licensing operations.

MARKETING AND DISTRIBUTION

Microsoft aligns its sales and marketing staff with several customer types, including OEMs, end-users, organizations, enterprises, applications developers, educators, and Internet content providers (ICPs) and infrastructure owners. The Company's sales and marketing group seeks to build long-term relationships with customers of Microsoft products. In addition to the OEM channel, Microsoft has three major geographic sales and marketing organizations: the South Pacific and the Americas; Europe, the Middle East and Africa; and Asia.

The OEM customer unit includes the sales force that works with original equipment manufacturers that preinstall Microsoft software on their PCs.

The end-user customer unit has responsibility for activities that target end-users that make individual buying decisions for the PCs they use at work or home. Most sales and marketing activities aimed at end-user customers are performed by this unit, including developing and administering reseller relationships; reseller sales terms and conditions; channel marketing and promotions; end-user marketing programs; and seminars, events, and sales training for resellers. The customer unit's sub-segments include direct marketing resellers and retailers. The key products marketed by the end-user customer unit are the Company's PC operating systems, desktop applications, and interactive media products.

The organization customer unit has responsibility for activities that target groups of users in small and medium organizations. The unit works with channel partners such as distributors, aggregators, value-added resellers, and Solution Providers to provide complete business solutions to this customer segment. The unit's sales and marketing activities include managing technical training programs for Solution Providers (described below) and channel resellers; and supporting and providing seminars, events, and sales training for channel partners. The Company works with the partners to provide software and support to a broad range of small and medium size organizations. The organization customer unit also runs the Microsoft Certified Professional program, which ensures the quality of Microsoft training for individuals and corporations.

The enterprise customer unit has responsibility for sales and marketing activities that target large organizations. The unit works directly with these organizations, and through large account resellers, to create and support enterprise-wide, mission critical solutions for business computing needs. The enterprise customer unit also provides seminars and forums to familiarize enterprises with technology issues and solutions.

The application developers customer unit targets corporate developers and independent software vendors (ISVs) who build business applications with a development platform based on Microsoft Windows and BackOffice architecture. The unit's sales and marketing activities include providing industry specific technical training, seminars, and events for ISVs. The application developers customer unit also focuses on vertical and horizontal industries and their associated software applications. A key focus of the group is Microsoft Developer Tools.

The education customer unit works with key education groups and other industry partners to provide programs and technology tools that help them expand and enhance learning opportunities for students. The education customer unit has three primary areas, including higher education, K-12, and management of the education channel and resellers.

The Internet customer unit is responsible for introducing the Company's products and technologies to the public infrastructure owners and ICPs. The customer unit also focuses on embedded and dedicated systems. Infrastructure owners include network operators (telephone companies, cable companies, Internet service providers, etc.) who build, own, and operate the public networks and ICPs who provide content for the Web.

FINISHED GOODS CHANNELS

Distributors and Resellers. The Company markets its products in the finished goods channels primarily through independent non-exclusive distributors and resellers. Distributors include CHS Electronics, Computer 2000, Inacom, Ingram Micro, Soft Bank, Tech Data, and Merisel. Resellers include Software Spectrum, Corporate Software & Technology, CompUSA, Software House International, Softmart, ASAP Software Express, and Best Buy. Microsoft has a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

Large Accounts. The Microsoft Select program offers flexible software acquisition, licensing, and maintenance options specially customized to meet the needs of large multinational organizations. Targeted audiences include technology specialists and influential end-users in large enterprises. Marketing efforts and fulfillment are generally coordinated with large account resellers. The Microsoft OPEN program is a licensing program that is targeted for small and medium size organizations. It is available through the reseller channel and offers discounts based on initial purchase volumes.

Solution Providers. Microsoft's Solution Providers program is a comprehensive support relationship with independent organizations that provide network and system integration, custom development, training, and technical support for business computing solutions. The program supports value-added resellers (VARs), system integrators, consultants, custom application developers, solution developers, Internet service and hosting organizations, independent content providers, and sitebuilders (companies that build Web sites for other companies), as well as technical support and training organizations. Under this business partnership strategy, the Company provides sales and product information, development services, early access to Microsoft products, and customer support tools including priority telephone support, education, and business development support. To ensure high-quality technical services for the Company's products, Microsoft Solution Providers are required to have Microsoft-certified professionals on staff. Microsoft Direct Access is a comprehensive and open program that allows independent technology providers to actively engage with Microsoft through the Microsoft Direct Access program online, quarterly briefings, training, and action packs.

Consulting Services. The Company's Consulting Services Division assists customers in deploying and using the Company's computer operating systems, applications, and communications products. The group works with Solution Providers and helps create enterprise-wide computing solutions for large corporate accounts.

International Sales Sites. The Company has established marketing and/or support subsidiaries in more than 60 countries. Product is generally delivered by the Company's owned or outsourced manufacturing operations. They also spend a significant portion of their time working with partners to help them become more proficient at providing these technical services. Notes to Financial Statements--(see Item 8) describe foreign operations and export sales.

The Company's international operations, both OEM and finished goods, are subject to certain risks common to foreign operations in general, such as governmental regulations, import restrictions, and foreign exchange rate fluctuations. Microsoft hedges a portion of its foreign exchange risk.

OEM CHANNEL

Microsoft operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of the Company's products with their computers. The Company also markets and licenses certain desktop applications, hardware, and interactive media programs to OEMs under similar arrangements. In almost all cases, the products are distributed under Microsoft trademarks. The Company has OEM agreements covering one or more of its products with virtually all of the major PC OEMs, including, Acer, Compaq, Dell, Fujitsu/ICL, Gateway 2000, Hewlett-Packard, IBM, NEC Packard Bell, Samsung, Siemens, Toshiba, and Vobis.

ADVERTISING

The Company works closely with large advertising and direct marketing firms. Advertising, direct marketing, worldwide packaging, and marketing materials are targeted to various end-user segments. The Company utilizes broad consumer media (television, radio, and business publications) and trade publications. Microsoft has programs under which qualifying resellers and OEMs are reimbursed for certain advertising expenditures. The Company maintains a broad advertising campaign emphasizing the Microsoft brand identity.

CUSTOMERS

The Company's customers include end-users, organizations, enterprises, ISPs, application developers, and OEMs. Most end-users of Microsoft products are individuals in businesses, government agencies, educational institutions, and at home. The end-users and organizations obtain Microsoft products primarily through resellers and OEMs, which include certain Microsoft products with their hardware. Notes to Financial Statements (see Item 8) describe customers that represent more than 10% of the Company's revenue. The Company's practice is to ship its products promptly upon receipt of purchase orders from its customers and, consequently, backlog is not significant.

PRODUCT SUPPORT

The Company provides product support coverage options to meet the needs of users of Microsoft products. Support personnel are located in various sites in the U.S. and around the world. Certain support is also supplied by qualified third-party support organizations. The Company hires individuals with product expertise and provides them with productivity tools, continuous product education and training, and consistent processes to deliver quality support for Microsoft products. Coverage options range from standard no-charge toll telephone support to fee-based offerings providing unlimited 800 number telephone and electronic technical support for all Microsoft products 24 hours per day, 7 days per week.

Users have access to troubleshooting "wizards" and Microsoft's KnowledgeBase, a library of thousands of technical articles that is updated regularly with useful information regarding Microsoft products. Microsoft provides access to KnowledgeBase via MSN, America Online, Prodigy, and the Internet. Additionally, several support offerings include Microsoft TechNet and Microsoft Developer Network information subscription services.

As a supplement or alternative to direct support, the Company enhances the third-party support channel by providing Microsoft Solution Providers with education, training, tools, and support. Microsoft Solution Providers include Authorized Training Centers, which offer advanced product education and certification on Microsoft products; and Authorized Support Centers, which provide a wide spectrum of multinational support, multivendor support, and integration services.

COMPETITION

The PC software business is intensely competitive and subject to extremely rapid technological change. Microsoft faces formidable competition in all areas of its business activity, including competition from many

companies much larger than Microsoft. The rapid pace of technological change continually creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. The Company also faces constant competition from software pirates who unlawfully copy and distribute Microsoft's copyrighted software products.

Operating systems. Microsoft's operating system products face substantial competition from a wide variety of companies. Major competitors such as IBM, Apple Computer, Compaq (Digital Equipment Corporation), Hewlett-Packard, Sun Microsystems and others are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on computers of their own manufacture. Many of these operating system software products are also licensed to third-party OEMs for preinstallation on their machines. Microsoft's operating system products compete with UNIX-based operating systems from a wide range of companies including IBM, AT&T, Hewlett-Packard, Sun Microsystems, The Santa Cruz Operation, and others. Variants of UNIX run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems. Over the past year the Linux operating system has gained increasing acceptance, and leading software developers such as Oracle and Corel have announced that they will develop applications that run on Linux. As PC technology increasingly moves toward connectivity and communications, Microsoft's operating system products will face increased competition from network server operating systems such as Novell's NetWare, Banyan's Vines, the many variants of UNIX, IBM's OS/2, "middleware" products such as IBM's Lotus Notes, and intranet servers from Netscape, IBM, Sun Microsystems, and others.

Business systems. The Company is a fairly recent entrant into the business of providing enterprise-wide computing solutions. Several competitors enjoy a larger share of sales and larger installed bases. Many companies offer operating system software for mainframes and midrange computers, including IBM, Hewlett-Packard, and Sun Microsystems. Since legacy business systems are typically support-intensive, these competitors also offer substantive support services. Software developers that provide competing server applications for PC-based distributed client/server environments include Oracle, IBM, Computer Associates, Sybase, and Informix. There are also several software vendors who offer connectivity servers. As mentioned above, there are numerous companies and organizations that offer Internet and intranet server software which compete against the Company's business systems. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with the Company's collaboration and e-mail products.

Desktop applications. The Company's competitors include many software application vendors, such as IBM (Lotus), Oracle, Apple (Filemaker, Inc.), Corel, and local application developers in Europe and the Far East. IBM and Corel have large installed bases with their spreadsheet and word processor products, respectively, and both have aggressive pricing strategies. Also, IBM and Apple preinstall certain of their software products on various models of their PCs, competing directly with Microsoft desktop application software.

Developer tools. The Company's developer products compete against offerings from Borland, Macromedia, Oracle, Sun Microsystems, Sybase, Symantec, and other companies.

News services. The Company's MSNBC joint ventures face formidable competition from other 24-hour cable and Internet news organizations such as CNN, CNN Headline News, and Fox News Network. MSNBC also competes with traditional news media such as newspapers and broadcast TV and Internet news services.

Consumer platforms. A wide variety of companies develop operating systems for information appliances, including Apple, Motorola, 3Com, Psion Software, and others. The Company's nascent WebTV offerings and other multimedia consumer products face competitors such as Sun Microsystems, Oracle, NetChannel, and others. An enormous range of companies, including media conglomerates, telephone companies, cable companies, retailers, hardware manufacturers, and software developers, are competing to make interactive services widely available to the home.

Internet platforms and services. The advent of the Internet as a computing, communication, and collaboration platform as well as a low cost and efficient distribution vehicle increases competition and creates uncertainty as to future technology directions. The Company faces intense competition in the development and

marketing of Internet (and intranet) software from a wide variety of companies and organizations including IBM, Netscape, Novell, Oracle, Real Networks, Sun Microsystems', and many others. In addition, the very low barriers to entry on the Internet have allowed numerous Web-based service companies to build significant businesses in areas such as electronic mail, electronic commerce, Web search engines, directories, and information of numerous types. Competitors include Netscape, Lycos, Yahoo, Excite, Infoseek, CitySearch, and many others.

Online services. Microsoft's online services network, MSN, faces formidable competition from America Online and other traditional online services as well as a vast array of sites on the World Wide Web that offer content of all types and email, chat, search and shopping services, among other things.

Interactive media. The Company's Interactive Media division faces many smaller but focused and branded competitors, particularly in the areas of entertainment and education. Consolidation in this area of software development has made certain competitors even stronger. Competitors include Intuit, Electronic Arts, The Learning Company (including Softkey, MECC, Broderbund, and Compton's), Voyager, Cendant (including Sierra On Line, Knowledge Adventures, and Davidson Associates), and Dorling Kindersley. Still other competitors own branded content, such as Disney and Lucas Arts.

Additionally, PC-based games are increasingly competing head-to-head against games created for proprietary systems such as Nintendo, Sony PlayStation, and Sega. Input devices face substantial competition from computer manufacturers, since computers are typically sold with a keyboard and mouse, and other manufacturers of these devices.

A number of Microsoft's most significant competitors, including IBM, Sun Microsystems, Oracle, and Netscape, are collaborating with one another on various initiatives directed at competition with Microsoft. These initiatives relate in part to efforts to move software from individual PCs to centrally-managed servers. While the likely technological and business success of such "thin client" strategies is currently unknown, widespread adoption of such computing systems would present significant challenges to the Company's historical business model.

The Company's competitive position may be adversely affected by one or more of these factors in the future, particularly in view of the fast pace of technological change in the software industry.

EMPLOYEES

As of June 30, 1998, the Company employed 27,055 people on a full-time basis, 18,425 in the U.S. and 8,630 internationally. Of the total, 10,019 were in product research and development, 13,547 in sales, marketing, and support, 1,142 in manufacturing and distribution, and 2,347 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be as successful in the future. None of the Company's employees are subject to collective bargaining agreements. The Company believes relations with its employees are excellent.

ITEM 2. PROPERTIES

The Company's corporate offices consist of approximately 5.2 million square feet of office building space located in King County, Washington. There are two sites that total approximately 300 acres of land. The Company recently completed the construction of three office buildings comprising approximately 565,000 square feet of space and is constructing a set of office buildings with approximately 418,000 square feet of space. This site will be occupied in the winter of 1999. The Company owns all of its corporate campus.

The Company entered into a build to suit lease agreement in the San Francisco, CA, Bay Area. This campus when complete will be approximately 515,000 square feet. It is scheduled to open in the spring of 1999.

The Company leases a 45,000 square foot disk duplication facility in Humacao, Puerto Rico. The Puerto Rico facility, which began operation in April 1990, is leased under a 10-year lease, with an option to renew for an additional 10 years. The Company's European manufacturing operation consists of a 161,000 square foot facility situated on 12 acres in Dublin, Ireland. The Ireland site also includes office buildings with 157,000 square feet for international localization. The Ireland facilities are fully owned by the Company. In Les Ulis, France, the Company owns a 199,000 square foot office building on four acres of land. In the United Kingdom, the Company owns 3 building that total 230,000 square feet. The Company is going to execute a sale lease back on this property during the next fiscal year.

In addition, the Company leases office space in numerous locations in the United States and many other countries.

The Company's facilities are fully utilized for current operations and suitable additional space is available to accommodate expansion needs.

ITEM 3. LEGAL PROCEEDINGS

The information set forth in Notes to Financial Statements--Contingencies on page 45-46 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 1998.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The information set forth on page 48 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.1.

ITEM 6. SELECTED FINANCIAL DATA

The information set forth on page 1 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.2.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The information set forth on pages 27-33 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information set forth on pages 27-33 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.3.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following financial statements and supplement data for the Company and independent auditors' report set forth on pages 26 and 34-49 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

- . Income Statements for the three years ended June 30, 1998
- . Cash Flows Statements for the three years ended June 30, 1998
- . Balance Sheets as of June 30, 1997 and 1998
- . Stockholders' Equity Statements for the three years ended June 30, 1998
- . Notes to Financial Statements
- . Independent Auditors' Report

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information with respect to Directors may be found under the caption "Election of Directors and Management Information" on pages 1 and 2 of the Company's Proxy Statement dated September 25, 1998, for the Annual Meeting of Shareholders to be held November 11, 1998 (the "Proxy Statement"). Such information is incorporated herein by reference.

The executive officers of Microsoft as of September 11, 1998 were as follows:

NAME	AGE	POSITION WITH THE COMPANY
----	---	-----
William H. Gates.....	42	Chairman of the Board; Chief Executive Officer
Steven A. Ballmer.....	42	President
Robert J. Herbold.....	56	Executive Vice President; Chief Operating Officer
Frank M. (Pete) Higgins....	40	Group Vice President, Interactive Media
Paul A. Maritz.....	43	Group Vice President, Platforms and Applications
Nathan P. Myhrvold.....	39	Group Vice President, Chief Technology Officer
Jeffrey S. Raikes.....	40	Group Vice President, Sales and Support
James E. Allchin.....	46	Senior Vice President, Personal and Business Systems
Orlando Ayala Lozano.....	42	Senior Vice President, South Pacific and Americas Region
Joachim Kempin.....	56	Senior Vice President, OEM, Internet Customer Unit, Embedded Systems
Michel Lacombe.....	47	Senior Vice President, Europe, Middle East, and Africa Region; President, Microsoft Europe
Robert L. Muglia.....	38	Senior Vice President, Applications and Tools Division
Craig Mundie.....	49	Senior Vice President, Consumer Platforms Division
William H. Neukom.....	56	Senior Vice President, Law and Corporate Affairs; Secretary
Bernard P. Vergnes.....	53	Senior Vice President, Microsoft; Chairman, Microsoft Europe
Gregory B. Maffei.....	38	Vice President, Finance; Chief Financial Officer

Mr. Gates co-founded Microsoft in 1975 and has been its Chairman of the Board and Chief Executive Officer since the original partnership was incorporated in 1981.

Mr. Ballmer was named President in July 1998 and had been Executive Vice President, Sales and Support since February 1992. He had been Senior Vice President, Systems Software since 1989. From 1984 until 1989, Mr. Ballmer served as Vice President, Systems Software. He joined Microsoft in 1980.

Mr. Herbold joined Microsoft as Executive Vice President and Chief Operating Officer in November 1994. Mr. Herbold had been with The Procter & Gamble Company since 1968, with experience in information services, advertising and market research. Most recently, he was P&G's Senior Vice President, Information Services and Advertising.

Mr. Higgins was named Group Vice President, Interactive Media Group in October 1996. He was named Group Vice President, Applications and Content in May 1995 and Senior Vice President, Desktop Applications Division in March 1993. He had been Vice President, Desktop Applications Division since 1992. Mr. Higgins joined Microsoft in 1983.

Mr. Maritz was named Group Vice President, Platforms and Applications in October 1996 and had been Group Vice President, Platforms since May 1995. He had been Senior Vice President, Product and Technology Strategy in November 1994 and had been Senior Vice President, Systems Division since February 1992. He had been Vice President, Advanced Operating Systems since 1989. Mr. Maritz joined Microsoft in 1986.

Mr. Myhrvold was named Group Vice President and Chief Technology Officer in October 1996. He was named Group Vice President, Applications and Content in May 1995 and had been Senior Vice President,

Advanced Technology since July 1993. He had been Vice President, Advanced Technology and Business Development since 1989. Mr. Myhrvold joined Microsoft in 1986.

Mr. Raikes was named Group Vice President, Sales and Support in July 1998. He had been Group Vice President, Sales and Marketing since July 1996. He was named Senior Vice President, Microsoft North America in January 1992 and had been Vice President, Office Systems since 1990. Mr. Raikes joined Microsoft in 1981.

Mr. Allchin was named Senior Vice President, Personal and Business Systems in February 1996. He was named Senior Vice President, Business Systems Division in November 1994 and had been Vice President, Business Systems Division, since July 1991. Mr. Allchin joined Microsoft in 1991.

Mr. Ayala was named Senior Vice President of South Pacific and Americas Region in February 1998. He had been Vice President of the developing markets of Africa, India, the Mediterranean and Middle East, Latin America, Southeast Asia and the South Pacific. He joined Microsoft in May 1991 as Senior Director of the Latin America Region.

Mr. Kempin was named Senior Vice President, OEM, Internet Customer Unit, Embedded Systems in February 1998. He had been Senior Vice President, OEM Sales since August 1993. He had been Vice President, OEM Sales since 1987. Mr. Kempin joined Microsoft in 1983.

Mr. Lacombe is President, Microsoft Europe. He was named Senior Vice President, Europe, Middle East, and Africa Region in February 1998. He had been President, Microsoft Europe and Senior Vice President, Microsoft since July 1997. He had been Vice President, Europe since September 1995 and Vice President, End User Customer Unit, Europe since April 1994. Mr. Lacombe had been Regional Director of Southern Europe from May 1991. Mr. Lacombe joined Microsoft in 1983.

Mr. Muglia was named Senior Vice President, Applications and Tools Division in February 1998. He had been Vice President of the Server Applications Division since 1997 and was Vice President of Developer Tools since 1995. He joined Microsoft in January 1988.

Mr. Mundie was named Senior Vice President, Consumer Platforms Division in February 1996. He was named Senior Vice President, Consumer Systems in May 1995 and had been Vice President, Advanced Consumer Technology since July 1993. He joined Microsoft as General Manager, Advanced Consumer Technology in December 1992.

Mr. Neukom was named Senior Vice President, Law and Corporate Affairs in February 1994. He joined Microsoft in 1985 as Vice President, Law and Corporate Affairs.

Mr. Vergnes is a Senior Vice President and Chairman, Microsoft Europe. He was named President, Microsoft Europe in April 1992. He had been Vice President, Europe since 1989. Mr. Vergnes joined Microsoft in 1983.

Mr. Maffei was named Vice President, Finance and Chief Financial Officer in July 1997. He was named Vice President, Corporate Development in July 1996 and Treasurer in April 1994. He joined Microsoft in April 1993 as Director, Business Development & Investments.

ITEM 11. EXECUTIVE COMPENSATION

The information in the Proxy Statement set forth under the captions "Information Regarding Executive Officer Compensation" on pages 4 through 6 and "Information Regarding the Board and its Committees" on page 2 is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information set forth under the caption "Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management" on page 3 of the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information set forth in Notes to Financial Statements -- Acquisition on page 44 of the 1998 Annual Report to Shareholders is incorporated herein by reference and is filed herewith as Exhibit 13.4.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Financial Statements and Schedules

The financial statements as set forth under Item 8 of this report on Form 10-K are incorporated herein by reference.

Financial statement schedules have been omitted since they are either not required, not applicable, or the information is otherwise included.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the last quarter of fiscal 1998.

(c) Exhibit Listing

EXHIBIT

NUMBER DESCRIPTION

- 3.1 Restated Articles of Incorporation (1)
- 3.2 Bylaws (1)
- 10.1 Microsoft Corporation 1991 Stock Option Plan (2)
- 10.2 Microsoft Corporation 1981 Stock Option Plan (3)
- 10.3 Microsoft Corporation Stock Option Plan for Non-Employee Directors (1)
- 10.4 Microsoft Corporation Stock Option Plan for Consultants and Advisors (1)
- 10.5 Microsoft Corporation 1997 Employee Stock Purchase Plan (2)
- 10.6 Microsoft Corporation Savings Plus Plan (1)
- 10.7 Trust Agreement dated June 1, 1993 between Microsoft Corporation and First Interstate Bank of Washington (4)
- 10.8 Form of Indemnification Agreement (4)
- 11. Computation of Earnings Per Share (5)
- 13.1 Quarterly and Market Information Incorporated by Reference to Page 48 of 1998 Annual Report to Shareholders ("1998 Annual Report")
- 13.2 Selected Financial Data Incorporated by Reference to Page 1 of 1998 Annual Report
- 13.3 Management's Discussion and Analysis of Results of Operations and Financial Condition Incorporated by Reference to Pages 27-33 of 1998 Annual Report
- 13.4 Financial Statements Incorporated by Reference to Pages 26 and 34-49 of 1998 Annual Report
- 21. Subsidiaries of Registrant Incorporated by Reference to Page 50 of 1998 Annual Report
- 23. Independent Auditors' Consent
- 27. Financial Data Schedule

-
- (1) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1994.
 - (2) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1997.
 - (3) Incorporated by reference to Registration Statement 33-37623 on Form S-8.
 - (4) Incorporated by reference to Annual Report on Form 10-K For The Fiscal Year Ended June 30, 1993.
 - (5) Incorporated by reference to Exhibit 13.4 filed herein.

SIGNATURES

PURSUANT TO THE REQUIREMENTS OF SECTION 13 OR 15(D) 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, IN THE CITY OF REDMOND, STATE OF WASHINGTON, ON SEPTEMBER 23, 1998.

MICROSOFT CORPORATION

By /s/ Gregory B. Maffei

 Gregory B. Maffei
 Vice President, Finance; Chief
 Financial Officer

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THIS REPORT HAS BEEN SIGNED BELOW BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT AND IN THE CAPACITIES INDICATED ON SEPTEMBER 23, 1998.

SIGNATURE

TITLE

/s/ William H. Gates _____ William H. Gates	Chairman of the Board of Directors and Chief Executive Officer
/s/ Paul G. Allen _____ Paul G. Allen	Director
/s/ Jill E. Barad _____ Jill E. Barad	Director
/s/ Richard A. Hackborn _____ Richard A. Hackborn	Director
/s/ David F. Marquardt _____ David F. Marquardt	Director
/s/ Robert D. O'Brien _____ Robert D. O'Brien	Director
/s/ Wm. G. Reed, Jr. _____ Wm. G. Reed, Jr.	Director
/s/ Jon A. Shirley _____ Jon A. Shirley	Director
/s/ Gregory B. Maffei _____ Gregory B. Maffei	Vice President, Finance; Chief Financial Officer (Principal Financial and Accounting Officer)

EXHIBIT INDEX

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 - (5) Incorporated by reference to Exhibit 13.4 filed herein.

EXHIBIT 13.1

QUARTERLY INFORMATION

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

	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
1996					
Revenue	\$2,016	\$2,195	\$2,205	\$ 2,255	\$ 8,671
Operating income	704	809	778	768	3,059
Net income	499	575	562	559	2,195
Basic earnings per share	0.21	0.24	0.24	0.23	0.93
Diluted earnings per share	0.19	0.23	0.22	0.22	0.86
Common stock price per share:					
High	27.32	25.85	26.77	31.47	31.47
Low	21.25	20.10	19.97	24.91	19.97
1997					
Revenue	\$2,295	\$2,680	\$3,208	\$ 3,175	\$11,358
Operating income	853	1,035	1,484	1,499	4,871
Net income	614	741	1,042	1,057	3,454
Basic earnings per share	0.26	0.31	0.43	0.44	1.44
Diluted earnings per share	0.24	0.28	0.40	0.40	1.32
Common stock price per share:					
High	34.66	43.07	51.75	67.47	67.47
Low	26.88	32.72	40.38	44.88	26.88
1998					
Revenue	\$3,130	\$3,585	\$3,774	\$ 3,995	\$14,484
Operating income	1,060	1,613	1,867	1,874	6,414
Net income	663	1,133	1,337	1,357	4,490
Basic earnings per share	0.27	0.47	0.55	0.55	1.83
Diluted earnings per share	0.25	0.42	0.50	0.50	1.67
Common stock price per share:					
High	75.38	73.31	90.94	108.56	108.56
Low	61.63	59.00	62.19	81.88	59.00

The Company's common stock is traded on The Nasdaq Stock Market under the symbol MSFT. On July 31, 1998, there were 70,491 registered holders of record of the Company's common stock. The Company has not paid cash dividends on its common stock.

FINANCIAL HIGHLIGHTS

(In millions, except earnings per share)

Year Ended June 30	1994	1995	1996	1997	1998
Revenue	\$4,649	\$5,937	\$ 8,671	\$11,358	\$14,484
Net income	1,146	1,453	2,195	3,454	4,490
Diluted earnings per share (1)	0.47	0.58	0.86	1.32	1.67
Cash and short-term investments	3,614	4,750	6,940	8,966	13,927
Total assets	5,363	7,210	10,093	14,387	22,357
Stockholders' equity	4,450	5,333	6,908	10,777	16,627

(1) Diluted earnings per share have been restated to reflect a two-for-one stock split in February 1998.

MANAGEMENT'S DISCUSSION AND ANALYSIS
RESULTS OF OPERATIONS FOR 1996, 1997, AND 1998

Microsoft develops, manufactures, licenses, and supports a wide range of software products, including scalable operating systems for intelligent devices, personal computers (PCs), and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company's interactive efforts include entertainment and information software programs; MSN, the Microsoft Network online service; Internet-based services; and alliances with companies involved with various forms of digital interactivity. Microsoft also sells personal computer input devices and books, and researches and develops advanced technologies for future software products.

REVENUE

The Company's revenue growth rate continued to slow, from 46% in the fiscal year ended June 30, 1996 and 31% in fiscal 1997 to 28% in fiscal 1998. Revenue growth was particularly strong in 1996 due to the retail introduction of the Microsoft Windows 95 operating system. The 1997 and 1998 growth rates, although slower than that of 1996, reflected the continued adoption of Windows 32-bit operating systems and Microsoft Office 97, particularly as Microsoft software is deployed across entire corporate, academic, and governmental organizations. Software license volume increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and organization license programs is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices

than new products. Also, prices of integrated suites, such as Microsoft Office, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. During each of the three years an increased percentage of products and programs included elements which were billed but unearned and recognized ratably, such as Windows operating systems, Office 97, maintenance, and other subscription models. See accompanying notes.

PRODUCT GROUPS. Platform product revenue was \$4.11 billion, \$5.97 billion, and \$7.64 billion in 1996, 1997, and 1998. Platform revenue is primarily licenses of PC operating systems; business systems with client/server, Internet, and intranet architectures; and software development tools.

The Company's principal desktop platform products are its 32-bit operating systems: Windows 95, Windows 98, and Windows NT Workstation. Released in August 1995, Windows 95 was a successor to the MS-DOS(R) and Microsoft Windows 3.x operating systems. Windows NT Workstation version 4.0 was released in fiscal 1997. Windows 98 became available at the end of fiscal 1998. Although the growth rate of new PC shipments slowed, desktop operating systems contributed to revenue growth as shipments of new PCs preinstalled with such systems increased during the three-year period. Additionally, increased penetration of higher value 32-bit operating systems, particularly Windows NT Workstation, led to growth in 1996, 1997, and 1998. In 1996, retail license sales of Windows 95 were a major factor in the Platform revenue increase, reflecting the typical sales pattern for major operating system upgrades. Also in 1996, a portion of Windows operating system revenue became subject to ratable recognition.

Business systems products offer an enterprise-wide distributed client/server, Internet, and intranet environment based on the Microsoft Windows NT Server operating system, Microsoft Exchange Server, Microsoft SQL Server, and other server applications in the Microsoft BackOffice (R) family of products. Revenue from these products increased strongly due to greater corporate demand, particularly for intranet solutions, although the growth rate slowed in 1998.

Although revenue was not significant, sales of WebTV terminals and service and preinstallations of Windows CE by OEMs on intelligent devices were strong in 1998.

Independent software vendors, corporate developers, and solutions developers license tools such as the Microsoft Visual Basic(R) development system to develop software for Windows operating systems and the Internet. Revenue from developer products increased steadily in 1996 and 1997 and was flat in 1998.

Applications and Content revenue was \$4.56 billion, \$5.39 billion, and \$6.84 billion in 1996, 1997, and 1998. Applications and Content revenue includes primarily licenses of desktop and consumer productivity applications, interactive media programs, and PC input devices. Microsoft Office for Windows 95 was released in fiscal 1996 and Microsoft Office 97 was released in fiscal 1997. Applications and Content revenue grew 27% in 1996, 18% in 1997, and 27% in 1998. The lower growth rate in 1997 was due primarily to the application of the ratable revenue recognition model for Office 97.

Absolute increases in desktop applications revenue during the three-year period were led by the various Microsoft Office integrated suites, including Standard, Professional, and Small Business Editions. The primary programs in Microsoft Office are the word processor Microsoft Word, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for the 32-bit version of Windows, the 16-bit version of Windows, and Macintosh operating systems, also include Microsoft Access database management program, Microsoft Outlook(TM) messaging and collaboration client, or other programs. Revenue from stand-alone versions of Microsoft Excel, Word,

and PowerPoint continued to decrease as the sales mix shifted to integrated product suites. Microsoft Project scheduling and project management program revenue increased during the three-year period.

Microsoft offers a broad range of interactive media products, which also showed moderate growth. Products include CD-ROM multimedia reference titles and programs for home and small office productivity, children's creativity, and entertainment. In addition to the Microsoft Network, online Internet services include travel information and reservations, local event information, and car buying information.

The Company also markets input devices. Mouse and gaming device sales increased while keyboard revenue was steady during the three-year period.

SALES CHANNELS. The Company distributes its products primarily through OEM licenses, organization licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers. Microsoft has three major sales and marketing geographies: the United States and Canada, Europe, and elsewhere in the world (Other International). Sales of organization licenses and packaged products in these channels are primarily to distributors and resellers. The trend has continued toward a higher percentage of organization licensing versus packaged products.

OEM channel revenue was \$2.50 billion in 1996, \$3.48 billion in 1997, and \$4.72 billion in 1998. The primary source of OEM revenue is the licensing of desktop operating systems, and OEM revenue is highly dependent on PC shipment volume.

U.S. and Canadian channel revenue was \$2.68 billion, \$3.41 billion, and \$4.36 billion in 1996, 1997, and 1998. Revenue in Europe was \$2.02 billion, \$2.54 billion, and \$3.15 billion in 1996, 1997, and 1998. Growth rates have been lower in Europe than in other geographic areas due to higher existing market shares and a more dramatic shift to licensing programs. Other International channel revenue was \$1.47 billion in 1996, \$1.93 billion in 1997, and \$2.26 billion in 1998. Growth rates were higher in the Other International channel in 1996 and 1997 due to customers accepting newly localized products, particularly in Japan, and penetration in emerging markets. However, revenue was relatively flat in Japan and Southeast Asia in 1998 due to economic issues and weak currencies.

The Company's operating results are affected by foreign exchange rates. Approximately 34%, 32%, and 34% of the Company's revenue was collected in foreign currencies during 1996, 1997, and 1998. Since a portion of local currency revenue is hedged and much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the impact of exchange rates is partially mitigated.

OPERATING EXPENSES

COST OF REVENUE. As a percentage of revenue, cost of revenue was 13.7% in 1996, 9.6% in 1997, and 8.3% in 1998. The decrease was due to the shifts in mix to CD-ROMs (which carry lower cost of goods than disks), licenses to OEMs and organizations, and higher-margin Windows NT Server, other servers, and client access licenses in the BackOffice product family. In 1998, the decrease was offset somewhat by costs of WebTV.

RESEARCH AND DEVELOPMENT. Microsoft continued to invest heavily in the future by funding research and development (R&D). Expense increases of 67% in 1996, 34% in 1997, and 30% in 1998 resulted primarily from development staff headcount growth and higher levels of third-party development costs in many areas, particularly Windows-based platforms, including desktop operating systems, server systems, and

consumer appliances, along with Internet and intranet technologies. R&D costs also increased for desktop and server applications, development tools, and interactive media initiatives such as MSN and other online services.

In August 1997, the Company acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid \$425 million in stock and cash. The accompanying income statement reflects a one-time write-off of in-process technologies under development by WebTV Networks of \$296 million.

SALES AND MARKETING. The increase in the absolute dollar amount of sales and marketing expenses in the three-year period was due primarily to expanded product-specific marketing programs, such as Windows 95 in 1996, Office 97 in 1997, and Windows 98 in 1998. Sales and marketing costs as a percentage of revenue decreased due to moderate headcount growth. Microsoft brand advertising and product support expenses declined in 1997, but rose slightly in 1998.

GENERAL AND ADMINISTRATIVE. Increases in general and administrative expenses were attributable to higher legal costs and growth in the number of people and computer systems necessary to support overall increases in the scope of the Company's operations.

OTHER EXPENSES. Other expenses increased due to recognition of Microsoft's share of joint venture activities, including DreamWorks Interactive and the MSNBC entities.

INTEREST INCOME AND INCOME TAXES

Interest income increased primarily as a result of a larger investment portfolio generated by cash from operations. The effective income tax rate was 35.0% in 1996 and 1997. The effective income tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies.

NET INCOME

Net income as a percent of revenue increased in 1996, 1997, and 1998 due to the lower relative cost of revenue, sales and marketing expenses, and general and administrative expenses, partially offset by investments in research and development, joint ventures, and WebTV.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled \$13.93 billion at June 30, 1998. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equities, including financial investments and strategic technology companies in many areas. During 1997, Microsoft invested \$1.0 billion in Comcast Corporation, a cable television and diversified telecommunications company. Comcast Special Class A common stock and convertible preferred stock are included in equity investments at fair market value on the balance sheet.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay \$220 million over a five-year period for its interest in the cable venture, to pay one-half of

operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

Microsoft has no material long-term debt and has \$100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at June 30, 1998 was \$16.63 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were \$420 million on June 30, 1998.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 347 million common shares while 807 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was \$48 billion as of June 30, 1998. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of \$980 million were used to repurchase common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next 12 months. Microsoft's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale cash needs that may arise, and to fund an increased stock buyback program over historical levels to reduce the dilutive impact of the Company's employee stock option and purchase programs.

Microsoft has not paid cash dividends on its common stock. The preferred stock pays \$2.196 per annum per share.

ISSUES AND UNCERTAINTIES

Microsoft does not provide forecasts of future financial performance. While Microsoft management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its growth outlook.

RAPID TECHNOLOGICAL CHANGE AND COMPETITION. Rapid change, uncertainty due to new and emerging technologies, and fierce competition characterize the PC software industry. The pace of change has recently accelerated due to the Internet and new programming languages, such as Java.

FUTURE INITIATIVES. The Company is expanding its efforts to provide and support mission-critical systems to large enterprises. Scalability of BackOffice server and application products, total cost of ownership of Windows- and Office-based systems, information storage unification, user interface simplification, and Internet and intranet integration are also major focus areas. Additionally, Microsoft is committed to providing technologies, operating systems, and interactive content for the future convergence of PCs, televisions, and the Internet. Future revenue from these initiatives may not duplicate historical revenue growth rates.

PC GROWTH RATES. The underlying PC unit growth rate and percentage of new PCs acquired as replacement units directly impact the Company's software revenue growth. The PC shipment growth rate may continue to decrease and the replacement rate may continue to increase, reducing future software revenue opportunity.

PRODUCT SHIP SCHEDULES. Delays in new-product releases dampen revenue growth rates and can cause operational inefficiencies that impact manufacturing and distribution logistics, independent software vendor (ISV) and OEM relationships, and customer support expenses.

CUSTOMER ACCEPTANCE. While the Company performs extensive usability and beta testing of new products, user acceptance and corporate penetration rates ultimately dictate the success of development and marketing efforts.

PRICES. Future product prices may decrease from historical levels, depending on competitive market and cost factors. European and Asian software prices vary by country and are generally higher than in the United States to cover localization costs and higher costs of distribution. Increased global license agreements, European monetary unification, or other factors could erode such price uplifts in the future.

EARNINGS PROCESS. An increasingly higher percentage of the Company's revenue is subject to ratable recognition. Subsequent product support and delivery of unspecified enhancements require the applicable portion of revenue for certain products to be recognized over the product's life cycle. This policy may be required for additional products, depending on specific license terms and conditions. Also, maintenance and other subscription programs may continue to increase in popularity, particularly with organizations.

SATURATION. Product upgrades, which enable users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices and margins than new products. As the desktop applications market has become saturated, the sales mix has shifted from standard products to upgrade products. This trend is likely to continue.

ORGANIZATION LICENSES. Average revenue per unit from organization license programs is lower than average revenue per unit from retail versions shipped through the finished goods channels. Unit sales under licensing programs may continue to increase.

CHANNEL MIX. Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenue was achieved through the OEM channel during 1997 and 1998.

COST OF REVENUE. Although cost of revenue as a percentage of revenue decreased in 1997 and 1998, it varies with channel mix, product mix within channels, and usage of online operations. The trend of declining cost of revenue as a percentage of revenue is unlikely to continue in 1999.

PAY AND PARTICIPATION MODEL. Microsoft employees currently receive salaries, incentive bonuses, other fringe benefits, and stock options. New government regulations, poor stock price performance, or other factors could diminish the value of the option program to current and prospective employees and force the Company into more of a cash compensation model. Had the Company paid employees in cash the grant date Black-Scholes value of options vested in 1996, 1997, and 1998, the pretax expense would have been approximately \$450 million, \$620 million, and \$850 million.

LONG-TERM RESEARCH AND DEVELOPMENT INVESTMENT CYCLE. Developing and localizing software is expensive and the investment in product development often involves a long payback cycle. The Company plans to continue significant investments in software research and development and related product opportunities from which significant revenue is not anticipated for a number of years. Management expects total spending for research and development in 1999 to increase over spending in 1998.

SALES, MARKETING, AND SUPPORT INVESTMENTS. The Company's plans for 1999 include accelerated investments in its sales, marketing, and support groups.

FOREIGN EXCHANGE. A large percentage of the Company's sales, costs of manufacturing, and marketing is transacted in local currencies. As a result, the Company's international results of operations are subject to foreign exchange rate fluctuations.

INVESTMENTS VALUE SENSITIVITY. The Company's investment portfolio is subject to interest rate and market price risk. A 10% increase in treasury security yields would reduce the carrying value of interest-sensitive securities at June 30, 1998 by \$128 million, and a 10% decrease in market values would reduce the carrying value of the Company's publicly traded equity securities by \$300 million. Many of these equity securities are highly volatile stocks.

INTELLECTUAL PROPERTY RIGHTS. Microsoft diligently defends its intellectual property rights, but unlicensed copying of software represents a loss of revenue to the Company. While this adversely affects U.S. revenue, revenue loss is even more significant outside of the United States, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, Microsoft actively educates consumers on the benefits of licensing genuine products and educates lawmakers on the advantages of a business climate where intellectual property rights are protected. However, continued efforts may not affect revenue positively.

FUTURE GROWTH RATE. The revenue growth rate in 1999 may not approach the level attained in prior years. As discussed previously, operating expenses are expected to increase in 1999. Because of the fixed nature of a significant portion of such expenses, coupled with the possibility of slower revenue growth, operating margins in 1999 may decrease from those in 1998.

LITIGATION. Litigation regarding intellectual property rights, patents, and copyrights occurs in the PC software industry. In addition, there are government regulation and investigation risks along with other general corporate legal risks.

YEAR 2000. The Year 2000 presents potential concerns for business and consumer computing. The consequences of this issue may include systems failures and business process interruption. It may also include additional business and competitive differentiation. Aside from the well-known calculation problems with the use of 2-digit date formats as the year changes from 1999 to 2000, the Year 2000 is a special case leap year and in many organizations using older technology, dates were used for special programmatic functions.

The problem exists for many kinds of software and hardware, including mainframes, mini computers, PCs, and embedded systems. Microsoft is in the process of gathering, testing, and producing information about Microsoft technologies impacted by the Year 2000 transition. First, Microsoft classified its core products into categories of compliance: compliant, compliant with minor issues, and not compliant. Second, if a product is stated to be non-compliant, Microsoft will provide information as to how an organization could bring that product into compliance. Microsoft is issuing patches and/or workarounds at no additional charge for most issues. Third, Microsoft is working to help organizations find solutions to Year 2000 problems. The technologies and services offered by Microsoft and companies it works with can be components in overall Year 2000 solutions. Microsoft is assisting companies with the task of recognizing how disparate technologies can fit together to create a viable solution set.

Current information about the Company's product, business, and technical concerns is available at the Microsoft Year 2000 Resource Center Web site (www.microsoft.com/year2000). The Web site also contains information about obtaining software patches to resolve various Year 2000 issues in certain

Microsoft products. Information on the Company's Web site is provided to customers for the sole purpose of assisting in planning for the transition to the Year 2000. Such information is the most currently available concerning the behavior of the Company's products in the next century and is provided "as is" without warranty of any kind. However, variability of definitions of "compliance" with the Year 2000 and of different combinations of software, firmware, and hardware will likely lead to lawsuits against the Company. The outcome of such lawsuits and the impact on the Company are not estimable at this time.

The Year 2000 issue also affects the Company's internal systems, including information technology (IT) and non-IT systems. Microsoft is assessing the readiness of its systems for handling the Year 2000. Although the assessment is still underway, management currently believes that all material systems will be compliant by the Year 2000 and that the cost to address the issues is not material. Nevertheless, Microsoft is creating contingency plans for certain internal systems.

All organizations dealing with the Year 2000 must address the effect this issue will have on their third-party supply chain. Microsoft is undertaking steps to identify its vendors and to formulate a system of working with key third-parties to understand their ability to continue providing services and products through the change to 2000. Microsoft will work directly with its key vendors, distributors, and resellers, and partner with them if necessary, to avoid any business interruptions in 2000. For these key third-parties, contingency plans will be developed.

Resolving Year 2000 issues is a worldwide phenomenon that will likely absorb a substantial portion of IT budgets and attention in the near term. Certain industry analysts believe the Year 2000 issue will accelerate the trend toward distributed PC-based systems from mainframe systems, while others believe a majority of IT resources will be devoted to fixing older mainframe software in lieu of large-scale transitions to systems based on software such as that sold by Microsoft. The impact of the Year 2000 on future Microsoft revenue is difficult to discern but is a risk to be considered in evaluating future growth of the Company.

MICROSOFT CORPORATION

FINANCIAL STATEMENTS

Income Statements for the three years ended June 30, 1998

Cash Flows Statements for the three years ended June 30, 1998

Balance Sheets as of June 30, 1997 and 1998

Stockholders' Equity Statements for the three years ended June 30, 1998

Notes to Financial Statements

Independent Auditors' Report

INCOME STATEMENTS
(In millions, except earnings per share)

Year Ended June 30	1996	1997	1998
Revenue	\$8,671	\$11,358	\$14,484
Operating expenses:			
Cost of revenue	1,188	1,085	1,197
Research and development	1,432	1,925	2,502
Acquired in-process technology	--	--	296
Sales and marketing	2,657	2,856	3,412
General and administrative	316	362	433
Other expenses	19	259	230
Total operating expenses	5,612	6,487	8,070
Operating income	3,059	4,871	6,414
Interest income	320	443	703
Income before income taxes	3,379	5,314	7,117
Provision for income taxes	1,184	1,860	2,627
Net income	2,195	3,454	4,490
Preferred stock dividends	--	15	28
Net income available for common shareholders	\$2,195	\$ 3,439	\$ 4,462
Earnings per share (1):			
Basic	\$ 0.93	\$ 1.44	\$ 1.83
Diluted	\$ 0.86	\$ 1.32	\$ 1.67

(1) Earnings per share have been restated to reflect a two-for-one stock split in February 1998.

See accompanying notes.

CASH FLOWS STATEMENTS
(In millions)

Year Ended June 30	1996	1997	1998
Operations			
Net income	\$ 2,195	\$ 3,454	\$ 4,490
Depreciation and amortization	480	557	1,024
Write-off of acquired in-process technology	--	--	296
Unearned revenue	983	1,601	3,268
Recognition of unearned revenue from prior periods	(477)	(743)	(1,798)
Other current liabilities	584	321	208
Accounts receivable	(71)	(336)	(520)
Other current assets	25	(165)	(88)
Net cash from operations	3,719	4,689	6,880
Financing			
Common stock issued	504	744	959
Common stock repurchased	(1,385)	(3,101)	(2,468)
Put warrant proceeds	124	95	538
Preferred stock issued	--	980	--
Preferred stock dividends	--	(15)	(28)
Stock option income tax benefits	352	796	1,553
Net cash from (used for) financing	(405)	(501)	554
Investments			
Additions to property and equipment	(494)	(499)	(656)
Cash portion of WebTV purchase price	--	--	(190)
Equity investments and other	(625)	(1,669)	(1,598)
Short-term investments	(1,551)	(921)	(4,828)
Net cash used for investments	(2,670)	(3,089)	(7,272)
Net change in cash and equivalents	644	1,099	162
Effect of exchange rates on cash and equivalents	(5)	6	(29)
Cash and equivalents, beginning of year	1,962	2,601	3,706
Cash and equivalents, end of year	2,601	3,706	3,839
Short-term investments	4,339	5,260	10,088
Cash and short-term investments	\$ 6,940	\$ 8,966	\$13,927

See accompanying notes.

BALANCE SHEETS
(In millions)

June 30	1997	1998
ASSETS		
Current assets:		
Cash and short-term investments	\$ 8,966	\$13,927
Accounts receivable	980	1,460
Other	427	502
<hr/>		
Total current assets	10,373	15,889
Property and equipment	1,465	1,505
Equity investments	2,346	4,703
Other assets	203	260
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Total assets	\$14,387	\$22,357
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LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 721	\$ 759
Accrued compensation	336	359
Income taxes payable	466	915
Unearned revenue	1,418	2,888
Other	669	809
<hr/>		
Total current liabilities	3,610	5,730
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Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock--shares authorized 100; shares issued and outstanding 13	980	980
Common stock and paid-in capital--shares authorized 8,000; shares issued and outstanding 2,408 and 2,470	4,509	8,025
Retained earnings	5,288	7,622
<hr/>		
Total stockholders' equity	10,777	16,627
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Total liabilities and stockholders' equity	\$14,387	\$22,357
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See accompanying notes.

STOCKHOLDERS' EQUITY STATEMENTS
(In millions)

Year Ended June 30	1996	1997	1998
CONVERTIBLE PREFERRED STOCK			
Balance, beginning of year	--	--	\$ 980
Convertible preferred stock issued	--	\$ 980	--
Balance, end of year	--	980	980
COMMON STOCK AND PAID-IN CAPITAL			
Balance, beginning of year	\$ 2,005	2,924	4,509
Common stock issued	504	744	1,262
Common stock repurchased	(41)	(91)	(165)
Structured repurchases price differential	--	--	328
Proceeds from sale of put warrants	124	95	538
Reclassification of put warrant obligation	(20)	45	--
Stock option income tax benefits	352	792	1,553
Balance, end of year	2,924	4,509	8,025
RETAINED EARNINGS			
Balance, beginning of year	3,328	3,984	5,288
Net income	2,195	3,454	4,490
Preferred stock dividends	--	(15)	(28)
Common stock repurchased	(1,344)	(3,010)	(2,631)
Reclassification of put warrant obligation	(210)	590	--
Net unrealized investment gains and other	15	285	503
Balance, end of year	3,984	5,288	7,622
Total stockholders' equity	\$ 6,908	\$10,777	\$16,627

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION. The financial statements include the accounts of Microsoft and its subsidiaries. Significant intercompany transactions and balances have been eliminated. Investments in 50% owned joint ventures are accounted for using the equity method; the Company's share of joint ventures' activities is reflected in other expenses.

ESTIMATES AND ASSUMPTIONS. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates.

FOREIGN CURRENCIES. Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenue, costs, and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

REVENUE RECOGNITION. Revenue is recognized when earned. The Company's revenue recognition policies are in compliance with American Institute of Certified Public Accountants Statements of Position 97-2 and 98-4, Software Revenue Recognition. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from organization license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. Revenue attributable to significant support (technical support and unspecified enhancements such as service packs and Internet browser updates) is based on the price charged or derived value of the undelivered elements and is recognized ratably on a straight-line basis over the product's life cycle. Costs related to insignificant obligations, which include telephone support for certain products, are accrued. Provisions are recorded for returns and bad debts.

RESEARCH AND DEVELOPMENT. Research and development costs are expensed as incurred. Statement of Financial Accounting Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.

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

INCOME TAXES. Income tax expense includes U.S. and international income taxes, plus an accrual for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

STOCK SPLIT. In February 1998, outstanding shares of common stock were split two-for-one. All share and per share amounts have been restated.

FINANCIAL INSTRUMENTS. The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and five years from the purchase date. All cash and short-term investments are classified as available for sale and are recorded at market. Cost approximates market for all classifications of cash and short-term investments; realized and unrealized gains and losses were not material.

Publicly tradeable equity securities are recorded at market; unrealized gains and losses are reflected in stockholders' equity. The pretax unrealized gain was \$1.4 billion at June 30, 1998.

PROPERTY AND EQUIPMENT. Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 30 years.

RECLASSIFICATIONS. Certain reclassifications have been made for consistent presentation.

UNEARNED REVENUE

Microsoft believes that Internet technologies are integral to its products and has committed to integrating these technologies, such as its browser software, Microsoft Internet Explorer, into existing products at no additional cost to its customers. Given this strategy and other commitments such as telephone support, Internet-based technical support, and unspecified product enhancements, Microsoft recognizes approximately 20% of Windows operating systems OEM revenue and approximately 35% of retail versions revenue over the product life cycles, currently estimated at two years. The unearned portion of revenue from Windows operating systems was \$860 million and \$1.19 billion at June 30, 1997 and 1998.

Since Office 97 is also tightly integrated with the Internet, and in the view of subsequent delivery of new Internet technologies, enhancements, and other support, a ratable revenue recognition policy was implemented for Office 97. Approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle. Unearned revenue associated with Office 97 totaled \$300 million and \$770 million at June 30, 1997 and 1998.

Unearned revenue also includes maintenance and other subscription contracts, including organization license agreements.

FINANCIAL RISKS

The Company's investment portfolio is diversified and consists primarily of short-term investment grade securities. Interest rate fluctuations impact the carrying value of the portfolio. While no hedge was in place on June 30, 1998, the Company routinely hedges the portfolio in case of a catastrophic increase in interest rates. At June 30, 1997 and 1998, approximately 31% and 40% of accounts receivable represented amounts due from ten customers. One customer accounted for approximately 13%, 12%, and 8% of revenue in 1996, 1997, and 1998.

Finished goods sales to international customers in Europe, Japan, and Australia are primarily billed in local currencies. Payment cycles are relatively short, generally less than 90 days. European manufacturing costs and international selling, distribution, and support costs are generally disbursed in local currencies. Local currency cash balances in excess of short-term operating needs are generally converted into U.S. dollar cash and short-term investments on receipt. Therefore, foreign exchange rate fluctuations generally do not create a risk of material balance sheet gains or losses. As a result, Microsoft's hedging activities for balance sheet exposures have been minimal.

Foreign exchange rates affect the translated results of operations of the Company's foreign subsidiaries. The Company hedges a percentage of planned international revenue with purchased options. The notional amount of the options outstanding at June 30, 1998 was \$2.1 billion. At June 30, 1998, the fair value and premiums paid for the options were not material.

CASH AND SHORT-TERM INVESTMENTS

June 30	1997	1998
Cash and equivalents:		
Cash	\$ 246	\$ 195
Commercial paper	1,660	2,771
Money market preferreds	946	454
Certificates of deposit	854	419
Cash and equivalents	3,706	3,839
Short-term investments:		
Commercial paper	261	868
Municipal securities	571	1,361
Corporate notes and bonds	1,907	3,998
U.S. government and agency securities	1,513	3,511
Certificates of deposit	1,008	350
Short-term investments	5,260	10,088
Cash and short-term investments	\$8,966	\$13,927

PROPERTY AND EQUIPMENT

June 30	1997	1998
Land	\$ 183	\$ 183
Buildings	1,027	1,259
Computer equipment	1,064	1,182
Other	503	428
Property and equipment--at cost	2,777	3,052
Accumulated depreciation	(1,312)	(1,547)
Property and equipment--net	\$ 1,465	\$ 1,505

During 1997 and 1998, depreciation expense, of which the majority related to computer equipment, was \$353 million and \$528 million; disposals were immaterial.

INCOME TAXES

The provision for income taxes consisted of:

Year Ended June 30	1996	1997	1998
Current taxes:			
U.S. and state	\$1,139	\$1,710	\$2,518
International	285	412	526
Current taxes	1,424	2,122	3,044
Deferred taxes	(240)	(262)	(417)
Provision for income taxes	\$1,184	\$1,860	\$2,627

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

Year Ended June 30	1996	1997	1998
U.S.	\$2,356	\$3,775	\$5,072
International	1,023	1,539	2,045
Income before income taxes	\$3,379	\$5,314	\$7,117

The effective income tax rate was 35.0% in 1996 and 1997. The effective tax rate increased to 36.9% in 1998 due to the nondeductible write-off of WebTV in-process technologies.

Income taxes payable were:

June 30	1997	1998
Deferred income tax assets:		
Revenue items	\$ 474	\$ 713
Expense items	505	613
Deferred income tax assets	979	1,326
Deferred income tax liabilities:		
Unrealized gain on investments		(479)
International earnings	(465)	(373)
Other	(4)	(26)
Deferred income tax liabilities	(469)	(878)
Current income tax liabilities	(976)	(1,363)
Income taxes payable	\$(466)	\$ (915)

Income taxes have been settled with the Internal Revenue Service (IRS) for all years through 1989. The IRS has assessed taxes for 1990 and 1991 which the Company is contesting in Tax Court. The IRS is examining the Company's U.S. income tax returns for 1992 through 1994. Management believes any related adjustments that might be required will not be material to the financial

statements. Income taxes paid were \$758 million in 1996, \$1.1 billion in 1997, and \$1.1 billion in 1998.

CONVERTIBLE PREFERRED STOCK

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred shareholders have preference over common stockholders in dividends and liquidation rights. In December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of \$79.875 and a cap of \$102.24 per preferred share. Net proceeds of \$980 million were used to repurchase common shares.

COMMON STOCK

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

Year Ended June 30	1996	1997	1998
Balance, beginning of year	2,352	2,388	2,408
Issued	88	94	101
Repurchased	(52)	(74)	(39)
Balance, end of year	2,388	2,408	2,470

REPURCHASE PROGRAM The Company repurchases its common stock in the open market to provide shares for issuing to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 1999.

In addition, under structured repurchases with an independent third-party, the Company executed two forward purchases totaling 21 million shares of stock. Under these arrangements, a portion of the purchase price will be paid in the next five or six years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net share or cash) is at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the two dates of agreement is reflected in common stock and paid-in capital.

PUT WARRANTS

To enhance its stock repurchase program, the Company sells put warrants to independent third-parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On June 30, 1998, 60 million warrants were outstanding. The outstanding put warrants at June 30, 1998 expire between November 1998 and June 2000 and have strike prices ranging from \$72 to \$77 per share. The outstanding put warrants permit a net-share settlement at the Company's option and do not result in a put warrant liability on the balance sheet.

EMPLOYEE STOCK AND SAVINGS PLANS

EMPLOYEE STOCK PURCHASE PLAN The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1996, 1997, and 1998, employees purchased 3.6 million, 2.8 million, and 2.2 million shares at average prices of \$18.86, \$29.82, and \$54.42 per share. At June 30, 1998, 36.8 million shares were reserved for future issuance.

SAVINGS PLAN The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may defer up to 15% of pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were \$15 million, \$28 million, and \$39 million in 1996, 1997, and 1998.

STOCK OPTION PLANS The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. The option exercise price is the fair market value at the date of grant. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest over seven and one-half years and expire after 10 years. At June 30, 1998, options for 222 million shares were vested and 523 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

	Shares	Price per Share		Weighted Average
		Range		
Balance, June 30, 1995	456	\$ 0.39 - \$20.79		\$ 7.28

Granted	114	20.05 - 29.47	22.50
Exercised	(80)	0.39 - 22.63	5.38
Canceled	(14)	1.30 - 27.72	13.93

Balance, June 30, 1996	476	0.55 - 29.47	11.04
Granted	110	27.66 - 59.60	29.15
Exercised	(90)	0.55 - 29.47	6.64
Canceled	(18)	8.50 - 48.57	19.42

Balance, June 30, 1997	478	1.12 - 59.60	15.72
GRANTED	69	33.12 - 87.25	62.56
EXERCISED	(88)	1.12 - 62.47	9.27
CANCELED	(13)	1.32 - 83.88	29.37

BALANCE, JUNE 30, 1998	446	1.12 - 87.25	23.87

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 1998 were as follows:

Range of exercise prices	Shares	Outstanding options		Exercisable options	
		Remaining life (years)	Weighted average price	Shares	Weighted average price
\$1.12-\$8.50	85	2.7	\$ 5.06	84	\$ 5.07
8.51-11.94	100	4.4	10.47	83	10.19
11.95-27.25	97	4.9	21.62	38	21.14
27.26-59.60	100	5.6	29.81	17	28.99
59.61-87.25	64	6.5	64.00	--	--

The Company follows Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, to account for stock option and employee stock purchase plans. No compensation cost is recognized because the option exercise price is equal to the market price of the underlying stock on the date of grant.

An alternative method of accounting for stock options is SFAS 123, Accounting for Stock-Based Compensation. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model and compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined based on the Black-Scholes value at the grant dates for awards as prescribed by SFAS 123, pro forma income statements for 1996, 1997, and 1998 would have been as follows:

Year Ended June 30	1996		1997		1998	
	Reported	Pro forma	Reported	Pro forma	REPORTED	PRO FORMA
Revenue	\$8,671	\$8,671	\$11,358	\$11,358	\$14,484	\$14,484
Operating expenses:						
Cost of revenue	1,188	1,204	1,085	1,107	1,197	1,227
Research and development	1,432	1,655	1,925	2,230	2,502	2,924
Acquired in-process technology	--	--	--	--	296	296
Sales and marketing	2,657	2,823	2,856	3,082	3,412	3,725
General and administrative	316	362	362	424	433	520
Other expenses	19	19	259	259	230	230
Total operating expenses	5,612	6,063	6,487	7,102	8,070	8,922
Operating income	3,059	2,608	4,871	4,256	6,414	5,562
Interest income	320	320	443	443	703	703
Income before income taxes	3,379	2,928	5,314	4,699	7,117	6,265
Provision for income taxes	1,184	1,026	1,860	1,646	2,627	2,325
Net income	2,195	1,902	3,454	3,053	4,490	3,940
Preferred stock dividends	--	--	15	15	28	28
Net income available for common shareholders	\$2,195	\$1,902	\$ 3,439	\$ 3,038	\$ 4,462	\$ 3,912
Diluted earnings per share	\$ 0.86	\$ 0.74	\$ 1.32	\$ 1.16	\$ 1.67	\$ 1.47

The pro forma disclosures in the previous table include the amortization of the fair value of all options vested during 1996, 1997, and 1998, regardless of the grant date. If only options granted after 1996 were valued, as prescribed by SFAS 123, pro forma net income would have been \$2,073 million, \$3,179 million, and \$4,019 million, and earnings per share would have been \$0.81, \$1.21, and \$1.50 for 1996, 1997, and 1998.

The weighted average Black-Scholes value of options granted under the stock option plans during 1996, 1997, and 1998 was \$8.86, \$11.72, and \$23.62. Value was estimated using an expected life of five years, no dividends, volatility of .32 in 1998 and .30 in prior years, and risk-free interest rates of 6.0%, 6.5%, and 5.7% in 1996, 1997, and 1998.

EARNINGS PER SHARE

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

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

Year Ended June 30	1996	1997	1998
Net income	\$2,195	\$3,454	\$4,490
Preferred stock dividends	--	15	28
Net income available for common shareholders	\$2,195	\$3,439	\$4,462
Average outstanding shares of common stock	2,368	2,391	2,432
Dilutive effect of:			
Common stock under structured repurchases	--	--	3
Preferred stock	--	13	17
Employee stock options	193	218	229
Common stock and common stock equivalents	2,561	2,622	2,681
Earnings per share:			
Basic	\$ 0.93	\$ 1.44	\$ 1.83
Diluted	\$ 0.86	\$ 1.32	\$ 1.67

ACQUISITION

In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals based on proprietary technologies. A director of the Company owned 10% of WebTV. Microsoft paid \$425 million in stock and cash for WebTV. The Company recorded an in-process technologies write-off of \$296 million in the first quarter of 1998.

SUBSEQUENT SALE

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. A pretax gain of \$160 million will be recognized in the first quarter of 1999. As part of a transitional service agreement, Microsoft agreed to make certain development tools and management systems available to Avid for use in the Softimage business.

COMMITMENTS

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was \$92 million, \$92 million, and \$95 million in 1996, 1997, and 1998. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1999, \$85; 2000, \$72; 2001, \$52; 2002, \$25; 2003, \$17; and thereafter, \$17.

In connection with the Company's communications infrastructure and the operation of online services, Microsoft has certain communication usage commitments. Future related minimum commitments, in millions of dollars, are: 1999, \$184; 2000, \$100; and

2001, \$30. Also, Microsoft has committed to certain volumes of outsourced telephone support and manufacturing of packaged product and has committed \$420 million for constructing new buildings.

During 1996, Microsoft and National Broadcasting Company (NBC) established two MSNBC joint ventures: a 24-hour cable news and information channel and an interactive online news service. Microsoft agreed to pay \$220 million over a five-year period for its interest in the cable venture, to pay one-half of operational funding of both joint ventures for a multiyear period, and to guarantee a portion of MSNBC debt.

CONTINGENCIES

On October 7, 1997, Sun Microsystems, Inc. brought suit against Microsoft in the U.S. District Court for the Northern District of California. Sun's Complaint alleges several claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java Compatibility logo, and against distributing Internet Explorer 4.0 unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary and punitive damages, and liquidated damages of \$35 million for the alleged source code disclosure.

On March 24, 1998, the court entered an order enjoining Microsoft from using the Java Compatibility logo on Internet Explorer 4.0 and the Microsoft Software Developers Kit for Java 2.0. Microsoft has taken steps to fully comply with the order.

On May 12, 1998, Sun filed companion motions seeking a preliminary injunction based on allegations of copyright infringement and unfair competition. Sun requested an order enjoining Microsoft from distributing any Java-based technology in any operating system, browser, or developers tools, including Windows 98, Internet Explorer 4.0 software, and the Visual J++(TM) 6.0 development system for Java, unless and until Microsoft includes with each such product an implementation of the Java run-time environment that passes Sun's compatibility test suite or an operable implementation of Sun's current Java run-time environment. The hearing for these motions is set for September 4, 1998.

On October 20, 1997, the Antitrust Division of the U.S. Department of Justice (DOJ) filed a Petition for An Order To Show Cause in United States District Court for the District of Columbia. In its petition, the DOJ contends that Microsoft has violated a 1994 consent decree by including Internet Explorer technology in Windows 95, and by preventing OEMs from removing Internet Explorer functionality from versions of Windows 95 the OEMs are licensed to install on computer systems they sell.

On December 11, 1997, the district court entered two orders. In the first order, Judge Thomas Penfield Jackson denied the DOJ's contempt petition, and dismissed the DOJ's request for relief concerning Microsoft's non-disclosure agreements because the DOJ had failed to present evidence that the agreements had interfered with any DOJ investigation. In addition, however, the court ruled that there were disputed issues of fact regarding Microsoft's violation of the consent decree, and concluded that the DOJ was likely to prevail on its claim that a violation had occurred. The court entered a preliminary injunction sua sponte requiring Microsoft not to condition the licensing of Windows 95 or

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any successor desktop operating system on a computer manufacturer also licensing any Microsoft browser software, including Internet Explorer 3.0 or 4.0. In the second order, the court appointed Harvard Law Professor Lawrence Lessig as a special master, to whom the court delegated the authority to conduct discovery, take evidence, and make proposed findings of fact and conclusions of law on all issues in the case by May 31, 1998.

Microsoft immediately appealed the preliminary injunction to the District of Columbia Circuit Court of Appeals. On May 5, 1998, Microsoft also sought a stay of the District Court's injunction insofar as it applied to Windows 98. On May 12, 1998, the Court of Appeals granted Microsoft's request for a stay. The Court of Appeals issued an opinion on Microsoft's appeal on June 23, 1998. It unanimously reversed the trial court, both as to the entry of the injunction and the reference to the special master. The opinion both cited procedural errors in the issuance of the injunction and errors of substantive law in the interpretation of the consent decree. The court remanded the case to Judge Jackson for further proceedings consistent with the Court's opinion. There has been no further action in that case since the Court of Appeals' decision.

Although the Court of Appeals could have reversed the district court solely on procedural grounds, it chose to address at length the central issue in both the consent decree case and in the new Sherman Act case brought by the DOJ and 20 state Attorneys General: whether Microsoft is unlawfully "tying" a "separate product" known as Microsoft Internet Explorer to the Windows operating system. Two members of the Court rejected the DOJ's main argument that Internet Explorer constitutes a separate product because Microsoft treats it separately in some circumstances. (One judge dissented in part from the reasoning in this part of the opinion.) The Court's discussion of antitrust tying law, although made in the context of the consent decree case, clearly provides guidance on many of the issues raised in the new Sherman Act case.

On May 18, 1998, the DOJ and a group of 20 state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion

of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-Microsoft Internet browsing software (or other software products); taking or threatening "action adverse" in consequence of a person's failure to license or distribute Microsoft Internet browsing software (or other software product) or distributing competing

products or cooperating with the government; and restrictions on the screens, boot-up sequence, or functions of Microsoft's operating system products. The state Attorneys General allege largely the same claims, and various pendent state claims. The states seek declaratory relief, and preliminary and permanent injunctive relief similar to that sought by the DOJ, together with statutory penalties under the state law claims. The foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. Hearings for the plaintiffs' motion for a preliminary injunction, Microsoft's motion for summary judgment, and a trial on the merits are scheduled to begin in September 1998. Microsoft believes that the claims are without merit and intends to defend against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of MS-DOS and Windows in the late 80's and early 90's--essentially the same complaints that resulted in the 1994 consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Fact discovery is scheduled to end in October 1998, and trial is scheduled for June 1999. Microsoft is vigorously defending the case.

Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

GEOGRAPHIC INFORMATION

Year Ended June 30	1996	1997	1998
REVENUE			
U.S. operations	\$ 6,739	\$ 8,877	\$11,331
European operations	2,215	2,770	3,719
Other international operations	1,267	1,757	1,776
Eliminations	(1,550)	(2,046)	(2,342)
Total revenue	\$ 8,671	\$11,358	\$14,484
OPERATING INCOME			
U.S. operations	\$ 2,118	\$ 3,474	\$ 4,591
European operations	649	1,013	1,470
Other international operations	297	469	423
Eliminations	(5)	(85)	(70)
Total operating income	\$ 3,059	\$ 4,871	\$ 6,414
IDENTIFIABLE ASSETS			
U.S. operations	\$ 8,193	\$11,630	\$18,294
European operations	2,280	3,395	5,052
Other international operations	1,042	705	1,113
Eliminations	(1,422)	(1,343)	(2,102)
Total identifiable assets	\$10,093	\$14,387	\$22,357

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the United States, licensing to OEMs, and exports of finished goods directly to international customers, primarily in Asia, South America, and Canada. Exports and international OEM transactions are primarily in U.S. dollars and totaled \$2.1 billion, \$2.3 billion, and \$2.9 billion in 1996, 1997, and 1998.

"Other international operations" primarily include subsidiaries in Japan, Canada, Australia, and Brazil. International revenue, which includes European operations, other international operations, exports, and OEM distribution, was 56%, 56%, and 53% of total revenue in 1996, 1997, and 1998. Most international identifiable assets are U.S. dollar denominated investment securities.

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1997 and 1998, and the related statements of income, cash flows, and stockholders' equity for each of the three years ended June 30, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1997 and 1998, and the results of their operations and their cash flows for each of the three years ended June 30, 1998 in conformity with generally accepted accounting principles.

/s/ DELOITTE & TOUCHE LLP

DELOITTE & TOUCHE LLP
Seattle, Washington
July 16, 1998
(August 3, 1998 as to Subsequent Sale Note)

SUBSIDIARIES

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399

Microsoft FSC Corp. (U.S. VIRGIN ISLANDS)

Microsoft Investments, Inc. (NEVADA)

Microsoft Ireland Operations Limited (IRELAND)

Microsoft Licensing, Inc. (NEVADA)

Microsoft Puerto Rico, Inc. (Manufacturing) (DELAWARE)

The Microsoft Network L.L.C. (DELAWARE)

GraceMac Corporation (NEVADA)

Microsoft de Argentina S.A.

Microsoft Pty. Limited (AUSTRALIA)

Microsoft Gesellschaft m.b.H. (AUSTRIA)

Microsoft N.V. (BELGIUM)

Microsoft Informatica Limitada (BRAZIL)

Microsoft Canada Co.

SOFTIMAGE, Inc. (CANADA)

Microsoft Chile S.A.

Microsoft Colombia Inc. (DELAWARE)

Microsoft de Centroamerica S.A. (COSTA RICA)

Microsoft Hrvatska d.o.o. (CROATIA)

Microsoft s.r.o. (CZECH REPUBLIC)

Microsoft Danmark ApS (DENMARK)

Microsoft Dominicana, S.A. (DOMINICAN REPUBLIC)

Microsoft Del Ecuador S.A.

Microsoft El Salvador S.A. de C.V.

Microsoft Corporation (Representative Office) (EGYPT)

Microsoft Oy (FINLAND)

Microsoft France S.A.R.L.

Microsoft G.m.b.H. (GERMANY)

Microsoft Hellas S.A. (GREECE)

Microsoft de Guatemala, S.A.

Microsoft Hong Kong Limited

Microsoft Hungary Kft.

Microsoft Corporation (India) Private Limited

Microsoft India (R&D) Private Limited

PT. Microsoft Indonesia

Microsoft Israel Ltd.

Microsoft S.p.A. (ITALY)

Microsoft Cote d'Ivoire (IVORY COAST)

Microsoft Company, Limited (JAPAN)

East Africa Software Limited (KENYA)

Microsoft CH (KOREA)

Microsoft (Malaysia) Sdn. Bhd.

Microsoft Mexico, S.A. de C.V.

Microsoft Indian Ocean Islands Limited (MAURITIUS)
Microsoft Maroc S.A.R.L. (MOROCCO)
Microsoft B.V. (THE NETHERLANDS)
Microsoft International B.V. (THE NETHERLANDS)
Microsoft New Zealand Limited
Microsoft Norge AS (NORWAY)
Microsoft de Panama, S.A.
Microsoft (China) Company Limited (THE PEOPLE'S REPUBLIC OF CHINA)
Microsoft Peru, S.A.
Microsoft Philippines, Inc.
Microsoft sp. z.o.o. (POLAND)
MSFT-Software Para Microcomputadores, LDA (PORTUGAL)
Microsoft Caribbean, Inc. (PUERTO RICO) (DELAWARE)
Microsoft Romania SRL
Microsoft ZAO (RUSSIA)
Microsoft Manufacturing B.V. (Representative Office)(RUSSIA)
Microsoft Singapore Pte Ltd.
Microsoft Slovakia s.r.o.
Microsoft d.o.o., Ljubljana (SLOVENIA)
Microsoft (S.A.) (Proprietary) Limited (SOUTH AFRICA)
Microsoft Iberica S.R.L. (SPAIN)
Microsoft Aktiebolag (SWEDEN)
Microsoft AG (SWITZERLAND)
Microsoft Taiwan Corporation
Microsoft (Thailand) Limited
Microsoft Bilgisayar Yazilim Hizmetleri Limited Sirketi (TURKEY)
Microsoft Corporation (UNITED ARAB EMIRATES)
Microsoft Limited (UNITED KINGDOM)
Microsoft Research Limited (UNITED KINGDOM)
Microsoft Uruguay, S.A.
Microsoft Venezuela, S.A.
The Resident Representative Office of MICROSOFT Corporation in Hanoi (VIETNAM)
Microsoft Corporation (Representative Office)(ZIMBABWE)
WebTV Networks, Inc. (California)
DreamWorks Interactive L.L.C. (WASHINGTON, 50% owned)
MSBET L.L.C. (DELAWARE, 50% owned)
MSFDC L.L.C. (DELAWARE, 50% owned)
MSNBC Cable, L.L.C. (DELAWARE, 50% owned)
MSNBC Interactive News, L.L.C. (DELAWARE, 50% owned)
Ninemsn Pty. Limited (AUSTRALIA)
WebTV Networks K.K. (JAPAN)

INDEPENDENT AUDITORS' CONSENT

Microsoft Corporation:

We consent to the incorporation by reference in Registration Statement Numbers 33-06335, 33-18381, 33-25575, 33-33695, and 33-37623 (Microsoft Corporation 1981 Stock Option Plan), 33-44302 and 33-51583 (Microsoft Corporation 1991 Stock Option Plan), 33-37622 (Microsoft Corporation 1991 Employee Stock Purchase Plan), 33-10732 (Microsoft Corporation Savings Plus Plan), 33-36498 (Microsoft Corporation Stock Option Plan for Non-Employee Directors), 33-45617 (Microsoft Corporation Stock Option Plan for Consultants and Advisors), 333-16665 (Microsoft Corporation 1997 Employee Stock Purchase Plan), 333-61729 (Microsoft Corporation 1998 Special Stock Award Program), and 33-06298 of Microsoft Corporation on Forms S-8 and 33-29823, 33-34794, 33-36347, 33-46958, 33-49496, 33-56039, 33-57277, 33-57899, 33-58867, 33-62725, 33-63471, 33-64870, 333-857, 333-1177, 333-2759, 333-5961, 333-8081, 333-12441, 333-17143, 333-18055, 333-18195, 333-23621, 333-31803, 333-37841, 333-41387, 333-43449, 333-45989, 333-52377, and 333-61507 of Microsoft Corporation on Forms S-3, and 333-26411 of Microsoft Corporation on Form S-4 of our report dated July 17, 1997 (August 1, 1997 as to Acquisition Note) appearing in and incorporated by reference in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 1998.

/s/ Deloitte & Touche LLP
Deloitte & Touche LLP
Seattle, Washington
September 23, 1998

This schedule contains summary financial information extracted from the accompanying financial statements and is qualified in its entirety by reference to such financial statements.

1,000,000

YEAR		
	JUN-30-1998	
	JUN-30-1998	13,927
		0
	1,460	0
		0
	15,889	3,052
	1,547	
	22,357	
	5,730	0
	0	980
		8,025
22,357		7,622
		14,484
	14,484	1,197
	1,197	
	6,873	
	0	
	0	
	7,117	
	2,627	
4,462		0
	0	0
		0
	4,462	
	1.83	
	1.67	