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

FORM 10-Q

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

For the Quarterly Period Ended December 31, 2001

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
(Exact name of registrant as specified in its charter)

Washington	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

One Microsoft Way, Redmond, Washington 98052-6399
(Address of principal executive office) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

The number of shares outstanding of the registrant's common stock as of January 31, 2002 was 5,415,221,834.

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2001

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

INCOME STATEMENTS

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

	Three Months Ended		Six Months Ended	
	2000	Dec. 31 2001	2000	Dec. 31 2001
Revenue	\$6,550	\$7,741	\$12,316	\$13,867
Operating expenses:				
Cost of revenue	864	1,544	1,689	2,428
Research and development	990	1,044	1,946	2,057
Sales and marketing	1,290	1,479	2,328	2,624
General and administrative	212	833	382	1,020
Total operating expenses	3,356	4,900	6,345	8,129
Operating income	3,194	2,841	5,971	5,738
Losses on equity investees and other	(28)	(37)	(80)	(67)
Investment income/(loss)	751	553	1,878	(427)
Income before income taxes	3,917	3,357	7,769	5,244
Provision for income taxes	1,293	1,074	2,564	1,678
Income before accounting change	2,624	2,283	5,205	3,566
Cumulative effect of accounting change (net of income taxes of \$185)	-	-	(375)	-
Net income	\$2,624	\$2,283	\$ 4,830	\$ 3,566
Basic earnings per share:				
Before accounting change	\$0.49	\$0.42	\$0.98	\$0.66
Cumulative effect of accounting change	-	-	(0.07)	-
	\$0.49	\$0.42	\$0.91	\$0.66
Diluted earnings per share:				
Before accounting change	\$0.47	\$0.41	\$0.93	\$0.64
Cumulative effect of accounting change	-	-	(0.06)	-
	\$0.47	\$0.41	\$0.87	\$0.64
Weighted average shares outstanding:				
Basic	5,330	5,395	5,325	5,396
Diluted	5,570	5,556	5,572	5,561

See accompanying notes.

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

	June 30 2001	Dec. 31 2001 (1)
Assets		
Current assets:		
Cash and equivalents	\$3,922	\$5,256
Short-term investments	27,678	32,973
Total cash and short-term investments	31,600	38,229
Accounts receivable, net of allowance for doubtful accounts of \$174 and \$204	3,671	5,095
Deferred income taxes	1,522	1,972
Other	2,417	2,692
Total current assets	39,210	47,988
Property and equipment, net	2,309	2,240
Equity and other investments	14,361	12,212
Goodwill	1,511	1,511
Intangible assets, net	401	344
Deferred income taxes	-	141
Other long-term assets	1,038	951
Total assets	\$58,830	\$65,387
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$1,188	\$1,229
Accrued compensation	742	899
Income taxes	1,468	2,396
Short-term unearned revenue	4,395	5,300
Other	1,461	1,743
Total current liabilities	9,254	11,567
Long-term unearned revenue	1,219	1,321
Deferred income taxes	409	-
Other long-term liabilities	659	951
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital - shares authorized 12,000; outstanding 5,383 and 5,403	28,390	30,175
Retained earnings, including accumulated other comprehensive income of \$587 and \$754	18,899	21,373
Total stockholders' equity	47,289	51,548
Total liabilities and stockholders' equity	\$58,830	\$65,387

(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS
(In millions)(Unaudited)

	Six Months Ended Dec. 31	
	2000	2001
Operations		
Net income	\$ 4,830	\$ 3,566
Cumulative effect of accounting change, net of tax	375	-
Depreciation, amortization, and other noncash items	489	577
Net recognized (gains)/losses on investments	(843)	1,462
Stock option income tax benefits	897	751
Deferred income taxes	996	(861)
Unearned revenue	3,288	3,825
Recognition of unearned revenue	(2,980)	(2,863)
Accounts receivable	(898)	(1,399)
Other current assets	(448)	97
Other long-term assets	(31)	(25)
Other current liabilities	155	1,602
Other long-term liabilities	49	222
Net cash from operations	5,879	6,954
Financing		
Common stock issued	698	786
Common stock repurchased	(3,225)	(1,266)
Repurchases of put warrants	(405)	-
Net cash used for financing	(2,932)	(480)
Investing		
Additions to property and equipment	(517)	(322)
Purchases of investments	(26,525)	(32,439)
Maturities of investments	2,970	2,290
Sales of investments	19,818	25,322
Net cash used for investing	(4,254)	(5,149)
Net change in cash and equivalents	(1,307)	1,325
Effect of exchange rates on cash and equivalents	(8)	9
Cash and equivalents, beginning of period	4,846	3,922
Cash and equivalents, end of period	\$ 3,531	\$ 5,256

See accompanying notes.

MICROSOFT CORPORATION

STOCKHOLDERS' EQUITY STATEMENTS
(In millions)(Unaudited)

	Three Months Ended Dec. 31		Six Months Ended Dec. 31	
	2000	2001	2000	2001
Common stock and paid-in capital				
Balance, beginning of period	\$26,661	\$29,296	\$23,195	\$28,390
Common stock issued	656	432	3,711	1,041
Common stock repurchased	(97)	(23)	(220)	(141)
Repurchases of put warrants	(486)	-	(405)	-
Stock option income tax benefits	444	336	897	751
Other, net	-	134	-	134
Balance, end of period	27,178	30,175	27,178	30,175
Retained earnings				
Balance, beginning of period	18,682	19,209	18,173	18,899
Net income	2,624	2,283	4,830	3,566
Other comprehensive income:				
Cumulative effect of accounting change	-	-	(75)	-
Net gains/(losses) on derivative instruments	67	8	499	(43)
Net unrealized investments gains/(losses)	(682)	105	(1,166)	151
Translation adjustments and other	(71)	20	(12)	59
Comprehensive income	1,938	2,416	4,076	3,733
Common stock repurchased	(1,376)	(252)	(3,005)	(1,259)
Balance, end of period	19,244	21,373	19,244	21,373
Total stockholders' equity	\$46,422	\$51,548	\$46,422	\$51,548

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments, consisting only of normal recurring items, as well as the accounting changes to adopt Statement of Financial Accounting Standards (SFAS) 133, Accounting for Derivative Instruments and Hedging Activities, SFAS 141, Business Combinations, and SFAS 142, Goodwill and Other Intangible Assets, necessary for their fair presentation in conformity with U.S. generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns, concessions and bad debts, and the length of product life cycles and building lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 2001 Form 10-K. Certain reclassifications have been made for consistent presentation.

Accounting Changes

Effective July 1, 2000, Microsoft adopted SFAS 133, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The adoption of SFAS 133 resulted in a pre-tax reduction to income of \$560 million (\$375 million after-tax) and a pre-tax reduction to other comprehensive income (OCI) of \$112 million (\$75 million after-tax).

Effective July 1, 2001, Microsoft adopted SFAS 141 and SFAS 142. SFAS 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting. It also specifies the types of acquired intangible assets that are required to be recognized and reported separate from goodwill. SFAS 142 requires that goodwill and certain intangibles no longer be amortized, but instead tested for impairment at least annually. There was no impairment of goodwill upon adoption of SFAS 142.

Net income and earnings per share for the second quarter and first six months of fiscal 2001 adjusted to exclude amortization expense (net of taxes) is as follows:

(In millions, except earnings per share)	Three Months Ended Dec. 31 2000	Six Months Ended Dec. 31 2000

Net income:		
Reported net income	\$2,624	\$4,830
Goodwill amortization	62	118
Equity method goodwill amortization	7	12

Adjusted net income	\$2,693	\$4,960
=====		
Basic earnings per share:		
Reported basic earnings per share	\$0.49	\$0.91
Goodwill amortization	0.01	0.02
Equity method goodwill amortization	-	-

Adjusted basic earnings per share	\$0.50	\$0.93
=====		
Diluted earnings per share:		
Reported diluted earnings per share	\$0.47	\$0.87
Goodwill amortization	0.01	0.02
Equity method goodwill amortization	-	-

Adjusted diluted earnings per share	\$0.48	\$0.89
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During the second quarter and first six months of fiscal 2002, no goodwill was acquired, impaired, or written off. As of December 31, 2001, Desktop and Enterprise Software and Services goodwill was \$1.10 billion, Consumer Software, Services, and Devices goodwill was \$256 million, and Consumer Commerce Investments goodwill was \$151 million.

All of Microsoft's acquired intangible assets are subject to amortization. There were no material acquisitions of intangible assets during the second quarter of fiscal 2002. During the first six months of fiscal 2002, the Company acquired \$28 million in contract-based intangible assets, \$13 million in technology-based intangible assets, and \$1 million in marketing-related and other intangible assets, which will be amortized over approximately 3 years. No significant residual value is estimated for these intangible assets. Intangible assets amortization expense was \$51 million for the second quarter of fiscal 2002 and \$99 million for the first six months of fiscal 2002. The components of intangible assets were as follows:

(In millions)	June 30, 2001		Dec. 31, 2001	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Contract-based	\$407	\$(177)	\$435	\$(240)
Technology-based	157	(27)	170	(49)
Marketing-related and other	83	(42)	84	(56)
Intangible assets	\$647	\$(246)	\$689	\$(345)

Amortization expense for the net carrying amount of intangible assets at December 31, 2001 is estimated to be \$90 million for the remainder of fiscal 2002, \$125 million in fiscal 2003, \$88 million in fiscal 2004, \$38 million in fiscal 2005, and \$3 million in fiscal 2006.

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 put warrants using the "reverse treasury stock" method and outstanding stock options using the "treasury stock" method.

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

EARNINGS PER SHARE

(In millions, except earnings per share)

	Three Months Ended		Six Months Ended	
	2000	Dec. 31 2001	2000	Dec. 31 2001
Income before accounting change (A)	\$2,624	\$2,283	\$5,205	\$3,566
Cumulative effect of accounting change	-	-	(375)	-
Net income available for common shareholders	\$2,624	\$2,283	\$4,830	\$3,566
Weighted average outstanding shares of common stock (B)	5,330	5,395	5,325	5,396
Dilutive effect of:				
Put warrants	31	-	20	-
Employee stock options	209	161	227	165
Common stock and common stock equivalents (C)	5,570	5,556	5,572	5,561
Earnings per share before accounting change:				
Basic (A/B)	\$0.49	\$0.42	\$0.98	\$0.66
Diluted (A/C)	\$0.47	\$0.41	\$0.93	\$0.64

Revenue Recognition

Revenue from products licensed to original equipment manufacturers (OEMs) has historically been recorded when OEMs ship licensed products to their customers. With the introduction of Windows XP in the second quarter of

fiscal 2002 and the implementation of a new internet-based system for granting licenses to OEMs on a just in time basis, revenue for certain products is recorded when the OEMs receive the licensed product, rather than when they ship licensed products to their customers. The effect of this change in the second quarter of fiscal 2002 was not material.

A portion of Microsoft's revenue is earned ratably over the product life cycle or, in the case of subscriptions, over the period of the license agreement. End users receive certain elements of the Company's products over a period of time. These elements include browser technologies and technical support. Consequently, Microsoft's earned revenue reflects the recognition of the fair value of these elements over the product's life cycle. The percentage of revenue recognized ratably ranges from approximately 15% to 25% of Windows desktop operating systems and approximately 10% to 20% of desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three years for Windows operating systems and 18 months for desktop applications. The Company also sells subscriptions to certain products via maintenance and certain organization license agreements.

At December 31, 2001, unearned revenue was \$6.62 billion, compared to \$5.12 billion at December 31, 2000. Desktop Applications unearned revenue was \$2.88 billion, compared to \$1.94 billion at December 31, 2000. Desktop Platforms unearned revenue was \$2.96 billion, compared to \$2.49 billion at December 31, 2000. Enterprise Software and Services unearned revenue was \$493 million, compared to \$393 million at December 31, 2000. Unearned revenue associated with Consumer Software, Services, and Devices and Other was \$287 million, compared to \$304 million a year ago.

Stockholders' Equity

The Company repurchases its common shares in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During the December quarter, the Company repurchased 2.7 million shares of common stock for \$141 million, compared to 22.8 million shares for \$1.5 billion in the comparable quarter of the prior year. For the first six months of fiscal 2002, the Company repurchased 24.3 million shares of common stock for \$1.3 billion, compared to 48.2 million shares of common stock for \$3.2 billion in the comparable period of the prior year. In addition, 2.6 million shares of common stock were acquired in the second quarter of fiscal 2002 under a structured stock repurchase transaction. The Company entered into the structured stock repurchase transaction in fiscal 2001 and agreed to acquire 5.1 million of its shares (half in October 2001 and half in June 2002) in exchange for an up-front net payment of \$264 million.

Operational Transactions

On December 19, 2001, AT&T and Comcast Corporation announced a definitive agreement to combine AT&T Broadband with Comcast in a new company to be called AT&T Comcast Corporation. In conjunction with the transaction, Microsoft has agreed to exchange its AT&T 5% convertible preferred debt for approximately 115 million shares of AT&T Comcast Corporation. It is expected that the transaction will close by December 31, 2002.

Investment Income/(Loss)

The components of investment income/(loss) are as follows:

(In millions)	Three Months Ended		Six Months Ended	
	2000	2001	2000	2001
		Dec. 31		Dec. 31
Dividends	\$ 88	\$ 81	\$ 185	\$ 169
Interest	419	417	850	866
Recognized net gains/(losses) on investments	244	55	843	(1,462)
Investment income/(loss)	\$751	\$553	\$1,878	(\$427)

Contingencies

The Company is a defendant in U.S. v. Microsoft, a lawsuit filed by the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of eighteen state Attorneys General alleging violations of the Sherman Act and various state antitrust laws. After the trial, the District Court entered Findings of Fact and Conclusions of Law stating that Microsoft had violated Sections 1 and 2 of the Sherman Act and various state antitrust laws. A Judgment was entered on June 7, 2000 ordering, among other things, the breakup of Microsoft into two companies. The Judgment was stayed pending an appeal. On June 28, 2001, the U.S. Court of Appeals for the District of Columbia Circuit

affirmed in part, reversed in part, and vacated the Judgment in its entirety and remanded the case to the District Court for a new trial on one Section 1 claim and for entry of a new judgment consistent with its ruling. In its ruling, the Court of Appeals substantially narrowed the bases of liability found by the District Court, but affirmed some of the District Court's conclusions that Microsoft had violated Section 2. On September 6, 2001, the plaintiffs announced that on remand they will not ask the Court to break Microsoft up, that they will seek imposition of conduct remedies, and that they will not retry the one Section 1 claim returned to the District Court by the Court of Appeals. On October 12, 2001, the trial court held a status conference and entered orders requiring the parties to engage in settlement discussions until November 2, 2001. Microsoft entered into a settlement with the United States on November 2, 2001. Nine states (New York, Ohio, Illinois, Kentucky, Louisiana, Maryland, Michigan, North Carolina and Wisconsin) agreed to settle on substantially the same terms on November 6, 2001. Nine states and the District of Columbia continue to litigate the remedies phase of United States v. Microsoft. The Court will now decide whether to approve the settlement as being in the public interest. With respect to the non-settling states remedies proceeding, the Court has scheduled an evidentiary hearing to begin on March 11, 2002. The non-settling States are seeking imposition of a remedy that would impose much broader restrictions on Microsoft's business than the proposed settlement with the Department of Justice and nine other states.

In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues. In addition, the European Commission has instituted proceedings in which it alleges that Microsoft has failed to disclose information that Microsoft competitors claim they need to interoperate fully with Windows 2000 clients and servers and has engaged in discriminatory licensing of such technology. The remedies sought, though not fully defined, include mandatory disclosure of Microsoft Windows operating system technology and imposition of fines. Microsoft denies the European Commission's allegations and intends to contest the proceedings vigorously.

A large number of overcharge class action lawsuits have been initiated against Microsoft. These cases allege that Microsoft has competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications and seek to recover alleged overcharges that the complaints contend Microsoft charged for these products. Microsoft believes the claims are without merit and is vigorously defending the cases. To date, Microsoft has won dismissals of all claims for damages by indirect purchasers under Federal law and in 15 separate state court proceedings. Claims on behalf of foreign purchasers have also been dismissed. Plaintiffs have appealed most of these rulings. While no trials or other proceedings have been held concerning any liability issues, courts in several states have ruled that these cases may proceed as class actions, while one court has denied class certification status to the claims in that state proceeding. On November 20, 2001, Microsoft announced that it and lead counsel for the Federal plaintiffs reached an agreement to settle all of these cases. On January 11, 2002, the District Court announced its decision not to approve the proposed settlement. The Company has recorded a contingent liability of approximately \$660 million representing Management's estimate of the costs of resolving the contingency. The Company intends to continue vigorously defending these lawsuits.

Netscape Communications Inc., a subsidiary of AOL-Time Warner Inc., filed an antitrust law suit against Microsoft on January 22, 2002 in Federal court in the District of Columbia, alleging a number of claims relating to competition with Netscape's Navigator browser. Netscape seeks injunctive relief, treble damages and its fees and costs. Microsoft denies these allegations and will vigorously defend this action.

A purported class action employment discrimination case filed in October 2000 in Federal court in Seattle, Washington against Microsoft, Donaldson v. Microsoft, was denied class certification status by a Federal judge on November 16, 2001. The Donaldson plaintiffs purported to represent a nationwide class of current and former African American and female Microsoft employees and alleged that Microsoft's compensation, evaluation, and promotion policies were discriminatory with respect to the plaintiffs in violation of Title VII of the 1964 Civil Rights Act and 42 U.S.C. ss. 1981. The court disagreed, finding no statistical support for plaintiffs' allegations and held that Microsoft's managerial system is not flawed. Following the court's ruling, the parties resolved their differences and the case is expected to be dismissed shortly.

The Securities and Exchange Commission is conducting a non-public investigation into the Company's accounting reserve practices. Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

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

Segment Information
(In millions)

Three Months Ended Dec. 31	Desktop and Enterprise Software and Services	Consumer Software, Services, and Devices	Consumer Commerce Investments	Other	Reconciling Amounts	Consolidated
2000						
Revenue	\$5,967	\$ 479	\$ 64	\$188	\$(148)	\$6,550
Operating income (loss)	3,982	(436)	(25)	31	(358)	3,194
2001						
Revenue	\$6,435	\$1,063	\$ 91	\$163	\$(11)	\$7,741
Operating income (loss)	4,098	(465)	6	22	(820)	2,841
Six Months Ended Dec. 31						
2000						
Revenue	\$11,086	\$ 942	\$127	\$344	\$(183)	\$12,316
Operating income (loss)	7,367	(697)	(64)	51	(686)	5,971
2001						
Revenue	\$11,868	\$1,547	\$185	\$289	\$(22)	\$13,867
Operating income (loss)	7,511	(783)	12	38	(1,040)	5,738

Desktop and Enterprise Software and Services Revenue:

(In millions)	Three Months Ended Dec. 31		Six Months Ended Dec. 31	
	2000	2001	2000	2001
Desktop Applications	\$2,526	\$2,451	\$4,601	\$4,663
Desktop Platforms	2,181	2,678	4,173	4,694
Desktop Software	4,707	5,129	8,774	9,357
Enterprise Software and Services	1,260	1,306	2,312	2,511
Total Desktop and Enterprise Software and Services	\$5,967	\$6,435	\$11,086	\$11,868

Microsoft has four segments: Desktop and Enterprise Software and Services; Consumer Software, Services, and Devices; Consumer Commerce Investments; and Other. Desktop and Enterprise Software and Services operating segment includes Desktop Applications, Desktop Platforms, and Enterprise Software and Services. Desktop Applications include Microsoft Office; Microsoft Project; Visio; client access licenses for Windows NT Server and Windows 2000 Server, Exchange, and BackOffice; Microsoft Great Plains; and bCentral. Desktop Platforms include Windows XP Professional and Home, Windows 2000 Professional, Windows NT Workstation, Windows Millennium Edition (Windows Me), Windows 98, and other desktop operating systems. Enterprise Software and Services includes Server Platforms; Server Applications; developer tools and services; and Enterprise services. Consumer Software, Services, and Devices operating segment includes Xbox video game system, MSN Internet access, MSN network services, PC and online games, learning and productivity software, mobility, and embedded systems. Consumer Commerce Investments operating segment includes Expedia, Inc., the HomeAdvisor online real estate service, and the CarPoint online automotive service. Other primarily includes Hardware and Microsoft Press.

Segment information is presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The Company's financial reporting systems present various data for management to run the business,

including profit and loss statements (P&Ls) prepared on a basis not consistent with U.S. generally accepted accounting principles. Assets are not allocated to segments for internal reporting presentations.

Reconciling items for revenue include certain elements of unearned revenue and the treatment of certain channel inventory amounts and estimates. In addition to the reconciling items for revenue, reconciling items for operating income (loss) for the three months ended December 31, include general and administrative expenses (\$212 million in 2000 and \$833 million in 2001), certain research expenses (\$35 million in 2000 and \$40 million in 2001), and other corporate level adjustments. For the six months ended December 31, reconciling items for operating income (loss) include general and administrative expenses (\$382 million in 2000 and \$1.02 billion in 2001), certain research expenses (\$74 million in 2000 and \$77 million in 2001), and other corporate level adjustments. The internal P&Ls use accelerated methods of depreciation and amortization. Additionally, losses on equity investees and minority interests are classified in operating income for internal reporting presentations.

Subsequent Event

On February 4, 2002, USA Networks, Inc. (USA) shareholders approved the merger transaction in which USA became the controlling shareholder of Expedia, Inc. As part of the transaction, Microsoft transferred all of its 33.7 million Expedia shares and warrants. In return, Microsoft received 20.1 million shares of USA common stock, 12.8 million shares of USA cumulative convertible preferred stock, and 14.2 million USA warrants.

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

Results of Operations

Microsoft develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices. Microsoft software includes scalable operating systems for servers, personal computers (PCs), and intelligent devices; server applications for client/server environments; knowledge worker productivity applications; and software development tools. The Company's online efforts include the MSN network of Internet products and services and alliances with companies involved with broadband access and various forms of digital interactivity. Microsoft also licenses consumer software programs; sells hardware devices; provides consulting services; trains and certifies system integrators and developers; and researches and develops advanced technologies for future software products. On November 15, 2001, Microsoft launched Xbox, its future-generation video game system.

Management's Discussion and Analysis contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors such as: entry into markets with vigorous competition, market acceptance of new products and services, continued acceptance of existing products and services, changes in licensing programs, delays in product development and related product release schedules, reliance on sole source suppliers, or shortages of key components for hardware products that delay product delivery, any of which may cause revenues and income to fall short of anticipated levels; obsolete inventory or product returns by distributors, resellers and retailers; warranty and other claims on hardware products; higher relative marketing expenses associated with new product releases; changes in the rate of PC shipments; technological shifts; customer demand for Microsoft's products and services; the support of third party software developers for new or existing platforms; the availability of competitive products or services at prices below Microsoft's prices or for no charge; changes in product and service mix; product life cycles; product sale terms and conditions; the company's ability to efficiently integrate acquired businesses; implementation of cost structures that align with revenue growth; the financial condition of Microsoft's customers and vendors; unavailability of insurance; uninsured losses; adverse results in litigation; the effects of terrorist activity and armed conflict such as disruptions in general economic activity and changes in Microsoft's operations and security arrangements; general economic conditions that affect demand for computer hardware or software; currency fluctuations; trade sanctions or changes to U.S. tax law resulting from the World Trade Organization decision with respect to the extraterritorial income provisions of U.S. tax law; financial market volatility or other changes affecting the value of Microsoft's investments that may result in a reduction in carrying value and recognition of losses; and other issues discussed in the Company's 2001 Form 10-K.

Revenue

Revenue for the second quarter of fiscal year 2002 was \$7.74 billion, an increase of 18% over the second quarter of fiscal 2001. The revenue growth was driven primarily by the launch of Microsoft Xbox video game system and licensing of Microsoft Windows XP Home and Professional operating systems. For the first six months of fiscal year 2002, revenue was \$13.87 billion, an increase of 13% over the first six months of fiscal 2001. The revenue growth was driven primarily by licensing of Microsoft XP Home and Professional and Windows 2000 Professional, the launch of Microsoft Xbox video game system, and licensing of Microsoft SQL Server.

Product Revenue

Microsoft has four segments: Desktop and Enterprise Software and Services; Consumer Software, Services, and Devices; Consumer Commerce Investments; and Other. The Management Discussion and Analysis presentation of revenue differs from that reported under the Company's Segment Information appearing in the Notes to Financial Statements because reconciling items are allocated to those segments.

Desktop and Enterprise Software and Services includes Desktop Applications; Desktop Platforms; and Enterprise Software and Services. Desktop and Enterprise Software and Services revenue was \$6.29 billion for the second quarter, an increase of 9% from \$5.79 billion recorded in the second quarter of the prior year. For the first six months of fiscal 2002, Desktop and Enterprise Software and Services revenue was \$11.69 billion, up 8% from \$10.85 billion in the prior year.

Desktop Applications includes revenue from Microsoft Office; Microsoft Project; Visio; client access licenses (CALs) for Windows NT Server and Windows 2000 Server, Exchange, and BackOffice; Microsoft Great Plains; and bCentral. Revenue from Desktop Applications was \$2.45 billion in the December quarter of fiscal 2002, declining slightly from the \$2.49 billion in the prior year's December quarter. The decline was due to a higher mix of multi-

year licensing agreements, resulting in an increase in revenue deferred to future quarters, and a slowdown in consumer purchases in the Asia region, most notably Japan. Revenue from client access licenses grew only slightly in the second quarter due to a ramp up in licensing of Exchange, BackOffice, and Windows NT Server and Windows 2000 Server CALs in the prior year's comparable quarter. Microsoft Great Plains revenue partially offset the decline in Desktop Applications revenue. Revenue from Desktop Applications was \$4.64 billion in the first half of fiscal 2002, flat in comparison with \$4.62 billion in the prior year. The decline in Office revenue was offset by revenue from Microsoft Great Plains and growth in revenue from client access licenses.

Desktop Platforms includes revenue from Windows XP Professional and Home, Windows 2000 Professional, Windows NT Workstation, Windows Me, Windows 98, and other desktop operating systems. Desktop Platforms revenue was \$2.55 billion in the second quarter, representing 24% growth from the second quarter of the prior year. Revenue was \$4.57 billion in the first half of fiscal 2002, representing 16% growth from the first half of fiscal 2001. This growth was driven by the onset of revenue from Windows XP Home and Professional operating systems retail sales, a higher mix of Windows 2000 and Windows XP Professional, and a resurgence of the system builder and direct OEMs. Revenue growth was partially offset by the contraction of PC shipments. The mix of Windows 2000 and Windows XP Professional as a percentage of all 32-bit operating systems will continue to impact Desktop Platforms revenue growth in the future.

Enterprise Software and Services includes Server Platforms; Server Applications; developer tools and services; and Enterprise services. December quarter revenue was \$1.29 billion, increasing 4% from \$1.24 billion in the December quarter of fiscal 2001. Server Platforms revenue growth was 2%, despite an overall decline in server shipments, led by an increased mix of Windows 2000 Advanced Server. Microsoft SQL Server and other .NET Enterprise Servers revenue grew only 9% from the prior year's second quarter due to a ramp up in licensing in the prior year's comparable quarter when adoption to the new product versions accelerated. Enterprise services revenue, representing consulting and product support services, was up 24% compared to the prior year's comparable quarter. Revenue from developer tools, training and certification, and other services declined 22% from the December quarter of fiscal 2001 as consumers wait for the release of Visual Studio .NET in the March quarter of fiscal 2002. Enterprise Software and Services revenue in the first six months of fiscal 2002 increased 9% to \$2.48 billion. Server Platforms revenue increased 11%, Server Applications revenue increased 19%, Enterprise services revenue increased 25%, and revenue from developer tools and services decreased 25% from the prior year comparable period.

The success of Microsoft's new volume licensing programs will continue to affect the mix of multi-year licensing agreements and the resulting impact on the timing of revenue recognition. In addition, product life cycles and the timing of revenue recognition could be impacted by Microsoft's ongoing .NET and Trustworthy Computing initiatives.

Consumer Software, Services, and Devices includes Xbox video game system, MSN Internet access, MSN network services, PC and online games, learning and productivity software, mobility, and embedded systems. Consumer Software, Services, and Devices revenue reached \$1.20 billion in the second quarter of fiscal 2002, compared to \$506 million in the second quarter of the prior year. Consumer Software, Services, and Devices revenue reached \$1.70 billion in the first six months of fiscal 2002, compared to \$985 million in the first six months of the prior year. The majority of the revenue growth from the prior year stemmed from the successful November 15 launch of the Xbox video game system in the United States and Canada. MSN Internet access revenue grew strongly as a result of an increased subscriber base, partially offset by a decline in the average revenue per subscriber due to a larger mix of subscribers contracted under promotional programs. Revenue from MSN network services continues to be affected by difficult economic conditions in the online advertising marketplace. Learning and productivity software revenue and PC and online games revenue declined due to the timing of new product releases and the softness in the overall consumer market. The continued success of Xbox in the United States and Canada, as well as the successful launches of Xbox in Japan, Europe, and Australia will be significant factors affecting revenue growth in the Consumer Software, Services, and Devices segment.

Consumer Commerce Investments include Expedia, Inc., the HomeAdvisor online real estate service, and the CarPoint online automotive service. Second quarter revenue totaled \$90 million, compared to \$64 million in the prior year's second quarter. Revenue for the first six months totaled \$184 million, compared to \$127 million in the prior year. Prior year revenue for Expedia, Inc. has been reclassified to reflect the reporting change of merchant revenue to a net basis, which represents the amount charged to the customer less the amount paid to the supplier.

On February 4, 2002, USA Networks, Inc. (USA) shareholders approved the merger transaction in which USA became the controlling shareholder of Expedia, Inc. As part of the transaction, Microsoft transferred all of its 33.7 million Expedia shares and warrants. In return, Microsoft received 20.1 million shares of USA common stock, 12.8 million shares of USA cumulative convertible preferred stock, and 14.2 million USA warrants.

Other primarily includes Hardware and Microsoft Press. Other revenue was \$163 million in the second quarter of fiscal 2002, declining from \$188 million reported in the prior year's December quarter. For the first half of fiscal 2002, Other revenue was \$292 million, compared to \$353 million reported in the prior year. Lower sales of Microsoft Press books due to the overall weakness in the consumer market and lower hardware peripheral sales contributed to the decline in revenue.

Distribution Channels

Microsoft distributes its products primarily through OEM licenses, organizational licenses, online services and products, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers who pre-install Microsoft products, primarily on PCs. Microsoft has three major geographic sales and marketing organizations: the South Pacific and Americas Region; the Europe, Middle East, and Africa Region; and the Asia Region. Sales of organizational licenses and retail packaged products via these channels are primarily to and through distributors and resellers.

OEM second quarter revenue was \$2.39 billion, up 16% from revenue of \$2.05 billion in the comparable quarter of fiscal 2001. For the first six months, OEM revenue was \$4.37 billion, up 13% from revenue of \$3.89 billion in the comparable period of fiscal 2001. Although total licenses reported declined from the prior year, revenue growth was positively impacted by the launch of Windows XP Professional and Home operating systems, an increased mix of the higher priced Windows 2000 and Windows XP Professional licenses, a higher average revenue per license, and the recognition of unearned revenue, which had been deferred in prior periods when PC growth rates were higher. Additionally, OEM revenue reflected resurgence in the system builder and direct OEMs. The recognition of unearned revenue which had been deferred in prior periods when PC shipment growth rates were higher is expected to have a smaller impact on revenue growth in future quarters. In addition, a sustained decline in PC shipments could result in a reduction of OEM revenue in future periods.

South Pacific and Americas Region revenue in the December quarter was \$3.24 billion, up 39% compared to \$2.33 billion in the prior year. Revenue in the first six months of fiscal 2002 was \$5.67 billion, up 26% compared to \$4.49 billion in the prior year. Revenue from the United States was the primary driver of the region's revenue growth, reflecting the launch of Xbox. Strong licensing of the new Windows XP operating systems and revenue from Microsoft Great Plains also contributed to the growth. Other product offerings influencing the growth included MSN access and .NET Enterprise Servers.

Europe, Middle East, and Africa Region revenue was \$1.42 billion, declining 1% from the \$1.43 billion reported in the second quarter of the prior year. The results were largely affected by a higher mix of multi-year licensing agreements in the second quarter of 2002, which deferred revenue to future quarters. This change in mix contributed to the decline in earned revenue from Office suites, however, revenue from the newly launched Windows XP Home and Professional operating systems and Enterprise Software was very healthy. For the first six months of fiscal 2002, revenue was \$2.52 billion, flat in comparison to the first six months of fiscal 2001. Revenue in the region would have decreased 4% in the second quarter and increased 1% in the first six months of fiscal 2002 if foreign exchange rates were constant with those of the prior year.

Asia Region revenue decreased 4% to \$705 million from \$737 million in the December quarter of the prior year. For the first six months of fiscal 2002, revenue decreased 9% to \$1.31 billion from the similar period of the prior year. The region's revenue decline was influenced by deteriorating economic conditions and declining consumer PC shipments, which affected the sales of localized versions of Microsoft Office XP. Had foreign exchange rates been held constant with those of the second quarter of 2001, revenue in the region would have grown 5%. Revenue for the first six months of fiscal 2002 would have been flat in comparison to the first six months of fiscal 2001 if foreign exchange rates were constant with those of the prior year.

Translated international revenue is affected by foreign exchange rates. The net impact of foreign exchange rates on revenue was negative in the December quarter compared to a year ago, due to a weaker Japanese yen, partially offset

by stronger European currencies versus the U.S. dollar. Had the rates from the prior year's comparable quarter been in effect in the second quarter of fiscal 2002, translated international revenue billed in local currencies would have been approximately \$38 million higher. The net impact of foreign exchange rates on revenue was also negative in the first six months of fiscal 2002 compared to a year ago, due to weaker Japanese and European currencies versus the U.S. dollar. Had the rates from the prior year's comparable period been in effect in the first six months of fiscal 2002, translated international revenue billed in local currencies would have been approximately \$181 million higher. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

Operating Expenses

Effective July 1, 2001, Microsoft adopted Statement of Financial Accounting Standards (SFAS) 141, Business Combinations, and SFAS 142, Goodwill and Other Intangible Assets. SFAS 141 requires business combinations to be accounted for using the purchase method of accounting. It also specifies the types of acquired intangible assets that are required to be recognized and reported separate from goodwill. SFAS 142 requires that goodwill and certain intangibles no longer be amortized, but instead tested for impairment at least annually. There was no impairment of goodwill upon adoption of SFAS 142. Goodwill amortization (on a pre-tax basis) was \$76 million in the second quarter of fiscal 2001 and \$145 million for the first six months of fiscal 2001.

Cost of revenue was \$1.54 billion or 19.9% as a percent of revenue in the second quarter, compared to \$864 million or 13.2% as a percent of revenue in the second quarter of the prior year. For the first half of fiscal 2002, cost of revenue was \$2.43 billion or 17.5% as a percentage of revenue, up from \$1.69 billion or 13.7% as a percentage of revenue in the first half of fiscal 2001. The launch of the Xbox video game console in the December quarter of 2002 drove the large majority of the increase from the prior year.

Research and development expenses in the second quarter increased 5% from the second quarter of the prior year to \$1.04 billion. Research and development expenses in the first half of fiscal 2002 increased 6% from the comparable prior year period. R&D expenses increased primarily due to higher Xbox and Windows XP headcount-related and product development costs associated with these new products. The discontinuation of goodwill amortization in accordance with SFAS 142 in fiscal 2002 partially offset the growth in headcount and development costs.

Sales and marketing expenses were \$1.48 billion in the December quarter, or 19.1% of revenue, compared to \$1.29 billion in the second quarter of the prior year, or 19.7% of revenue. Sales and marketing expenses as a percent of revenue decreased primarily due to the large relative increase in revenue associated with the onset of Xbox revenue. Lower relative marketing costs in MSN Network and MSN Access, partially offset by the marketing costs surrounding the launches of Xbox and Windows XP and higher relative headcount-related costs also contributed to the decrease in sales and marketing expenses as a percent of revenue. For the first half of fiscal 2002, sales and marketing expenses were \$2.62 billion, or 18.9% of revenue, compared to \$2.33 billion, or 18.9% of revenue, in the first half of fiscal 2001. Sales and marketing expense as a percentage of revenue was flat reflecting marketing costs surrounding the launches of Xbox and Windows XP and higher relative headcount-related costs, offset by the large relative increase in revenue associated with the onset of Xbox revenue and lower relative marketing costs in MSN Network.

General and administrative costs were \$833 million in the second quarter compared to \$212 million in the comparable quarter of the prior year. General and administrative costs were \$1.02 billion in the first six months compared to \$382 million in the comparable period of the prior year. The general and administrative costs in the December quarter and first six months of fiscal 2002 included a charge of approximately \$660 million for a contingent liability related to the overcharge class action lawsuits. Excluding this charge, higher headcount-related costs were more than offset by insurance recoveries and other miscellaneous items.

Non-operating Items, Investment Income/(Loss), and Income Taxes

Losses on equity investees and other incorporates Microsoft's share of income or loss from investments accounted for using the equity method, and income or loss attributable to minority interests. Losses on equity investees and other increased to \$37 million in the second quarter of fiscal 2002, compared to \$28 million in the comparable quarter of fiscal 2001, due to increased losses associated with the Company's share of MSNBC businesses. The increased loss was partially offset by the elimination of amortization of goodwill on equity investments in accordance with SFAS 142 in fiscal 2002. Losses on equity investees and other decreased to \$67 million in the first six months of fiscal 2002, compared to \$80 million in the comparable period of the prior year, primarily reflecting a

decrease in the number of such investments compared to the first six months of fiscal 2001 in addition to the elimination of amortization of goodwill in accordance with SFAS 142 in fiscal 2002.

In the second quarter, the Company reported \$553 million in investment income. The investment income included \$573 million of bond portfolio return and dividend income and \$20 million in net recognized losses. Net recognized losses included a write down for other-than-temporary impairments of \$127 million, net realized gains on equity securities of \$136 million, and \$29 million in net losses attributable to derivative instruments. In the prior year comparable quarter, the Company reported \$751 million in investment income, which included \$574 million of bond portfolio income and dividends and \$177 million of net recognized gains. For the first six months of fiscal 2002, investment loss was \$427 million. The loss included \$1.19 billion of bond portfolio return and dividend income, offset by \$1.61 billion in net recognized losses. Net recognized losses included a write down for other-than-temporary impairments of \$1.95 billion, primarily as a result of further declines in the fair values of European cable and telecommunications holdings, net realized gains on equity securities of \$527 million, and \$186 million in net losses attributable to derivative instruments. In the comparable six months of the prior year, the Company reported \$1.88 billion in investment income, which included \$1.07 billion of bond portfolio income and dividends and \$805 million of net recognized gains.

At December 31, 2001, unrealized losses on Equity and Other Investments of \$755 million (recorded within other comprehensive income) were deemed to be temporary in nature. Changes in the duration and extent to which the fair value is less than cost; the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors; and the Company's intent and ability to hold the investment, among other factors, could result in some investments being deemed other-than-temporarily impaired in future periods. Unrealized gains on Equity and Other Investments at December 31, 2001 (also recorded within other comprehensive income) were \$2.03 billion.

Effective July 1, 2000, Microsoft adopted SFAS 133, Accounting for Derivative Instruments and Hedging Activities, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The adoption of SFAS 133 resulted in a cumulative pre-tax reduction to income of \$560 million (\$375 million after-tax) and a cumulative pre-tax reduction to other comprehensive income of \$112 million (\$75 million after-tax).

The effective tax rate for fiscal 2002 is estimated to be 32%. The effective tax rate for fiscal 2001 was 33%.

Financial Condition

Cash and short-term investments totaled \$38.23 billion as of December 31, 2001. Cash flow from operations was \$6.95 billion in the first six months of fiscal 2002, an increase of \$1.08 billion from the first six months of the prior year. The increase reflects strong growth in earned and unearned revenue, partially offset by an increase in accounts receivable and other working capital. Cash used for financing was \$480 million in the first six months of fiscal 2002, a decrease of \$2.45 billion from the first six months of the prior year. The decrease reflects lower common stock repurchases and the repurchase of put warrants in the prior year. During the first six months of fiscal 2002, the Company repurchased 24.3 million shares of common stock under its share repurchase program, compared to 48.2 million shares repurchased in the first six months of the prior year. In addition, 2.6 million shares of common stock were acquired in the second quarter of fiscal 2002 under a structured stock repurchase transaction. The Company entered into the structured stock repurchase transaction in the third quarter of fiscal 2001 and agreed to acquire 5.1 million of its shares (half in October 2001 and half in June 2002) in exchange for an up-front net payment of \$264 million. Cash used for investing was \$5.15 billion in the first six months of fiscal 2002, an increase of \$895 million from the first six months of the prior year, reflecting the increase in the investment portfolio.

Microsoft has no material long-term debt. Stockholders' equity at December 31, 2001 was \$51.55 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. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were \$126 million on December 31, 2001. The Company has not engaged in any transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to affect materially liquidity or the availability of or requirements for capital resources. Since fiscal 1990, Microsoft has repurchased 881 million common shares while 2.17 billion shares were issued under the Company's employee stock option and purchase plans.

Management believes existing cash and short-term investments together with funds generated from operations should be sufficient to meet operating requirements. The Company's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale needs and to fund the share repurchase program. Microsoft has not paid cash dividends on its common stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to foreign currency, interest rate, and securities price risks. A portion of these risks is hedged, but fluctuations could impact the Company's results of operations and financial position. The Company hedges the exposure of accounts receivable and a portion of anticipated revenue to foreign currency fluctuations, primarily with option contracts. The Company monitors its foreign currency exposures daily to maximize the overall effectiveness of its foreign currency hedge positions. Principal currencies hedged include the Euro, Japanese yen, British pound, and Canadian dollar. Fixed income securities are subject to interest rate risk. The portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. The Company routinely uses options to hedge its exposure to interest rate risk in the event of a catastrophic increase in interest rates. Many securities held in the Company's equity and other investments portfolio are subject to price risk. The Company uses options to hedge its price risk on certain highly volatile equity securities.

The Company uses a value-at-risk (VAR) model to estimate and quantify its market risks. The VAR model is not intended to represent actual losses in fair value, but is used as a risk estimation and management tool. Assumptions applied to the VAR model at June 30, 2001 and December 31, 2001 include the following: normal market conditions; Monte Carlo modeling with 10,000 simulated market price paths; a 97.5% confidence interval; and a 20-day estimated loss in fair value for each market risk category. Accordingly, 97.5% of the time the estimated 20-day loss in fair value would not exceed \$66 million and \$85 million at June 30, 2001 and December 31, 2001 for foreign currency denominated investments and accounts receivable, \$363 million and \$430 million at June 30, 2001 and December 31, 2001 for interest-sensitive investments, or \$520 million and \$339 million at June 30, 2001 and December 31, 2001 for equity securities.

Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Shareholders was held on November 7, 2001.

The following proposal was adopted by the margins indicated:

1. To elect a Board of Directors to hold office until their successors are elected and qualified. Number of Shares

	Number of Shares	
	For	Withheld
William H. Gates, III	4,340,965,193	296,482,703
Steven A. Ballmer	4,336,639,640	300,808,256
James I. Cash	4,607,613,804	29,834,092
Raymond V. Gilmartin	4,579,207,377	58,240,519
David F. Marquardt	4,609,054,130	28,393,766
Ann McLaughlin Korologos	4,606,847,011	30,600,885
William G. Reed, Jr.	4,608,933,110	28,514,786
Jon A. Shirley	4,557,970,345	79,477,551

The following proposal was not adopted by the margins indicated:

2. Shareholder proposal regarding business practices in China.

For	314,747,525
Against	3,008,218,191
Abstain	249,630,228
Broker non-vote	1,064,851,952

Item 6. Exhibits and Reports on Form 8-K

(A) EXHIBITS

3.2 Bylaws of Microsoft Corporation

(B) REPORTS ON FORM 8-K

The Company filed no reports on Form 8-K during the quarter ended December 31, 2001. Items 2, 3, and 5 are not applicable and have been omitted.

Signature

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

Microsoft Corporation

Date: February 8, 2002

By: /s/ John G. Connors

John G. Connors
Senior Vice President; Chief
Financial Officer

(Principal Financial and Accounting
Officer and Duly Authorized Officer)

BYLAWS
OF
MICROSOFT CORPORATION

ARTICLE I
Shareholders

1.1 Annual Meeting. The annual meeting of the shareholders of the Corporation for the election of Directors and for the transaction of such other business as properly may be submitted to such annual meeting, shall be held at the hour and on the date designated by the Board of Directors or an authorized committee of the Board of Directors, such date to be within 150 days of the end of the fiscal year.

1.2 Special Meetings. Special meetings of the shareholders of the Corporation, for any purpose or purposes, may be called at any time by the Board of Directors or an authorized committee of the Board of Directors.

1.3 Place of Meetings. Meetings of shareholders shall be held at such place within or without the State of Washington as determined by the Board of Directors, or an authorized committee, pursuant to proper notice.

1.4 Notice. Written notice of each shareholders' meeting stating the date, time, and place and, in case of a special meeting, the purpose(s) for which such meeting is called, shall be given by the Corporation not less than ten (10) (unless a greater period of notice is required by law in a particular case) nor more than sixty (60) days prior to the date of the meeting, to each shareholder of record, to the shareholder's address as it appears on the current record of shareholders of the Corporation.

1.5 Quorum of Shareholders. At any meeting of the shareholders, a majority in interest of all the shares entitled to vote on a matter, represented by shareholders of record in person or by proxy, shall constitute a quorum of that voting group for action on that matter.

Once a share is represented at a meeting, other than to object to holding the meeting or transacting business, it is deemed to be present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless a new record date is or must be set for the adjourned meeting. At such reconvened meeting, any business may be transacted that might have been transacted at the meeting as originally notified.

If a quorum exists, action on a matter is approved by a voting group if the votes cast within the voting group favoring the action exceed the votes cast within the voting group opposing the action, unless the question is one upon which by express provision of the Washington Business Corporation Act, as amended ("WBCA"), or of the Articles of Incorporation or of these Bylaws a different vote is required.

1.6 Adjournment. A majority of the shares represented at the meeting, even if less than a quorum, may adjourn the meeting from time to time. At such reconvened meeting at which a quorum is present any business may be transacted at the meeting as originally notified. If a meeting is adjourned to a different date, time, or place, notice need not be given of the new date, time, or place if a new date, time, or place is announced at the meeting before adjournment; however, if a new record date for the adjourned meeting is or must be fixed in accordance with

the WBCA, notice of the adjourned meeting must be given to persons who are shareholders as of the new record date.

1.7 Record Date and Transfer Books. For the purpose of determining shareholders who are entitled to notice of or to vote at any meeting of shareholders or any adjournment thereof, or entitled to receive payment of any dividend, or in order to make a determination of shareholders for any other proper purpose, the Board of Directors may fix in advance a record date for any such determination of shareholders, such date in any case to be not more than seventy (70) days and, in case of a meeting of shareholders, not less than ten (10) days prior to the date on which the particular action, requiring such determination of shareholders, is to be taken.

If no record date is fixed for such purposes, the date on which notice of the meeting is mailed or the date on which the resolution of the Board of Directors declaring such dividend is adopted, as the case may be, shall be the record date for such determination of shareholders.

When a determination of shareholders entitled to vote at any meeting of shareholders has been made as provided in this section, such determination shall apply to any adjournment thereof, unless the Board of Directors fixes a new record date, which it must do if the meeting is adjourned more than one hundred twenty (120) days after the date is fixed for the original meeting.

1.8 Voting Record. The officer or agent having charge of the stock transfer books for shares of the Corporation shall make at least ten (10) days before each meeting of shareholders a complete record of the shareholders entitled to vote at such meeting or any adjournment thereof, arranged by any applicable voting groups and in alphabetical order, with the address of and the number of shares held by each. Such record shall be produced and kept open at the time and place of the meeting and shall be subject to the inspection of any shareholder or any shareholder's agent during the whole time of the meeting for the purposes thereof.

1.9 Proxies. Shareholders of record may vote at any meeting either in person or by proxy. A shareholder may appoint a proxy to vote for the shareholder by submission of (i) an appointment form signed by the shareholder or the shareholder's attorney-in-fact, or (ii) an electronic transmission which contains or is accompanied by information from which it can be reasonably verified that the transmission was authorized by the shareholder or by the shareholder's attorney-in-fact. As used in this Section 1.9, "electronic transmission" means any process of communication not directly involving the physical transfer of paper that is suitable for the retention, retrieval, and reproduction of information by the recipient. An appointment of proxy is effective when an appointment form or an electronic transmission (or documentary evidence thereof, including verification information) is received by the person authorized to tabulate votes for the Corporation. The proxy has the same power to vote as that possessed by the shareholder, unless the appointment form or electronic transmission contains an express limitation on the power to vote or direction as to how to vote the shares on a particular matter, in which event the Corporation must tabulate the votes in a manner consistent with that limitation or direction. An appointment of proxy is valid for eleven (11) months unless a longer period is expressly provided in the appointment form or electronic transmission.

1.10 Organization of Meeting. The officer designated by the Board of Directors as Chief Executive Officer (or in his absence, any other officer designated by the Board of Directors) may call any meeting of shareholders to order and shall be the Chairman thereof. The Secretary of the Corporation, if present at any meeting of its shareholders, shall act as the Secretary of such meeting. If the Secretary is absent from any such meeting, the Chairman of such meeting may appoint a Secretary for the meeting.

1.11 Order of Business. The Chairman of a meeting of shareholders, determined in accordance with Section 1.10, shall have discretion to establish the order of business for such meeting subject to any specific order established by the Board of Directors.

ARTICLE II

Board of Directors

2.1 Number and Qualifications. The business affairs and property of the Corporation shall be managed by a Board of not less than three directors nor more than eleven directors. The number of directors may at any time be increased or decreased by resolution of the Board of Directors or by the shareholders at the annual meeting. Directors need not be shareholders of the Corporation or residents of the state of Washington.

2.2 Election - Term of Office. The directors shall be elected by the shareholders at each annual shareholders' meeting to hold office until the next annual meeting of the shareholders and until their respective successors are elected and qualified. If, for any reason, the directors shall not have been elected at any annual meeting, they may be elected at a special meeting of shareholders called for that purpose in the manner provided by these Bylaws.

2.3 Regular Meetings. Regular meetings of the Board of Directors shall be held at such places, and at such times as the Board may determine, and, if so determined, no notice thereof need be given. A regular meeting of the Board may be held without notice immediately after the annual meeting of shareholders at the same place at which such meeting was held.

2.4 Special Meetings. Special meetings of the Board of Directors may be held at any time or place upon the call of a majority of directors, the Chief Executive Officer or the Chief Operating Officer by oral or written notice, given or mailed to each director not less than two (2) days before such meeting.

2.5 Notice. No notice is required for regular meetings of the Board of Directors. Notice of special meetings of the Board of Directors, stating the date, time, and place thereof, shall be given at least two (2) days prior to the date of the meeting. The purpose of the meeting need not be given in the notice. Such notice may be oral or written. Written notice may be transmitted by: mail; private carrier; personal delivery; telegraph or teletype; electronic mail; telephone, or wire or wireless device that transmits a facsimile of the notice. Written notice is effective at the earliest of the following: (a) when received; (b) five (5) days after deposit in the U.S. mail if mailed with first class postage; (c) on the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee.

2.6 Waiver of Notice. A director may waive notice of a special meeting of the Board either before or after the meeting, and such waiver shall be deemed to be the equivalent of giving notice. The waiver must be in writing, signed by the director entitled to the notice and delivered to the Corporation for inclusion in its corporate records. Attendance or participation of a director at a meeting shall constitute waiver of notice of that meeting unless said director attends or participates for the express purpose of objecting to the transaction of business because the meeting has not been lawfully called or convened.

2.7 Quorum of Directors. A majority of the members of the Board of Directors shall constitute a quorum for the transaction of business, but if at any meeting of the Board there shall be less than a quorum present, a majority of those present may adjourn the meeting from time to time until a quorum shall have been obtained. When a quorum is present at any meeting, a majority of the members present shall decide any question brought before such meeting, except as otherwise provided by the Articles of Incorporation or by these Bylaws.

2.8 Adjournment. A majority of the directors present, even if less than a quorum, may adjourn a meeting and continue it to a later time. Notice of the adjourned meeting or of the business to be transacted thereat, other than by announcement, shall not be necessary. At any adjourned meeting at which a quorum is present, any business may be transacted which could have been transacted at the meeting as originally called.

2.9 Resignation. Any director of the Corporation may resign at any time by giving written notice to the Board of Directors, the Chairman, the President, or the Secretary of the Corporation. Any such resignation is effective when the notice is delivered, unless the notice specifies a later effective date.

2.10 Vacancies. Unless otherwise provided by the WBCA, in case of any vacancy in the Board of Directors, including a vacancy resulting from an increase in the number of directors, the remaining directors, whether constituting a quorum or not, may fill the vacancy.

2.11 Compensation. The Board shall have the sole authority to fix the amount of compensation of directors.

2.12 Committees. The Board of Directors, by resolution adopted by a majority of the full Board of Directors, may designate from among its members one or more committees, each of which:

a. Shall have two (2) or more members;

b. Shall be governed by the same rules regarding meetings, action without meetings, notice, and waiver of notice, and quorum and voting requirements as applied to the Board of Directors; and

c. To the extent provided in such resolution, shall have and may exercise all the authority of the Board of Directors, except no such committee shall have the authority to:

(1) Authorize or approve a distribution except according to a general formula or method prescribed by the Board of Directors;

(2) Approve or propose to shareholders action which the WBCA requires to be approved by shareholders;

(3) Fill vacancies on the Board of Directors or on any of its committees;

(4) Amend the Articles of Incorporation;

(5) Adopt, amend, or repeal the Bylaws;

(6) Approve a plan of merger not requiring shareholder approval;

or

(7) Authorize or approve the issuance or sale or contract for sale of shares, or determine the designation and relative rights, preferences, and limitations on a class or series of shares, except that the Board of Directors may authorize a committee, or a senior executive officer of the Corporation, to do so within limits specifically prescribed by the Board of Directors.

ARTICLE III

Special Measures Applying to Meetings of
Shareholders, the Board of Directors and Committees of the Board

3.1 Action by Written Consent. Any action required or permitted to be taken at a meeting of the Board of Directors or a committee of the Board may be accomplished without a meeting if the action is taken by all the members of the Board or all the members of the committee, as the case may be. The action must be evidenced by one or more written consents describing the action to be taken, signed by all directors or all members of the committee, as the case may be, and delivered to the Corporation for inclusion in the minutes. Directors' consents may be signed either before or after the action taken.

Action taken by unanimous written consent is effective when the last director signs the consent, unless the consent specifies a later effective date.

3.2 Use of Communications Equipment. Meetings of the shareholders, the Board of Directors and committees of the Board may be effectuated by means of a conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other during the meeting. Participation by such means shall constitute presence in person at such meeting.

3.3 Oral and Written Notice. Oral notice may be communicated in person or by telephone, wire or wireless equipment that does not transmit a facsimile of the notice. Oral notice is effective when communicated if communicated in a comprehensible manner.

Written notice may be transmitted by mail, private carrier, or personal delivery; telegraph or teletype; or telephone, wire, or wireless equipment that transmits a facsimile of the notice and provides the transmitter with an electronically generated receipt. Written notice is effective at the earliest of the following: (a) when received; (b) five (5) days after its deposit in the U.S. mail if mailed with first-class postage; (c) on the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee.

ARTICLE IV

Officers

4.1 Positions. The officers of the Corporation may consist of a Chairman, a President, one or more Vice Presidents (who may be designated as Corporate Vice Presidents, Senior Vice Presidents or Executive Vice Presidents), a Secretary and a Treasurer as appointed by the Board of Directors or the Chief Executive Officer. The Corporation may have such additional or assistant officers (sometimes referred to as "additional officers") as the Board of Directors, Chief Executive Officer or Chief Operating Officer may deem necessary for its business and may appoint from time to time. The Board of Directors shall also have the authority, but shall not be required, to designate officers as the Chief Executive Officer, the Chief Operating Officer, the Chief Financial Officer or similar such titles. Any two or more offices may be held by the same person.

If a director/officer has not been designated as Chairman, or if the designated Chairman is not present, the Board of Directors shall elect a Chairman from amongst its members to serve as Chairman of the Board of Directors. The Chairman shall preside at all meetings of the Board of Directors, and shall have such other powers as the Board may determine.

4.2 Appointment and Term of Office. The officers of the Corporation shall be appointed annually by the Board of Directors at the first meeting of the Board of Directors held

after each annual meeting of the shareholders. If officers are not appointed at such meeting, such appointment shall occur as soon as possible thereafter, or may be left vacant. Each officer shall hold office until a successor shall have been appointed and qualified or until said officer's earlier death, resignation, or removal.

4.3 Authority and Duties of the Chief Executive Officer. The Chief Executive Officer shall have general charge and supervision of the business of the Corporation, shall see that all orders, actions and resolutions of the Board of Directors are carried out, and shall have such other authority and shall perform such other duties as set forth in these bylaws or, to the extent consistent with the bylaws, such other authorities and duties as prescribed by the Board of Directors.

4.4 Authority and Duties of Other Officers. Each officer other than the Chief Executive Officer shall have the authority and shall perform the duties set forth in these bylaws or, to the extent consistent with the bylaws, the duties prescribed by the Board of Directors, by the Chief Executive Officer, or by an officer authorized by the Board of Directors to prescribe the duties of such officer. Any designation of duties by the Chief Executive Officer or other officer shall be subject to review by the Board of Directors but shall be in full force and effect in the absence of such review.

4.5 Compensation and Contract Rights. The Board of Directors shall have authority (a) to fix the compensation, whether in the form of salary, bonus, stock options or otherwise, of all officers and employees of the Corporation, either specifically or by formula applicable to particular classes of officers or employees, and (b) to authorize officers of the Corporation to fix the compensation of subordinate employees. The Board of Directors shall have authority to appoint a Compensation Committee and may delegate to such committee any or all of its authority relating to compensation. The appointment of an officer shall not of itself create contract rights.

4.6 Resignation or Removal. Any officer of the Corporation may resign at any time by giving written notice to the Board of Directors. Any such resignation is effective when the notice is delivered, unless the notice specifies a later date, and shall be without prejudice to the contract rights, if any, of such officer.

The Board of Directors, by majority vote of the entire Board, may remove any officer or agent, with or without cause. An officer or assistant officer, if appointed by another officer, may also be removed by any officer authorized to appoint officers or assistant officers. The removal shall be without prejudice to the contract rights, if any, of the person so removed.

4.7 Vacancies. If any office becomes vacant by any reason, the directors may appoint a successor or successors who shall hold office for the unexpired term or leave such office vacant.

ARTICLE V

Certificates of Shares and Their Transfer

5.1 Issuance; Certificates of Shares. No shares of the Corporation shall be issued unless authorized by the Board. Such authorization shall include the maximum number of shares to be issued, the consideration to be received, and a statement that the Board considers the consideration to be adequate. Shares may but need not be represented by certificates. Certificates for shares of the Corporation shall be in such form as is consistent with the provisions of the WBCA or the law of a predecessor corporation and after the effective date of these Bylaws shall state:

- a. The name of the Corporation and that the Corporation is organized under the laws of the State of Washington;
- b. The name of the person to whom issued; and
- c. The number and class of shares and the designation of the series, if any, which such certificate represents.

The certificate shall be signed by original or facsimile signature of two officers of the Corporation, and the seal of the Corporation may be affixed thereto.

5.2 Rules and Regulations Concerning the Issue, Transfer and Registration of Shares. The Board of Directors shall have power and authority to make all such rules and regulations as the Board may deem proper or expedient concerning the issue, transfer and registration of shares of stock. In case of the loss, mutilation, or destruction of a certificate of stock, a duplicate certificate may be issued upon such terms as the Board shall authorize. The Board shall have power and authority to appoint from time to time one or more transfer agents and registrar of the shares of stock.

5.3 Shares without Certificates. The Board of Directors may authorize the issue of some or all of the shares without certificates. Within a reasonable time after the issue or transfer of shares without certificates, the corporation shall send the shareholder a written statement of the information required on certificates by the WBCA.

ARTICLE VI

Books and Records

6.1 Books of Accounts, Minutes, and Share Register. Except as otherwise provided by law the Corporation:

- a. Shall keep as permanent records minutes of all meetings of its shareholders and Board of Directors, a record of all actions taken by the Board of Directors without a meeting, and a record of all actions taken by a committee of the Board of Directors exercising the authority of the Board of Directors on behalf of the Corporation;

- b. Shall maintain appropriate accounting records;

- c. Or its agent shall maintain a record of its shareholders, in a form that permits preparation of a list of the names and addresses of all shareholders, in alphabetical order by class of shares showing the number and class of shares held by each; and

- d. Shall keep a copy of the following records at its principal office:

- (1) The Articles or Restated Articles of Incorporation and all amendments to them currently in effect;

- (2) The Bylaws or Restated Bylaws and all amendments to them currently in effect;

- (3) The minutes of all shareholders' meetings, and records of all actions taken by shareholders without a meeting, for the past three (3) years;

(4) Its financial statements for the past three (3) years, including balance sheets showing in reasonable detail the financial condition of the Corporation as of the close of each fiscal year, and an income statement showing the results of its operations during each fiscal year prepared on the basis of generally accepted accounting principles or, if not, prepared on a basis explained therein;

(5) All written communications to shareholders generally within the past three (3) years;

(6) A list of the names and business addresses of its current directors and officers; and

(7) Its most recent annual report delivered to the Secretary of State of Washington.

6.2 Copies of Resolutions. Any person dealing with the Corporation may rely upon a copy of any of the records of the proceedings, resolutions, or votes of the Board of Directors or shareholders, when certified by the Secretary, an assistant secretary, or other officer authorized by the Board.