# 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 March 31, 2008**

**OR**

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

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

**None**
**(Former name, former address and former fiscal year, if changed since last report)**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class | Outstanding at April 21, 2008 |
|---|---|
| Common Stock, $0.00000625 par value per share | 9,313,292,833 shares |

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**MICROSOFT CORPORATION**

**FORM 10-Q**

**For the Quarter Ended March 31, 2008**

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## Part I. Financial Information

### Item 1. Financial Statements

## MICROSOFT CORPORATION

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

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Revenue | **$14,454** | $14,398 | **$44,583** | $37,751 |
| Operating expenses: | | | | |
| Cost of revenue | **2,514** | 2,140 | **8,732** | 7,456 |
| Research and development | **2,035** | 1,750 | **5,757** | 5,173 |
| Sales and marketing | **3,155** | 2,936 | **9,161** | 8,126 |
| General and administrative | **2,341** | 983 | **4,125** | 2,461 |
| Total operating expenses | **10,045** | 7,809 | **27,775** | 23,216 |
| Operating income | **4,409** | 6,589 | **16,808** | 14,535 |
| Investment income and other | **401** | 382 | **1,038** | 1,282 |
| Income before income taxes | **4,810** | 6,971 | **17,846** | 15,817 |
| Provision for income taxes | **422** | 2,045 | **4,462** | 4,787 |
| Net income | **$ 4,388** | $ 4,926 | **$13,384** | $11,030 |
| Earnings per share: | | | | |
| Basic | **$ 0.47** | $ 0.51 | **$ 1.43** | $ 1.12 |
| Diluted | **$ 0.47** | $ 0.50 | **$ 1.41** | $ 1.11 |
| Weighted average shares outstanding: | | | | |
| Basic | **9,307** | 9,725 | **9,349** | 9,821 |
| Diluted | **9,428** | 9,862 | **9,492** | 9,955 |
| Cash dividends declared per common share | **$ 0.11** | $ 0.10 | **$ 0.33** | $ 0.30 |

See accompanying notes.

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MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

| | March 31, 2008 (Unaudited) | June 30, 2007(1) |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 11,820** | $ 6,111 |
| Short-term investments (including securities pledged as collateral of $2,318 and $2,356) | **14,521** | 17,300 |
| Total cash, cash equivalents, and short-term investments | **26,341** | 23,411 |
| Accounts receivable, net of allowance for doubtful accounts of $147 and $117 | **9,871** | 11,338 |
| Inventories | **774** | 1,127 |
| Deferred income taxes | **1,721** | 1,899 |
| Other | **2,782** | 2,393 |
| Total current assets | **41,489** | 40,168 |
| Property and equipment, net | **5,516** | 4,350 |
| Equity and other investments | **8,659** | 10,117 |
| Goodwill | **10,346** | 4,760 |
| Intangible assets, net | **1,639** | 878 |
| Deferred income taxes | **1,367** | 1,389 |
| Other long-term assets | **1,731** | 1,509 |
| Total assets | **$ 70,747** | $ 63,171 |
| **Liabilities and stockholders' equity** | | |
| Current liabilities: | | |
| Accounts payable | **$ 3,600** | $ 3,247 |
| Accrued compensation | **2,427** | 2,325 |
| Income taxes | **3,765** | 1,040 |
| Short-term unearned revenue | **10,385** | 10,779 |
| Securities lending payable | **2,476** | 2,741 |
| Other | **4,375** | 3,622 |
| Total current liabilities | **27,028** | 23,754 |
| Long-term unearned revenue | **1,754** | 1,867 |
| Other long-term liabilities | **4,411** | 6,453 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock and paid-in capital – shares authorized 24,000; outstanding 9,310 and 9,380 | **63,375** | 60,557 |
| Retained deficit, including accumulated other comprehensive income of $1,355 and $1,654 | **(25,821)** | (29,460) |
| Total stockholders' equity | **37,554** | 31,097 |
| Total liabilities and stockholders' equity | **$ 70,747** | $ 63,171 |

(1) Derived from audited financial statements.

See accompanying notes.

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## MICROSOFT CORPORATION

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

| | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 |
|---|---|---|---|---|
| **Operations** | | | | |
| Net income | **$ 4,388** | $ 4,926 | **$ 13,384** | $ 11,030 |
| Depreciation, amortization, and other noncash items | **532** | 445 | **1,448** | 1,059 |
| Stock-based compensation expense | **373** | 321 | **1,066** | 1,214 |
| Net recognized gains on investments | **(179)** | (61) | **(500)** | (296) |
| Excess tax benefits from stock-based payment arrangements | **(9)** | (7) | **(111)** | (55) |
| Deferred income taxes | **103** | 981 | **783** | 630 |
| Unearned revenue | **5,228** | 4,551 | **15,044** | 13,797 |
| Recognition of unearned revenue | **(5,368)** | (6,121) | **(15,701)** | (14,436) |
| Accounts receivable | **1,857** | 1,455 | **2,077** | 1,011 |
| Other current assets | **(69)** | 7 | **141** | (350) |
| Other long-term assets | **(1)** | (32) | **(67)** | (431) |
| Other current liabilities | **1,389** | 772 | **525** | (424) |
| Other long-term liabilities | **(1,162)** | 54 | **(562)** | 645 |
| Net cash from operations | **7,082** | 7,291 | **17,527** | 13,394 |
| **Financing** | | | | |
| Common stock issued | **268** | 784 | **3,249** | 5,618 |
| Common stock repurchased | **(1,240)** | (6,878) | **(8,227)** | (20,358) |
| Common stock cash dividends | **(1,023)** | (976) | **(2,995)** | (2,853) |
| Excess tax benefits from stock-based payment arrangements | **9** | 7 | **111** | 55 |
| Other | **—** | — | **—** | (23) |
| Net cash used in financing | **(1,986)** | (7,063) | **(7,862)** | (17,561) |
| **Investing** | | | | |
| Additions to property and equipment | **(759)** | (461) | **(1,964)** | (1,444) |
| Acquisition of companies, net of cash acquired | **(138)** | (41) | **(5,967)** | (502) |
| Purchases of investments | **(3,481)** | (7,257) | **(15,795)** | (29,214) |
| Maturities of investments | **462** | 1,688 | **1,262** | 3,847 |
| Sales of investments | **2,829** | 6,264 | **18,645** | 32,413 |
| Securities lending payable | **309** | 318 | **(265)** | (86) |
| Net cash from/(used in) investing | **(778)** | 511 | **(4,084)** | 5,014 |
| Effect of exchange rates on cash and cash equivalents | **42** | 13 | **128** | 50 |
| Net change in cash and cash equivalents | **4,360** | 752 | **5,709** | 897 |
| Cash and cash equivalents, beginning of period | **7,460** | 6,859 | **6,111** | 6,714 |
| Cash and cash equivalents, end of period | **$11,820** | $ 7,611 | **$ 11,820** | $ 7,611 |

See accompanying notes.

**MICROSOFT CORPORATION**

**STOCKHOLDERS' EQUITY STATEMENTS**
**(In millions)(Unaudited)**

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **Common stock and paid-in capital** | | | | |
| Balance, beginning of period | **$ 62,528** | $ 61,152 | **$ 60,557** | $ 59,005 |
| Common stock issued | **224** | 782 | **3,259** | 5,616 |
| Common stock repurchased | **(221)** | (1,499) | **(1,842)** | (4,605) |
| Stock-based compensation expense | **373** | 321 | **1,066** | 1,214 |
| Stock option income tax benefits/(deficiencies) | **461** | 71 | **268** | (410) |
| Other, net | **10** | — | **67** | 7 |
| Balance, end of period | **63,375** | 60,827 | **63,375** | 60,827 |
| **Retained deficit** | | | | |
| Balance, beginning of period | **(28,097)** | (24,519) | **(29,460)** | (18,901) |
| Cumulative effect of a change in accounting principle – adoption of FIN 48 (1) | **—** | — | **(395)** | — |
| Cumulative effect of a change in accounting principle – adoption of EITF 06-2 (1) | **—** | — | **(17)** | — |
| Net income | **4,388** | 4,926 | **13,384** | 11,030 |
| Other comprehensive income: | | | | |
| Net losses on derivative instruments | **(78)** | (31) | **(29)** | (59) |
| Net unrealized investments gains/(losses) | **(211)** | (41) | **(375)** | 296 |
| Translation adjustments and other | **16** | 25 | **105** | 69 |
| Comprehensive income | **4,115** | 4,879 | **13,085** | 11,336 |
| Common stock cash dividends | **(1,021)** | (955) | **(3,081)** | (2,904) |
| Common stock repurchased | **(818)** | (5,259) | **(5,953)** | (15,385) |
| Balance, end of period | **(25,821)** | (25,854) | **(25,821)** | (25,854) |
| Total stockholders' equity | **$ 37,554** | $ 34,973 | **$ 37,554** | $ 34,973 |

(1) See Note 1 of Notes to Financial Statements.

See accompanying notes.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
*(Unaudited)*

**Note 1 – Basis of Presentation and Consolidation and Recent Accounting Pronouncements**

***Basis of Presentation***

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

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2007 Form 10-K.

***Basis of Consolidation***

The financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments in which we exercise significant influence but do not exercise control and are not the primary beneficiary are accounted for using the equity method. Investments in which we are not able to exercise significant influence over the investee and which do not have readily determinable fair values are accounted for under the cost method.

***Recently Adopted Accounting Pronouncements***

On July 1, 2007, we adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, we may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Upon adoption, we recognized a $395 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle. See Note 13 – Income Taxes.

On July 1, 2007, we adopted Emerging Issues Task Force Issue No. 06-2 ("EITF 06-2"), *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43*. EITF 06-2 requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. Upon adoption, we recognized a $17 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle.

MICROSOFT CORPORATION

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

***Recent Accounting Pronouncements Not Yet Adopted***

In March 2008, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, which requires additional disclosures about the objectives of the derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective for us beginning January 1, 2009. We are currently assessing the potential impact that adoption of SFAS No. 161 may have on our financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*, which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for us beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*, which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for us beginning July 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. We are currently assessing the potential impact that adoption of SFAS No. 160 may have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings. SFAS No. 159 is effective for us beginning July 1, 2008. We are currently assessing the potential impact that electing fair value measurement would have on our financial statements and have not determined what election we will make.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. In February 2008, the FASB issued FASB Staff Position ("FSP") 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS No. 157 is effective for us beginning July 1, 2008; FSP 157-2 delays the effective date for certain items to July 1, 2009. We are currently assessing the potential impact that adoption of this statement may have on our financial statements.

MICROSOFT CORPORATION

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

**Note 2 – Inventories**

Components of inventories were as follows:

| (In millions) | March 31, 2008 | June 30, 2007 |
|---|---|---|
| Raw materials | $ **444** | $ 435 |
| Work in process | **66** | 148 |
| Finished goods | **264** | 544 |
| Inventories | $ **774** | $ 1,127 |

**Note 3 – Earnings Per Share**

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options, stock awards, and shared performance stock awards.

Components of basic and diluted earnings per share were as follows:

| (In millions, except earnings per share) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Net income available for common shareholders (A) | **$ 4,388** | $ 4,926 | **$13,384** | $11,030 |
| Weighted average outstanding shares of common stock (B) | **9,307** | 9,725 | **9,349** | 9,821 |
| Dilutive effect of employee stock options and awards | **121** | 137 | **143** | 134 |
| Common stock and common stock equivalents (C) | **9,428** | 9,862 | **9,492** | 9,955 |
| Earnings per share: | | | | |
| Basic (A/B) | **$ 0.47** | $ 0.51 | **$ 1.43** | $ 1.12 |
| Diluted (A/C) | **$ 0.47** | $ 0.50 | **$ 1.41** | $ 1.11 |

The following shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. In addition, the following shared performance stock awards have been excluded from the calculation of diluted earnings per share because the number of shares ultimately issued is contingent on our performance against metrics established for the performance period.

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Shares excluded from calculation of diluted EPS | **84** | 230 | **79** | 248 |
| Shared performance stock awards excluded from calculation of diluted EPS | — | 10 | — | 10 |

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**Note 4 – Unearned Revenue**

The components of unearned revenue were as follows:

| (In millions) | March 31, 2008 | June 30, 2007 |
|---|---|---|
| Volume licensing programs | **$ 9,080** | $ 9,334 |
| Undelivered elements | **1,516** | 1,839 |
| Other | **1,543** | 1,473 |
| Unearned revenue | **$ 12,139** | $ 12,646 |

Unearned revenue by segment was as follows:

| (In millions) | March 31, 2008 | June 30, 2007 |
|---|---|---|
| Client | **$ 2,524** | $ 2,875 |
| Server and Tools | **3,890** | 3,652 |
| Microsoft Business Division | **5,253** | 5,771 |
| Other | **472** | 348 |
| Unearned revenue | **$ 12,139** | $ 12,646 |

**Note 5 – Stockholders' Equity**

***Share Repurchases***

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately $16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. As of March 31, 2008, approximately $7.7 billion remained of the $36.2 billion approved repurchase amount. All repurchases were made using cash resources. The repurchase program may be suspended or discontinued at any time without notice.

We repurchased the following shares of common stock under the above-described repurchase plans:

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| (In millions) | 2008 | 2007 | 2008 | 2007 |
| Shares of common stock repurchased | **30** | 237 | **230** | 728 |
| Value of common stock repurchased | **$ 1,020** | $ 6,744 | **$7,449** | $19,746 |

MICROSOFT CORPORATION

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

***Dividends***

Our Board of Directors declared the following dividends:

| Declaration Date | Per Share Dividend | Record Date | Total Amount (in millions) | Payment Date |
|---|---|---|---|---|
| *(Fiscal year 2008)* | | | | |
| September 12, 2007 | $ 0.11 | November 15, 2007 | $ 1,034 | December 13, 2007 |
| December 19, 2007 | $ 0.11 | February 21, 2008 | $ 1,023 | March 13, 2008 |
| March 17, 2008 | $ 0.11 | May 15, 2008 | $ 1,024 | June 12, 2008 |
| *(Fiscal year 2007)* | | | | |
| September 13, 2006 | $ 0.10 | November 16, 2006 | $ 979 | December 14, 2006 |
| December 20, 2006 | $ 0.10 | February 15, 2007 | $ 977 | March 8, 2007 |
| March 26, 2007 | $ 0.10 | May 17, 2007 | $ 952 | June 14, 2007 |

The estimate of the amount to be paid as a result of the March 17, 2008 declaration was included in other current liabilities on our balance sheet as of March 31, 2008.

## Note 6 – Investment Income and Other

Components of investment income and other were as follows:

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| **(In millions)** | **2008** | **2007** | **2008** | **2007** |
| Dividends and interest | **$ 226** | $ 333 | **$ 671** | $ 1,018 |
| Net recognized gains/(losses) on investments | **(13)** | 39 | **225** | 505 |
| Net gains/(losses) on derivatives | **191** | 22 | **275** | (209) |
| Other | **(3)** | (12) | **(133)** | (32) |
| Investment income and other | **$ 401** | $ 382 | **$ 1,038** | $ 1,282 |

## Note 7 – Product Warranties

We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include technical support, parts, and labor over a period generally ranging from 90 days to three years. For software warranty, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software.

**MICROSOFT CORPORATION**

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

The changes in our aggregate product warranty liabilities were as follows:

| (In millions) | Three Months Ended March 31, 2008 | Nine Months Ended March 31, 2008 |
|---|---|---|
| Balance, beginning of period | $ 861 | $ 850 |
| Accrual for warranties issued | 64 | 334 |
| Adjustments to pre-existing warranties | 23 | 39 |
| Settlements of warranty claims | (174) | (449) |
| Balance, end of period | $ 774 | $ 774 |

**Note 8 – Contingencies**

**Government competition law matters.** In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were “not reasonable.” Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should accrue after that date. On February 27, 2008, the Commission issued a fine of €899 million relating to the period prior to October 22, 2007, which is accrued in the accompanying financial statements. On January 14, 2008, the Commission announced that it was opening two new competition law investigations. These investigations relate primarily to interoperability with respect to our Microsoft Office family of products and the inclusion of various capabilities in our Windows operating system software, including Web browsing software. These investigations were precipitated by complaints filed with the Commission by a trade association of Microsoft’s competitors and a firm that offers Web browsing software.

We are subject to a Consent Decree and Final Judgment that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Consent Decree imposed various constraints on our Windows operating system businesses. Portions of the Consent Decree were scheduled to expire on January 31, 2008; we voluntarily agreed to extend other elements of the Consent Decree to November 2009. In October 2007, some states filed a motion with the U.S. District Court for the District of Columbia seeking to have most of the remaining provisions of the Final Judgment in the action to which they are party extended for five years. The U.S. Department of Justice and other states advised the Court that they would not seek any extension of the Final Judgments to which they are party. On January 29, 2008, the court issued a decision granting the states’ motion to extend these additional provisions of the consent decree until November 2009.

In other ongoing investigations, various foreign governments and several state attorneys general have requested information from us concerning competition, privacy, and security issues.

**Antitrust, unfair competition, and overcharge class actions.** A large number of antitrust and unfair competition class action lawsuits have been filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals of damages claims of indirect purchasers under federal law and in 15 states. Courts refused to certify classes in two additional states. We have reached agreements to settle all claims that have been made to date in 19 states and the District of Columbia.

**MICROSOFT CORPORATION**

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

Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers.

The settlements in all states have received final court approval. Cases in Arizona, Mississippi and Canada have not been settled. We estimate the total cost to resolve all of these cases will range between $1.7 billion and $1.9 billion. The actual cost depends on factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims. At March 31, 2008, we have recorded a liability related to these claims of approximately $1.0 billion, which reflects our estimated exposure of $1.7 billion less payments made to date of approximately $700 million, mostly for administrative expenses, vouchers, and legal fees.

**Other antitrust litigation and claims.** In November 2004, Novell, Inc. filed a complaint in U.S. District Court in Utah, now transferred with other cases to Maryland, asserting antitrust and unfair competition claims against us related to Novell's ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. Both parties appealed, and in October 2007, the court of appeals affirmed the decision of the trial court, remanding the case to that court for further proceedings.

**Patent and intellectual property claims.** We are vigorously defending more than 45 patent infringement cases. Microsoft and Alcatel-Lucent are parties to a number of legal proceedings relating to certain patents of each of the companies. Some of these actions began before the merger of Alcatel and Lucent in 2006. For simplicity, we refer to the post-merger entity of Alcatel-Lucent throughout this discussion.

- In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents. Alcatel-Lucent has asserted claims under these patents against computer manufacturers that sell computers with our operating system and application software pre-installed. In February 2007, the jury returned a verdict in Alcatel-Lucent's favor in the first of a series of patent trials, and awarded $1.5 billion in damages. In September 2007, on our motions for judgment as a matter of law, the trial court overturned the jury verdict and entered orders dismissing plaintiff's claims on multiple grounds. Alcatel-Lucent has appealed. The trial court previously dismissed Alcatel-Lucent's claims with respect to a second group of patents and two patents in a third grouping. In April 2008, a jury returned a verdict in Alcatel-Lucent's favor in a trial on a consolidated group of video and user interface patents. The jury concluded that Microsoft had infringed two patents and awarded $367 million in damages. Microsoft will seek post-trial relief and, if necessary, will appeal the verdict.
- In March 2006, Alcatel-Lucent filed a lawsuit against us in U.S. District Court in California, claiming the Xbox 360 violates one of its patents. In response, we asserted counterclaims that Alcatel-Lucent infringes 10 Microsoft patents by its sales of various products. The case has been set for trial in April 2008.
- In November 2006, Alcatel-Lucent filed two patent infringement cases against us in U.S. District Court in Texas, asserting Mediaroom and various networking functionalities violate seven of its patents. In

April 2007, we asserted infringement counterclaims based on four of our patents relating to functionality similar to that accused by Alcatel-Lucent. The trial on all of the patents is set for January 2009.

- In February 2007, we filed a complaint against Alcatel-Lucent with the International Trade Commission claiming Alcatel-Lucent is infringing four Microsoft patents related to our unified communications technology and seeking to prevent the import into the U.S. of certain Alcatel-Lucent unified communications products. Trial of this matter took place in October 2007. The administrative law judge ruled that Alcatel-Lucent infringed one of the four asserted patents.
- In April 2007, the Multimedia Patent Trust filed a complaint against Microsoft, Dell, and Gateway in San Diego, California accusing the parties of infringing three video-related patents that originally belonged to Alcatel-Lucent. Alcatel-Lucent created the Multimedia Patent Trust prior to the companies' merger and transferred the patents at issue to the trust.

The actual costs to resolve these cases will depend upon many factors such as the outcome of post-trial motions, any appeals, and the results of the remaining trials.

In *Z4 Technologies, Inc. v. Microsoft*, filed in U.S. District Court in Texas in September 2004, the plaintiff alleged that Microsoft product activation functionality used in certain products (including versions of Windows and Office) infringes its patents. In April 2006, the jury rendered a $115 million verdict against us, and the trial court enhanced damages by $25 million due to a finding of willful infringement. The court declined to award a permanent injunction. In April 2008, the parties reached a settlement of the matter.

In *Veritas Operating Corporation v. Microsoft*, filed in U.S. District Court in Washington in May 2006, a subsidiary of Symantec filed an action asserting trade secret misappropriation, breach of contract, and patent infringement relating to certain storage technologies. The parties have reached a settlement of the matter.

Adverse outcomes in some or all of the matters described in this section may result in significant monetary damages or injunctive relief against us that would adversely affect distribution of our operating system or application products. We may enter into material settlements because of these risks.

**Other.** We are also subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

As of March 31, 2008, we had accrued aggregate liabilities of approximately $2.2 billion in other current liabilities and approximately $600 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could be up to $2.0 billion in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial position and on the results of operations for the period in which the effects become reasonably estimable.

MICROSOFT CORPORATION

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

**Note 9 – Segment Information**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. This standard requires segmentation based on our internal organization and reporting of revenue and operating income based upon internal accounting methods. Our financial reporting systems present various data for management to operate the business, including internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segments are designed to allocate resources internally and provide a framework to determine management responsibility. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our Chief Executive Officer. Our five segments are Client; Server and Tools; Online Services Business; Microsoft Business Division; and Entertainment and Devices Division. We have recast certain prior period amounts to conform to the way we internally manage and monitor performance at the segment level during the current period.

Segment revenue and operating income/(loss) was as follows:

| (In millions) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 |
|---|---|---|---|---|
| **Revenue** | | | | |
| Client | **$ 3,924** | $ 5,153 | **$12,207** | $11,128 |
| Server and Tools | **3,260** | 2,752 | **9,446** | 8,095 |
| Online Services Business | **843** | 603 | **2,377** | 1,764 |
| Microsoft Business Division | **4,747** | 4,827 | **13,668** | 11,771 |
| Entertainment and Devices Division | **1,576** | 935 | **6,564** | 4,913 |
| Unallocated and other | **104** | 128 | **321** | 80 |
| Consolidated | **$14,454** | $14,398 | **$44,583** | $37,751 |
| **Operating income/(loss)** | | | | |
| Client | **$ 2,965** | $ 4,067 | **$ 9,453** | $ 8,666 |
| Server and Tools | **991** | 869 | **3,003** | 2,651 |
| Online Services Business | **(258)** | (178) | **(775)** | (409) |
| Microsoft Business Division | **3,098** | 3,363 | **8,900** | 7,754 |
| Entertainment and Devices Division | **54** | (345) | **524** | (776) |
| Reconciling amounts | **(2,441)** | (1,187) | **(4,297)** | (3,351) |
| Consolidated | **$ 4,409** | $ 6,589 | **$16,808** | $14,535 |

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

Reconciling amounts include adjustments to conform with U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, and accelerated amortization for depreciation, stock

MICROSOFT CORPORATION

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

awards, and performance-based stock awards. In addition, certain revenue and expenses are excluded from segments or included in corporate-level activity, including certain legal settlements and accruals for legal contingencies.

Significant reconciling items were as follows:

| (In millions) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 |
|---|---|---|---|---|
| Summary of reconciling amounts: | | | | |
| Corporate-level activity (1) | **$(2,779)** | $(1,430) | **$(5,122)** | $(3,451) |
| Stock-based compensation expense | **229** | 103 | **545** | 42 |
| Revenue reconciling amounts | **94** | 118 | **278** | 31 |
| Other | **15** | 22 | **2** | 27 |
| Total | **$(2,441)** | $(1,187) | **$(4,297)** | $(3,351) |

(1) Corporate-level activity excludes stock-based compensation expense and revenue reconciling amounts presented separately in those line items.

**Note 10 – Acquisitions**

On August 10, 2007, we acquired all the outstanding shares of aQuantive, Inc. (“aQuantive”) for $5.9 billion, which was paid primarily in cash. Headquartered in Seattle, Washington, aQuantive is a digital marketing business that we expect will play a key role in the future development of our Online Services Business. We also believe the acquisition will help us build and support next-generation advertiser and publisher solutions in environments such as cross media planning, video-on-demand, and Internet protocol television. aQuantive was consolidated into our results of operations starting August 10, 2007, the acquisition date.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

| (In millions) | aQuantive as of August 10, 2007 |
|---|---|
| Cash and cash equivalents | $ 342 |
| Accounts receivable, net | 273 |
| Other current assets | 6 |
| Property, plant and equipment | 50 |
| Intangible assets | 939 |
| Goodwill | 5,189 |
| Deferred income taxes | 179 |
| Other long-term assets | 7 |
| Total assets acquired | $ 6,985 |
| Accrued compensation | 37 |
| Other current liabilities | 683 |
| Deferred income taxes | 338 |
| Other long-term liabilities | 70 |
| Total liabilities assumed | $ 1,128 |
| Net assets acquired | $ 5,857 |

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As a result of this acquisition, we recorded $5.2 billion of goodwill in our Online Services Business. Of the $939 million of acquired intangible assets, $24 million was assigned to in-process research and development assets and was expensed during the first quarter. The remaining acquired intangible assets include $476 million of customer relationships with a weighted average life of six years, $327 million of technology-based intangible assets with a weighted average life of four years, and $112 million of other intangible assets with a weighted average life of five years.

In addition to aQuantive, we acquired 14 other entities during the nine months ended March 31, 2008 for total consideration of $520 million which was paid primarily in cash. All of the entities were consolidated within Microsoft starting on their respective acquisition dates. Pro forma results of operations have not been presented because the effects of all of these acquisitions, individually and in aggregate, were not material to our consolidated results of operations.

## Note 11 – Goodwill

| | Three Months Ended March 31, 2008 | | | Nine Months Ended March 31, 2008 | | |
|---|---|---|---|---|---|---|
| **(In millions)** | **Balance as of January 1, 2008** | **Acquisitions /purchase accounting adjustments** | **Balance as of March 31, 2008** | **Balance as of July 1, 2007** | **Acquisitions /purchase accounting adjustments** | **Balance as of March 31, 2008** |
| Client | $ 77 | **$ —** | **$ 77** | $ 77 | **$ —** | **$ 77** |
| Server and Tools | 655 | **84** | **739** | 580 | **159** | **739** |
| Online Services Business | 5,923 | **(52)** | **5,871** | 552 | **5,319** | **5,871** |
| Microsoft Business Division | 3,225 | **—** | **3,225** | 3,132 | **93** | **3,225** |
| Entertainment and Devices Division | 429 | **5** | **434** | 419 | **15** | **434** |
| Total | $ 10,309 | **$ 37** | **$ 10,346** | $ 4,760 | **$ 5,586** | **$ 10,346** |

None of the amount recorded as goodwill during the nine months ended March 31, 2008 is expected to be deductible for tax purposes. The purchase price allocation for all of the acquisitions is preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities become available. Any change in the fair value of the net assets of the acquired company will change the amount of the purchase price allocable to goodwill.

## Note 12 – Intangible Assets

The components of finite-lived intangible assets were as follows:

| | March 31, 2008 | | | June 30, 2007 | | |
|---|---|---|---|---|---|---|
| **(In millions)** | **Gross carrying amount** | **Accumulated amortization** | **Net carrying amount** | **Gross carrying amount** | **Accumulated amortization** | **Net carrying amount** |
| Contract-based | **$1,004** | **$ (777)** | **$ 227** | $ 988 | $ (727) | $ 261 |
| Technology-based | **1,363** | **(589)** | **774** | 916 | (407) | 509 |
| Marketing-related | **162** | **(57)** | **105** | 57 | (39) | 18 |
| Customer-related | **631** | **(98)** | **533** | 122 | (32) | 90 |
| Total | **$3,160** | **$ (1,521)** | **$1,639** | $2,083 | $ (1,205) | $ 878 |

MICROSOFT CORPORATION

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

Acquired intangibles are generally amortized on a straight-line basis over their weighted average lives. Intangible assets amortization expense was $121 million for the three months and $335 million for the nine months ended March 31, 2008, as compared with $58 million for the three months and $148 million for the nine months ended March 31, 2007. The estimated future amortization expense related to intangible assets as of March 31, 2008 is expected to be $130 million for the remainder of fiscal year 2008, $448 million for fiscal year 2009, $399 million for fiscal year 2010, $316 million for fiscal year 2011, and $346 million for fiscal year 2012 and thereafter.

**Note 13 – Income Taxes**

As discussed in Note 1, adopting FIN 48 had the following impact on our financial statements: increased current assets by $228 million, long-term assets by $1.1 billion, long-term liabilities by $2.1 billion, and our retained deficit by $395 million; and decreased our income taxes payable by $394 million. As of July 1, 2007, we had $7.1 billion of unrecognized tax benefits of which $5.3 billion, if recognized, would affect our effective tax rate. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. As of July 1, 2007, we had accrued interest related to uncertain tax positions of $863 million, net of federal income tax benefit, on our balance sheet.

During the quarter ended March 31, 2008, we reached an agreement with the Internal Revenue Service ("IRS") on the 2000-2003 examination. As a result, we reduced our unrecognized tax benefits by $4.7 billion and recognized a tax provision reduction of $1.2 billion. We are currently under audit by the IRS for the tax years 2004-2006. Although the timing and outcome of the 2004-2006 examination is inherently uncertain, we currently do not believe the examination will be concluded within the next 12 months. Other long-term liabilities related to income taxes were $3.3 billion as of March 31, 2008 and $5.1 billion as of June 30, 2007.

The effective tax rate was 9% and 25%, respectively, for the three and nine months ended March 31, 2008. The fiscal year 2008 rates reflect a decline in the recurring effective tax rate from 31% to 30% primarily as a result of resolution of tax positions relating to the 2000-2003 IRS examination. The effective tax rate also declined as a result of the reduction in previously accrued taxes and interest related to the 2000-2003 IRS examination. This decline was partially offset by the tax effect of the European Commission fine of €899 million, which is not tax deductible.

The effective tax rate was 29% and 30%, respectively, for the three and nine months ended March 31, 2007. These rates reflect an increase in the recurring effective tax rate from 31% to 31.5% due to a higher mix of earnings in high rate tax jurisdictions and were offset by a $195 million reduction resulting from various changes in tax positions taken in prior periods, related primarily to favorable developments in an IRS position and multiple foreign audit assessments.

We are subject to income tax in many jurisdictions outside the United States, none of which are individually material to our financial position, cash flows, or results of operations.

Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases and are stated at enacted tax rates expected to be in effect when taxes are actually paid or recovered. We have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $11.2 billion as of March 31, 2008 and $6.1 billion as of June 30, 2007, primarily resulting from earnings for certain non-U.S. subsidiaries, which are permanently reinvested outside the United States. The amount of unrecognized deferred tax liabilities associated with these temporary differences was $3.2 billion as of March 31, 2008 and $1.8 billion as of June 30, 2007.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the "Corporation") as of March 31, 2008, and the related consolidated statements of income, stockholders' equity, and cash flows for the three-month and nine-month periods ended March 31, 2008 and 2007. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2007, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated August 3, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2007 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

DELOITTE & TOUCHE LLP

/S/ DELOITTE & TOUCHE LLP

**Seattle, Washington**
**April 24, 2008**

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

### Special Note About Forward-Looking Statements

Certain statements in Management's Discussion and Analysis ("MD&A"), other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "plan," "may," "should," "will," "would," "will be," "will continue," "will likely result," and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties, which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled "Risk Factors" (refer to Part II, Item 1A). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

### OVERVIEW

The following MD&A is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying notes to the financial statements ("Notes").

We develop, manufacture, license, and support a wide range of software products for many computing devices. Our software products include operating systems for servers, PCs, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solutions applications; and software development tools. We provide consulting and product support services, and we train and certify system integrators and developers. We sell the Xbox video game console and games, the Zune digital music and entertainment device, PC games, and PC peripherals. Online communication and information services are delivered through our MSN portals, channels around the world, and through our search products.

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated over 40% of its yearly segment revenues in our second fiscal quarter. In fiscal year 2007, our revenue was highest in the third quarter due to the recognition of $1.7 billion of revenue previously deferred from the Express Upgrade to Windows Vista and Microsoft Office Technology Guarantee programs and pre-shipments of Windows Vista and the 2007 Microsoft Office system. The technology guarantee programs provided customers who purchased current products with free or discounted rights to Windows Vista and the 2007 Microsoft Office system when those products became available to consumers. We believe the seasonality of revenue is likely to continue in the future consistent with our experience prior to fiscal year 2007.

All growth and percentage comparisons refer to the three or nine months ended March 31, 2008, as compared with the three or nine months ended March 31, 2007, unless otherwise noted.

***Proposed Acquisition of Yahoo! Inc.***

On January 31, 2008, we made a proposal to the Yahoo! Inc. ("Yahoo") board of directors to acquire all the outstanding shares of Yahoo common stock for consideration of $31 per Yahoo share, representing a total value of approximately $44.6 billion at the time of the offer. Our proposal would allow the Yahoo shareholders to elect to receive cash or 0.9509 of a share of Microsoft common stock for each of their shares of Yahoo common stock, subject to proration so that in the aggregate, one-half of the outstanding shares of Yahoo common stock would be exchanged for shares of Microsoft common stock and the other half would be exchanged for cash. On February 11, 2008, the Yahoo board of directors stated publicly that our offer undervalued the company and was not in the best interests of its shareholders. There are no assurances that any acquisition will be completed.

**Summary**

| (In millions, except per share amounts and percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Revenue | **$14,454** | $14,398 | — % | **$44,583** | $37,751 | 18% |
| Operating income | **$ 4,409** | $ 6,589 | (33)% | **$16,808** | $14,535 | 16% |
| Diluted earnings per share | **$ 0.47** | $ 0.50 | (6)% | **$ 1.41** | $ 1.11 | 27% |

Revenue growth for the three months ended March 31, 2008 was driven primarily by increased Xbox platform sales, increased Windows Server and SQL Server revenue, and increased online advertising revenue, offset by decreased licensing revenue from Windows Vista and the 2007 Microsoft Office system. During the three months ended March 31, 2007, we recognized approximately $1.7 billion of revenue deferred during the first half of fiscal year 2007 related to the Express Upgrade to Windows Vista and Microsoft Office Technology Guarantee programs and pre-shipments of Windows Vista and the 2007 Microsoft Office system. Revenue growth for the nine months ended March 31, 2008 was driven primarily by licensing of the 2007 Microsoft Office system, increased Xbox platform sales, increased revenue associated with Windows Server and SQL Server, and increased licensing of Windows Vista. Foreign currency exchange rates accounted for a $403 million or three percentage point increase in revenue during the three months and a $1.0 billion or three percentage point increase during the nine months ended March 31, 2008.

Operating income declined during the three months ended March 31, 2008, driven primarily by increased costs for legal settlements and legal contingencies, increased headcount-related expenses, and increased cost of revenue (data center and online costs, costs associated with the growth in consulting services, and Xbox 360 product costs reflecting increased Xbox 360 console sales, partially offset by decreased Xbox 360 manufacturing costs per console). Operating income growth for the nine months ended March 31, 2008 was primarily driven by the increased revenue, partially offset by increased costs for legal settlements and legal contingencies, increased cost of revenue (reflecting the items noted above and increased Windows Vista product costs), and increased headcount-related expenses. We incurred $1.5 billion of legal charges during the three months and $1.8 billion during the nine months ended March 31, 2008, primarily related to the European Commission fine of €899 million as compared with $296 million of legal charges during the three months and $494 million during the nine months ended March 31, 2007, primarily related to antitrust and unfair competition consumer class actions and intellectual property claims. Total headcount-related expenses increased 14% during the three months and 11% during the nine months ended March 31, 2008, driven by a 13% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount.

Worldwide macroeconomic factors have a strong correlation to business and consumer demand for our software, services, games, and Internet service offerings. We are monitoring the changing economic conditions and expect the following for fiscal year 2008: we continue to expect double-digit revenue growth; we estimate worldwide PC shipments will grow 11% to 13%; and we expect a continued favorable impact from changes in year-over-year foreign currency exchange rates.

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

Revenue and operating income/(loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the United States of America ("U.S. GAAP") and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 9 – Segment Information is presented on a basis consistent with our current internal management reporting, in accordance with Statement of Financial Accounting Standards ("SFAS") No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. Prior period amounts have been recast to conform to the way we internally manage and monitor performance at the segment level during the current period.

***Client***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Revenue | **$ 4,025** | $ 5,274 | (24)% | **$12,498** | $11,167 | 12% |
| Operating income | **$ 3,097** | $ 4,204 | (26)% | **$ 9,824** | $ 8,689 | 13% |

Client offerings consist of premium edition and standard Windows operating systems. Premium offerings are those that include additional functionality and are sold at a price above our standard versions. Premium offerings include Windows XP Professional, Windows XP Media Center Edition, Windows XP Tablet PC Edition, Windows Vista Business, Windows Vista Home Premium, Windows Vista Ultimate, and Windows Vista Enterprise. Standard Windows operating systems include Windows XP Home and Windows Vista Home Basic. Client revenue growth correlates with the growth of purchases of PCs from OEMs that pre-install versions of Windows operating systems because the OEM channel accounts for approximately 80% of total Client revenue. The differences between unit growth rates and revenue growth rates from year to year are affected by changes in the mix of OEM Windows operating systems licensed with premium edition operating systems as a percentage of total OEM Windows operating systems licensed ("OEM premium mix"), changes in the geographical mix, and changes in the channel mix of products sold by large, multi-national OEMs versus those sold by local and regional system builders.

Client revenue decreased during the three months ended March 31, 2008, primarily reflecting revenue of approximately $1.2 billion recognized during the third quarter of the prior fiscal year upon the January 2007 release of Windows Vista to consumers. The amount had been deferred during the first half of fiscal year 2007 as a result of the Express Upgrade to Windows Vista Technology Guarantee program. Client revenue increased during the nine months ended March 31, 2008, primarily reflecting licensing of Windows Vista. During the three months ended March 31, 2008, OEM revenue decreased $1.1 billion or 25%, primarily reflecting revenue recognized during the third quarter of fiscal year 2007 related to the technology guarantee program, partially offset by a 5% increase in OEM license units. During the nine months ended March 31, 2008, OEM revenue increased $1.3 billion or 14%, driven by 14% growth in OEM license units. Revenue from commercial and retail licensing of Windows operating systems decreased $146 million or 18% during the three months ended March 31, 2008, primarily reflecting revenue recognized during the third quarter of the prior year related to the January 2007 consumer launch of Windows Vista. Revenue from commercial and retail licensing of Windows operating systems increased $71 million or 4% during the nine months ended March 31, 2008, primarily due to sales from Enterprise Agreements and anti-piracy efforts in emerging markets. The OEM premium mix increased five percentage points to 76% compared with the third quarter of last year and nine percentage points to 75% compared with the first nine months of last year, driven by increased consumer premium mix. Based on our estimates, total worldwide PC shipments from all sources grew 8% to 10% from the third quarter of the previous year and 12% to 14% from the first nine months of the previous year driven by demand in both emerging and mature markets.

Client operating income decreased during the three months ended March 31, 2008, reflecting the decreased revenue, partially offset by decreased sales and marketing expenses and decreased cost of revenue. Client operating income increased during the nine months ended March 31, 2008, reflecting the increased revenue, partially offset by increased cost of revenue. Sales and marketing expenses decreased $111 million or 21% during the three months, driven by decreased global advertising. Cost of revenue decreased $31 million or 11% during the three months, reflecting higher support services related to commercial and retail licensing during the third quarter of the prior fiscal year for the Windows Vista launch, and increased $162 million or 30% during the nine months, driven by Windows Vista product costs. Headcount-related expenses decreased 7% during the three months and were flat during the nine months ended March 31, 2008, driven by a 2% decrease in headcount over the past 12 months and decreased stock-based compensation expense.

For the fourth quarter of fiscal year 2008, we expect PC market growth will exceed OEM revenue growth. We expect PC shipments to grow 11% to 13% for fiscal year 2008. We believe that PC unit growth rates will be higher in the consumer segment than in the business segment and higher in emerging markets than in mature markets.

***Server and Tools***

| (In millions, except percentages) | Three Months ended March 31, 2008 | Three Months ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Revenue | **$ 3,255** | $ 2,748 | 18% | **$ 9,433** | $ 8,087 | 17% |
| Operating income | **$ 1,092** | $ 911 | 20% | **$ 3,220** | $ 2,656 | 21% |

Server and Tools offerings consist of server software licenses and client access licenses ("CAL") for Windows Server, Microsoft SQL Server, and other server products. It also includes developer tools, training, certification, Microsoft Press, Premier and Professional product support services, and Microsoft Consulting Services. Server and Tools concentrates on licensing products, applications, tools, content, and services that make information technology professionals and developers more productive and efficient. We use multiple channels for licensing, including pre-installed OEM versions, licenses through partners, and licenses directly to end customers. We sell licenses both as one-time licenses, and as multi-year volume licenses.

Server and Tools revenue increased during the three and nine months ended March 31, 2008, reflecting growth in both product and services revenue. Server and server application revenue (including CAL revenue) and developer tools, training, and certificate revenue increased $381 million or 17% during the three months and $932 million or 14% during the nine months ended March 31, 2008, primarily driven by growth in new and recurring volume licensing of Windows Server and SQL Server products, reflecting broad adoption of the Windows Platform and applications. Consulting and Premier and Professional product support services revenue increased $126 million or 24% during the three months and $414 million or 28% during the nine months ended March 31, 2008, primarily due to higher demand for consulting and support services in corporate enterprises. Foreign currency exchange rates accounted for a $120 million or four percentage point increase in revenue for the three months and $296 million or four percentage point increase in revenue for the nine months ended March 31, 2008.

Server and Tools operating income increased for the three and nine months ended March 31, 2008, primarily reflecting the increased revenue, partially offset by increased sales and marketing expenses, cost of revenue for services, and research and development expenses. Sales and marketing expenses increased $165 million or 20% during the three months and $397 million or 16% during the nine months ended March 31, 2008, primarily reflecting increased headcount-related expenses associated with our corporate sales force. Cost of revenue increased $92 million or 17% during the three months and $261 million or 16% during the nine months ended March 31, 2008, reflecting the growth in services provided. Research and development expenses increased $71 million or 17% during the three months and $136 million or 11% during the nine months ended March 31, 2008, primarily driven by increased headcount-related expenses. Headcount-related expenses increased 8%

during the three months and 7% during the nine months ended March 31, 2008, driven by a 10% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

For the fourth quarter of fiscal year 2008, we expect continued growth in both product and services revenue. We expect product revenue growth from platform adoption through new and renewal volume licensing growth coupled with our new product offerings.

***Online Services Business***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Revenue | **$ 843** | $ 603 | 40% | **$ 2,377** | $ 1,764 | 35% |
| Operating loss | **$ (228)** | $ (171) | (33)% | **$ (745)** | $ (407) | (83)% |

Online Services Business ("OSB") provides personal communications services, such as e-mail and instant messaging, online information offerings, such as Live Search, and the MSN portals and channels around the world. OSB also provides a variety of online services such as MSN Internet Access and MSN Premium Web Services. We earn revenue primarily from online advertising, including search, home page, email, and messaging services, from consumers and partners through subscriptions and transactions generated from online paid services, and from MSN narrowband Internet Access subscribers. We continue to launch new online initiatives and expect to do so in the future. During fiscal year 2008, we launched a new release of Windows Live Search and the Windows Live suite of applications and services.

During the first quarter of fiscal year 2008, we completed our acquisition of aQuantive, Inc. ("aQuantive"), a digital marketing business which we expect will play a key role in the future development of our advertising business. aQuantive earns revenue from online advertising and from digital marketing and advertising agency services. We believe the acquisition will help us build and support next-generation advertiser and publisher solutions in environments such as cross-media planning, video-on-demand, and Internet protocol television. aQuantive was consolidated into our results of operations starting August 10, 2007, the acquisition date.

OSB revenue increased during the three and nine months ended March 31, 2008, driven primarily by increased online advertising revenue and the inclusion of aQuantive revenue, partially offset by decreased access revenue. Online advertising revenue increased $175 million or 39% to $619 million during the three months and $460 million or 36% to $1.7 billion during the nine months ended March 31, 2008. This increase reflects growth in our existing online advertising business and includes aQuantive online advertising revenue of $47 million during the three months and $128 million during the nine months ended March 31, 2008. Agency revenue, which is solely derived from aQuantive, was $97 million during the three months and $251 million during the nine months ended March 31, 2008. Access revenue was $60 million for the three months and $197 million for the nine months ended March 31, 2008, reflecting decreases of 29% for both periods. As of March 31, 2008, we had 448 million Windows Live IDs compared with 380 million as of the same period last year.

OSB operating loss increased during the three and nine months ended March 31, 2008, driven primarily by increased cost of revenue and increased sales and marketing expenses, partially offset by increased revenue. Cost of revenue increased $176 million or 61% during the three months and $545 million or 68% during the nine months ended March 31, 2008, primarily driven by increased data center costs, online content expenses, and aQuantive-related expenses. Sales and marketing expenses increased $69 million or 33% during the three months and $231 million or 39% during the nine months ended March 31, 2008, primarily due to increased marketing costs and amortization of customer-related intangible assets. OSB operating loss for the three months ended March 31, 2008 included $46 million of amortization of intangible assets acquired from aQuantive, and OSB operating loss for the nine months ended March 31, 2008 included $122 million of intangible assets amortization and a $24 million in-process research and development write-off. Headcount-related expenses increased 27% during the three months and 19% during the nine months ended March 31, 2008, driven by a 26% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

For the fourth quarter of fiscal year 2008, online advertising revenue is expected to benefit from our acquisition of aQuantive, while revenue from narrowband Internet Access is expected to continue to decline. We also expect operating expenses to increase as we continue to invest in our long-term strategy. We believe these investments will lay the groundwork for future growth.

***Microsoft Business Division***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Revenue | **$ 4,745** | $ 4,827 | (2)% | **$13,668** | $11,768 | 16% |
| Operating income | **$ 3,138** | $ 3,399 | (8)% | **$ 9,017** | $ 7,794 | 16% |

Microsoft Business Division ("MBD") offerings consist of the Microsoft Office system and Microsoft Dynamics business solutions. Microsoft Office system products are designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions. Growth of revenue from the Microsoft Office system offerings, which generate over 90% of MBD revenue, depends on our ability to add value to the core Office product set and to continue to expand our product offerings in other information worker areas such as enterprise content management, collaboration, unified communications, and business intelligence. Microsoft Dynamics products provide business solutions for financial management, customer relationship management, supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises. We evaluate our results based upon the nature of the end user in two primary parts: business revenue, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

MBD revenue decreased during the three months ended March 31, 2008, primarily reflecting revenue of approximately $500 million recognized during the third quarter of the prior fiscal year upon the January 2007 release of the 2007 Microsoft Office system to consumers. The amount had been deferred during the first half of fiscal year 2007, as a result of the Microsoft Office Technology Guarantee program. MBD revenue increased during the nine months ended March 31, 2008, primarily reflecting licensing of the 2007 Microsoft Office system. Business revenue increased $555 million or 17% during the three months and $1.9 billion or 21% during the nine months ended March 31, 2008, primarily as a result of growth in volume licensing agreement revenue and strong transactional license sales to businesses. The increase in business revenue also included a 13% increase in Microsoft Dynamics customer billings during the three months and a 20% increase during the nine months ended March 31, 2008. Consumer revenue decreased $636 million or 39% primarily reflecting revenue of approximately $500 million recognized during the third quarter related to the 2007 Microsoft Office Technology Guarantee program and remained flat during the nine months ended March 31, 2008, primarily reflecting the consumer launch of the 2007 Microsoft Office system in the prior fiscal year. Foreign currency exchange rates accounted for a $194 million or four percentage point increase in revenue during the three months and a $458 million or four percentage point increase in revenue during the nine months ended March 31, 2008.

MBD operating income decreased for the three months ended March 31, 2008, reflecting the decreased revenue, increased sales and marketing expenses, research and development expenses, and cost of revenue. MBD operating income increased for the nine months ended March 31, 2008, reflecting the increased revenue, partially offset by increased sales and marketing expenses, cost of revenue, and research and development expenses. Sales and marketing expenses increased $72 million or 8% during the three months and $386 million or 16% during the nine months ended March 31, 2008, primarily reflecting increased headcount-related expenses associated with our corporate sales force. Research and development expenses increased $58 million or 19% during the three months and $132 million or 14% during the nine months ended March 31, 2008, primarily reflecting increased headcount-related expenses. Cost of revenue increased $41 million or 20% during the three months and $138 million or 25% during the nine months ended March 31, 2008, primarily driven by an increase in online costs reflecting the April 2007 acquisition of Tellme Networks. Headcount-related expenses increased 16% during the three months and 9% during the nine months ended March 31, 2008, driven by a 7% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense during the nine month period.

For the fourth quarter of fiscal year 2008, we expect revenue to continue to increase over the prior year due to the strong performance of the 2007 Microsoft Office system. We continue to develop plans to grow revenue in new areas such as unified communications and through our existing portfolio of Microsoft Dynamics products. In April 2008, we acquired Fast Search & Transfer ASA, an enterprise search company, for approximately $1.2 billion in cash. We believe the acquisition will broaden our enterprise search technology product offerings to businesses and will enable innovations in related areas such as our portal and content management.

***Entertainment and Devices Division***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Revenue | **$ 1,576** | $ 936 | 68% | **$6,565** | $4,916 | 34% |
| Operating income/(loss) | **$ 89** | $ (324) | * | **$ 614** | $ (746) | * |

* *Not meaningful*

The Entertainment and Devices Division (“EDD”) products include the Xbox 360 platform (which includes the Microsoft Xbox video game console system, Xbox 360 video games, Xbox Live, and Xbox 360 accessories), PC games, consumer software and hardware products, the Zune digital music and entertainment platform, Mediaroom (our Internet protocol television software), the Windows Mobile software platform, the Windows Embedded device operating system, and Windows Automotive. The success of video game consoles is determined by console innovation and quality, the portfolio of video game content for the console, online offerings, and the market share of the console. We believe that the functionality of the Xbox 360 console, games portfolio, and online offerings are well positioned relative to competitive consoles.

EDD revenue increased during the three and nine months ended March 31, 2008, primarily due to increased Xbox 360 platform sales. During the three months ended March 31, 2008, Xbox platform and PC game revenue increased $418 million or 85% primarily as a result of increased Xbox 360 console sales, Xbox 360 video game sales, and Xbox Live revenue. Xbox platform and PC game revenue increased $1.4 billion or 42% during the nine months ended March 31, 2008, as a result of increased Xbox 360 console sales, video game sales led by Halo 3, Xbox Live revenue, and Xbox 360 accessory sales. We shipped 1.3 million Xbox 360 consoles in the third quarter and 7.5 million Xbox 360 consoles in the first nine months of fiscal year 2008, compared with 0.5 million and 5.9 million Xbox 360 consoles in the third quarter and the first nine months of fiscal year 2007, respectively.

EDD operating income increased during the three months ended March 31, 2008, primarily due to the increased revenue, partially offset by increased cost of revenue, research and development expenses, and sales and marketing expenses. EDD operating income increased during the nine months ended March 31, 2008, primarily due to the increased revenue, partially offset by increased cost of revenue and research and development expenses. Cost of revenue increased $79 million or 11% during the three months and $143 million or 4% during the nine months ended March 31, 2008, primarily driven by increased Xbox 360 product costs reflecting increased Xbox 360 console sales, partially offset by decreased Xbox 360 manufacturing costs per console. Research and development expenses increased $77 million or 26% during the three months and $101 million or 11% during the nine months ended March 31, 2008, primarily reflecting increased headcount-related expenses. Sales and marketing expenses increased $62 million or 29% during the three months ended March 31, 2008, reflecting an increase in headcount-related expenses associated with product marketing and retail account sales force. Headcount-related expenses increased 35% and 20% during the three and nine months ended March 31, 2008, respectively, reflecting a 13% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense during the nine month period.

For the fourth quarter of fiscal year 2008, we expect revenue to increase due to increased sales of Xbox 360 consoles and related games, accessories, and services. Revenue from existing mobility and embedded devices is expected to increase due to unit volume increases of Windows Mobile software driven by increased market demand for phone-enabled devices and Windows Embedded operating systems. In April 2008, we acquired Danger, Inc., a software-as-a-service company that provides mobile operators with an integrated end-to-end solution to deliver mobile data and Internet services to their subscribers, for approximately $500 million in cash.

***Corporate-Level Activity***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Corporate-level results | **$(2,779)** | $(1,430) | (94)% | **$(5,122)** | $(3,451) | (48)% |

Certain corporate-level results are not allocated to our segments. Those results include expenses related to corporate operations related to broad-based sales and marketing, product support services, human resources, legal, finance, information technology, corporate development and procurement activities, research and development and other costs, and legal settlements and contingencies.

Corporate-level expenses increased for the three and nine months ended March 31, 2008, primarily reflecting increased costs for legal settlements and legal contingencies and increased headcount-related expenses. We incurred $1.5 billion of legal charges during the three months and $1.8 billion during the nine months ended March 31, 2008, primarily related to the European Commission fine of €899 million as compared with $296 million of legal charges during the three months and $494 million during the nine months ended March 31, 2007, primarily related to antitrust and unfair competition consumer class actions and intellectual property claims. Headcount-related expenses increased 14% during the three months and 13% during the nine months ended March 31, 2008, driven by a 6% increase in headcount over the past 12 months, an increase in salaries and benefits for existing headcount, and an increase in stock-based compensation.

## OPERATING EXPENSES

***Cost of Revenue***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | Three Months Ended March 31, 2007 | Percentage Change | Nine Months Ended March 31, 2008 | Nine Months Ended March 31, 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Cost of revenue | **$ 2,514** | $ 2,140 | 17% | **$8,732** | $7,456 | 17% |
| As a percent of revenue | **17%** | 15% | 2ppt | **20%** | 20% | —ppt |

Cost of revenue includes manufacturing and distribution costs for products sold and programs licensed, operating costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, warranty costs, inventory valuation adjustments, and costs associated with the delivery of consulting services. Cost of revenue increased during the three and nine months ended March 31, 2008, reflecting increased OSB data center and online costs, increased costs associated with the growth in consulting services, and increased Xbox 360 product costs, reflecting increased Xbox 360 console sales, partially offset by decreased Xbox 360 manufacturing costs per console. The increase in cost of revenue during the nine months ended March 31, 2008, also reflects increased Windows Vista product costs. Cost of revenue as a percentage of revenue was lower in the prior year reflecting an increased percentage of higher margin sales as a result of the recognition of approximately $1.7 billion of revenue deferred during the first half of fiscal year 2007 related to the Express Upgrade to Windows Vista and Microsoft Office Technology Guarantee programs.

### *Research and Development*

| (In millions, except percentages) | Three Months Ended March 31, 2008 | 2007 | Percentage Change | Nine Months Ended March 31, 2008 | 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Research and development | **$ 2,035** | $ 1,750 | 16% | **$5,757** | $5,173 | 11% |
| As a percent of revenue | **14%** | 12% | 2ppt | **13%** | 14% | (1)ppt |

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. The increase in research and development expenses for the three and nine months ended March 31, 2008 was primarily driven by an increase in headcount-related expenses. Headcount-related expenses increased 14% during the three months and 10% during the nine months ended March 31, 2008, reflecting a 9% increase in headcount over the past 12 months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-compensation expense.

### *Sales and Marketing*

| (In millions, except percentages) | Three Months Ended March 31, 2008 | 2007 | Percentage Change | Nine Months Ended March 31, 2008 | 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| Sales and marketing | **$ 3,155** | $ 2,936 | 7% | **$9,161** | $8,126 | 13% |
| As a percent of revenue | **22%** | 20% | 2ppt | **21%** | 22% | (1)ppt |

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses increased during the three months ended March 31, 2008, primarily as a result of increased headcount-related expenses. Sales and marketing expenses increased during the nine months ended March 31, 2008, primarily as a result of increased headcount-related expenses. Headcount-related expenses increased 15% during the three months and 14% during the nine months ended March 31, 2008, reflecting both an increase in salaries and benefits for existing headcount and a 7% increase in headcount over the past 12 months, partially offset by decreased stock-based compensation expense during the nine month period.

***General and Administrative***

| (In millions, except percentages) | Three Months Ended March 31, 2008 | 2007 | Percentage Change | Nine Months Ended March 31, 2008 | 2007 | Percentage Change |
|---|---|---|---|---|---|---|
| General and administrative | **$ 2,341** | $ 983 | 138% | **$4,125** | $2,461 | 68% |
| As a percent of revenue | **16%** | 7% | 9ppt | **9%** | 7% | 2ppt |

General and administrative costs include payroll, employee benefits, stock-based compensation expense and other headcount-related expenses associated with finance, legal, facilities, certain human resources, other administrative headcount, and legal and other administrative fees. General and administrative expenses increased for the three and nine months ended March 31, 2008, primarily reflecting increased costs for legal settlements and legal contingencies. We incurred $1.5 billion of legal charges during the three months and $1.8 billion during the nine months ended March 31, 2008, primarily related to the European Commission fine of €899 million as compared with $296 million of legal charges during the three months and $494 million during the nine months ended March 31, 2007, primarily related to antitrust and unfair competition consumer class actions and intellectual property claims. Headcount-related expenses increased 13% during the three months and 8% during the nine months ended March 31, 2008, reflecting a 12% increase in headcount over the past 12 months, an increase in salaries and benefits for existing headcount, and an increase in stock-based compensation expense.

## INVESTMENT INCOME, INCOME TAXES, AND OTHER

***Investment Income and Other***

The components of investment income and other were as follows:

| (In millions) | Three Months Ended March 31, 2008 | 2007 | Change | Nine Months Ended March 31, 2008 | 2007 | Change |
|---|---|---|---|---|---|---|
| Dividends and interest | **$ 226** | $ 333 | $ (107) | **$ 671** | $ 1,018 | $ (347) |
| Net recognized gains/(losses) on investments | **(13)** | 39 | (52) | **225** | 505 | (280) |
| Net gains/(losses) on derivatives | **191** | 22 | 169 | **275** | (209) | 484 |
| Other | **(3)** | (12) | 9 | **(133)** | (32) | (101) |
| Investment income and other | **$ 401** | $ 382 | $ 19 | **$ 1,038** | $ 1,282 | $ (244) |

During the three and nine months ended March 31, 2008, dividends and interest income decreased, reflecting lower interest rates on our fixed-income investments and a reduction in the average balance of interest-bearing investments. Net recognized gains/(losses) on investments, which includes other-than-temporary impairments of $179 million for the three months and $248 million for the nine months ended March 31, 2008, decreased primarily due to declines in equity values as a result of the recent stock market decline.

During the three and nine months ended March 31, 2008, net gains on derivatives increased primarily due to higher net gains on equity, interest rate, and commodity derivatives. We use derivative instruments to manage exposures to interest rates, equity prices, and foreign currency markets and to facilitate portfolio diversification. Gains and losses arising from derivatives not designated as accounting hedges are in large part economically offset by unrealized losses and gains, respectively, in the underlying securities, which are recorded as a component of other comprehensive income. Net losses related to foreign currency contracts relate primarily to changes in time value of options used to hedge anticipated foreign currency revenues. Other of $133 million for the nine months ended March 31, 2008 includes the correction of several immaterial items from prior periods.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Collateral and/or security interest is determined based upon the underlying security and the creditworthiness of the borrower. Cash collateral is recorded as an asset with a corresponding liability.

***Income Taxes***

The effective tax rate was 9% and 25%, respectively, for the three and nine months ended March 31, 2008. The fiscal year 2008 rates reflect a decline in the recurring effective tax rate from 31% to 30%, primarily as a result of resolution of tax positions relating to our agreement with the Internal Revenue Service ("IRS") of the 2000-2003 examination. The effective tax rate also declined as a result of the reduction in previously accrued taxes and interest related to the 2000-2003 IRS examination. This decline was partially offset by the tax effect of the European Commission fine of €899 million, which is not tax deductible.

The effective tax rate was 29% and 30%, respectively, for the three and nine months ended March 31, 2007. These rates reflect an increase in the recurring effective tax rate from 31% to 31.5% due to a higher mix of earnings in high rate tax jurisdictions and were offset by a $195 million reduction resulting from various changes in tax positions taken in prior periods, related primarily to favorable developments in an IRS position and multiple foreign audit assessments.

On July 1, 2007, we adopted the provisions of the Financial Accounting Standards Board ("FASB") Interpretation No. 48 ("FIN 48") *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109,* which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, we may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures.

Adopting FIN 48 had the following impact on our financial statements: increased current assets by $228 million, long-term assets by $1.1 billion, long-term liabilities by $2.1 billion, and our retained deficit by $395 million; and decreased our income taxes payable by $394 million. As of July 1, 2007, we had $7.1 billion of unrecognized tax benefits of which $5.3 billion, if recognized, would affect our effective tax rate. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. As of July 1, 2007, we had accrued interest related to uncertain tax positions of $863 million, net of federal income tax benefit, on our balance sheet.

## FINANCIAL CONDITION

Cash and cash equivalents and short-term investments totaled $26.3 billion as of March 31, 2008, compared with $23.4 billion as of June 30, 2007. Equity and other investments were $8.7 billion as of March 31, 2008, compared with $10.1 billion as of June 30, 2007. Our investments consist primarily of fixed-income securities, diversified among industries and individual issuers. Our investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S.-dollar-denominated securities, but also includes foreign-denominated securities in order to diversify financial risk. We invest primarily in short-term securities to facilitate rapid deployment for immediate cash needs. As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was $25.8 billion at March 31, 2008. Our retained deficit is not expected to affect our future ability to operate or pay dividends given our continuing profitability and strong cash and financial position.

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to price positions. This pricing methodology applies to exchange-traded mutual funds, domestic and international equities, U.S. treasuries, and Agency securities. If quoted prices in active markets for identical assets or liabilities to price positions are not available, then we use inputs other than the quoted prices which are observable either directly or indirectly, predominately based on prices received from third-party vendors. Assets and liabilities measured using unobservable inputs are an immaterial portion of our portfolio.

While we own certain mortgage and asset-backed fixed-income securities, our portfolio as of March 31, 2008, does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from sub-prime collateral. The majority of the mortgage-backed securities is collateralized by prime residential mortgages and carries a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association. The remainder of the mortgage position is collateralized by high quality international prime residential mortgage loans.

### *Unearned Revenue*

Unearned revenue from volume licensing programs represents customer billings, paid either upfront or annually at the beginning of each billing coverage period, that are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. For certain other licensing arrangements, revenue attributable to undelivered elements, including free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis for Windows XP and previous PC operating systems, is based on the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the life cycle of the related product. Other unearned revenue includes services, Microsoft Dynamics business solution products, Xbox Live subscriptions, advertising, and Mediaroom for which we have been paid upfront and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected recognition of unearned revenue as of March 31, 2008:

| (In millions) | Recognition of Unearned Revenue |
|---|---|
| Three months ended: | |
| June 30, 2008 | $ 4,428 |
| September 30, 2008 | 2,933 |
| December 31, 2008 | 2,087 |
| March 31, 2009 | 937 |
| Thereafter | 1,754 |
| Unearned revenue | $ 12,139 |

See Note 4 – Unearned Revenue (Part I, Item 1).

### *Cash Flows*

Cash flow from operations for the nine months ended March 31, 2008 increased $4.1 billion from the first nine months of fiscal year 2007 to $17.5 billion due to an increase in cash received from customers, including an increase in accounts receivable collections of $1.1 billion. The increase also reflects a reduction in cash used for repayment of other current liabilities of $949 million. Cash used for financing was $7.9 billion in the first nine months of fiscal year 2008, a decrease of $9.7 billion from the corresponding period in fiscal year 2007. The decrease reflects $8.2 billion of common stock repurchases in the nine months ended March 31, 2008, compared with $20.4 billion in the first nine months of the prior fiscal year, which included the impact of our tender offer on August 17, 2006. This impact was partially offset by a $2.4 billion decrease in proceeds from issuance of common stock, reflecting the JPMorgan exercise of approximately 113 million call options for $3.3 billion in December 2006. Cash used for investing was $4.1 billion in the first nine months of fiscal year 2008, as compared with cash provided from investing of $5.0 billion in the first nine months of fiscal year 2007, a change of $9.1 billion. This change reflects a $5.5 billion increase in cash paid for acquisition of companies, reflecting the purchase of aQuantive in the first quarter of fiscal year 2008, along with a $2.9 billion decrease in cash from combined investment purchases, sales, and maturities.

As previously mentioned, on January 31, 2008, we submitted to the board of directors of Yahoo a proposal to acquire all of the outstanding shares of Yahoo common stock, and on February 11, 2008, the Yahoo board of directors stated publicly that our offer undervalued the company and was not in the best interests of its shareholders. We currently are reviewing various alternatives to finance the cash portion of the proposed acquisition if we are successful in acquiring all of the outstanding shares. There are no assurances that any acquisition will be completed.

In April 2008, we acquired Fast Search & Transfer ASA for approximately $1.2 billion and Danger, Inc. for approximately $500 million in cash. As a result of our agreement with the IRS related to the 2000-2003 examination, we expect to pay them approximately $3.0 billion during the next year. As previously noted, we were fined €899 million by the European Commission in February 2008 (see Note 8 – Contingencies of Part I, Item 1). During the fourth quarter of fiscal year 2008, we expect to either pay the fine or, if we appeal, we may deliver a bank guarantee as an assurance the fine will be paid if an appeal is unsuccessful.

We currently have no material long-term debt. Stockholders' equity at March 31, 2008 was $37.6 billion. We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of requirements for capital resources.

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately $16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. As of March 31, 2008, approximately $7.7 billion remained of the $36.2 billion approved repurchase amount.

Our Board of Directors declared the following dividends:

| Declaration Date | Per Share Dividend | Record Date | Total Amount (in millions) | Payment Date |
|---|---|---|---|---|
| *(Fiscal year 2008)* | | | | |
| September 12, 2007 | $ 0.11 | November 15, 2007 | $1,034 | December 13, 2007 |
| December 19, 2007 | $ 0.11 | February 21, 2008 | $1,023 | March 13, 2008 |
| March 17, 2008 | $ 0.11 | May 15, 2008 | $1,024 | June 12, 2008 |
| *(Fiscal year 2007)* | | | | |
| September 13, 2006 | $ 0.10 | November 16, 2006 | $ 979 | December 14, 2006 |
| December 20, 2006 | $ 0.10 | February 15, 2007 | $ 977 | March 8, 2007 |
| March 26, 2007 | $ 0.10 | May 17, 2007 | $ 952 | June 14, 2007 |

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

***Off-Balance Sheet Arrangements***

We provide indemnifications of varying scope and amount to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. We evaluate estimated losses for such indemnifications under Statement of Financial Accounting Standards ("SFAS") No. 5, *Accounting for Contingencies*, as interpreted by FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. We consider factors such as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any material liabilities related to such indemnifications in our financial statements.

## RECENT ACCOUNTING PRONOUNCEMENTS

***Recently Adopted Accounting Pronouncements***

On July 1, 2007, we adopted FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, we may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Upon adoption, we recognized a $395 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle. See Note 13 – Income Taxes.

On July 1, 2007, we adopted Emerging Issues Task Force Issue No. 06-2 ("EITF 06-2"), *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43*. EITF 06-2 requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. Upon adoption, we recognized a $17 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle.

***Recent Accounting Pronouncements Not Yet Adopted***

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, which requires additional disclosures about the objectives of the derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective for us beginning January 1, 2009. We are currently assessing the potential impact that adoption of SFAS No. 161 may have on our financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*, which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for us beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51,* which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for us beginning July 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. We are currently assessing the potential impact that adoption of SFAS No. 160 may have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings. SFAS No. 159 is effective for us beginning July 1, 2008. We are currently assessing the potential impact that electing fair value measurement may have on our financial statements and have not determined what election we will make.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. In February 2008, the FASB issued FASB Staff Position ("FSP") 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS No. 157 is effective for us beginning July 1, 2008; FSP 157-2 delays the effective date for certain items to July 1, 2009. We are currently assessing the potential impact that adoption of this statement may have on our financial statements.

## APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

We account for the licensing of software in accordance with American Institute of Certified Public Accountants Statement of Position ("SOP") 97-2, *Software Revenue Recognition*. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence ("VSOE") of fair value exists for those elements. For some of our products, customers receive certain elements of our products over a period of time. These elements include free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. The fair value of these elements is recognized over the estimated life cycle for the Windows XP and previous PC operating systems. For Windows Vista, there are no significant undelivered elements and accordingly, no license revenue is deferred for Windows Vista sales. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment also is required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and SAB Topic 5M, *Accounting for Noncurrent Marketable Equity Securities*, provide guidance on determining when an investment is other-than-temporarily impaired. Investments are reviewed quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, operational and financing cash flow factors, and rating agency actions. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (July 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition or sale or disposition of a significant portion of a reporting unit. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit. We allocate goodwill to reporting units based on the reporting unit expected to benefit from the combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach.

We account for research and development costs in accordance with applicable accounting pronouncements, including SFAS No. 2, *Accounting for Research and Development Costs*, and SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. SFAS No. 86 specifies that costs incurred internally in researching and developing a computer software product should be charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all software costs should be capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through coding and testing. This is generally shortly before the products are released to manufacturing. We determined that technological feasibility was reached with Windows Vista and the 2007 Microsoft Office system during the second quarter of fiscal year 2007 and accordingly, we capitalized approximately $120 million of software development costs. The amortization of these costs will be included in cost of revenue over the estimated life of the products. Previously, costs incurred prior to technological feasibility were not material and were expensed as incurred.

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. SFAS No. 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency such as a legal proceeding or claim should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our results of operations, financial position, or our cash flows.

SFAS No. 109, *Accounting for Income Taxes*, establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, or cash flows. Accruals for uncertain tax positions are provided for in accordance with the requirements of FIN 48.

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

We account for product warranties in accordance with SFAS No. 5, *Accounting for Contingencies*. We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include technical support, parts, and labor over a period generally ranging from 90 days to three years. For software warranty, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software. We reevaluate our estimates at least quarterly to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

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

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

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

VaR is calculated by computing the exposures of each holding's market value to a range of over 1,000 equity, fixed-income, foreign exchange, and commodity risk factors. The exposures are then used to compute the parameters of a distribution of potential changes in the total market value of all holdings, taking into account the weighted historical volatilities of the different rates and prices and the weighted historical correlations among the different rates and prices. The VaR is then calculated as the total loss that will not be exceeded at the 97.5

percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, credit risk, and legal risk.

Certain securities in our equity portfolio are held for strategic purposes. We hedge the value of a portion of these securities through the use of derivative contracts such as put-call collars. In these arrangements, we hedge a security's equity price risk below the purchased put strike and forgo most or all of the benefits of the security's appreciation above the sold call strike. We also hold equity securities for general investment return purposes. We have incurred material impairment charges related to these securities in previous periods.

The VaR amounts disclosed below are used as a risk management tool and reflect an estimate of potential reductions in fair value of our portfolio. Losses in fair value over the specified holding period can exceed the reported VaR by significant amounts and can also accumulate over a longer time horizon than the specified holding period used in the VaR analysis. VaR amounts are not necessarily reflective of potential accounting losses, including determinations of other-than-temporary losses in fair value in accordance with U.S. GAAP.

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

The following table sets forth the one-day VaR for substantially all of our positions as of and for the three months ended March 31, 2008, and as of June 30, 2007:

| Risk Categories (In millions) | March 31, 2008 | June 30, 2007 | Three months ended March 31, 2008 Average | High | Low |
|---|---|---|---|---|---|
| Interest rates | **$ 26** | $ 34 | **$ 30** | **$ 35** | **$ 25** |
| Currency rates | **116** | 55 | **94** | **131** | **75** |
| Equity prices | **52** | 60 | **52** | **59** | **45** |
| Commodity prices | **5** | 7 | **5** | **6** | **4** |

Total one-day VaR for the combined risk categories was $140 million at March 31, 2008 and $95 million at June 30, 2007. The total VaR is 29% less at March 31, 2008, and 39% less at June 30, 2007, than the sum of the separate risk categories in the above table due to the diversification benefit of the overall portfolio.

**Item 4. Controls and Procedures**

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Part II. Other Information

### Item 1. Legal Proceedings

In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were "not reasonable." Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should be imposed from that date. On February 27, 2008, the Commission issued a fine of €899 million relating to the period prior to October 22, 2007. On January 14, 2008, the Commission announced that it was opening two new competition law investigations. These investigations relate primarily to interoperability with respect to our Microsoft Office family of products and the inclusion of various capabilities in our Windows operating system software, including Web browsing software. These investigations were precipitated by complaints filed with the Commission by a trade association of Microsoft's competitors and a firm that offers Web browsing software.

We are subject to a Consent Decree and Final Judgment that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Consent Decree imposed various constraints on our Windows operating system businesses. Portions of the Consent Decree were scheduled to expire on January 31, 2008; we voluntarily agreed to extend other elements of the Consent Decree to November 2009. In October 2007, some states filed a motion with the U.S. District Court for the District of Columbia seeking to have most of the remaining provisions of the Final Judgment, in the action to which they are party, extended for five years. The U.S. Department of Justice and other states advised the Court that they would not seek any extension of the Final Judgments to which they are party. On January 29, 2008, the court issued a decision granting the states' motion to extend these additional provisions of the consent decree until November 2009.

See Note 8 – Contingencies (Part I, Item 1) for more information regarding other legal proceedings in which we are involved.

### Item 1A. Risk Factors

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and trading price of our common stock.

**Challenges to our business model may reduce our revenues and operating margins.** Our business model has been based upon customers paying a fee to license software that we developed and distributed. Under this license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. In recent years, certain "open source" software business models have evolved into a growing challenge to our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not have to bear the full costs of research and development for the software. Some of these firms may build upon Microsoft ideas that we provide to them free or at low royalties in connection with our interoperability initiatives. A prominent example of open source software is the Linux operating system. Proponents of open source software continue efforts to convince governments worldwide to mandate the use of open source software in their purchase and deployment of software products. Although we believe our products provide customers with significant advantages in security, productivity, and total cost of ownership, the open source software model continues to pose a significant challenge to our business model. To the extent open source software gains increasing market acceptance, sales of our products may decline, we may have to reduce the prices we charge for our products, and revenue and operating margins may decline.

Another development is the software-as-a-service business model, under which companies provide applications, data, and related services over the Internet. Providers use primarily advertising or subscription-based revenue models. Recent advances in computing and communications technologies have made this model viable and enabled the rapid growth of some of our competitors. We are devoting significant resources toward developing our own competing software plus services strategies. It is uncertain whether these strategies will be successful.

**We face intense competition.** We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio is a competitive advantage, our competitors that are focused on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products, in some cases on the basis of technical specifications for Microsoft technologies that we make available. In response to competition, we are developing versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins and operating income.

**We may not be able to adequately protect our intellectual property rights.** Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights or additional compliance burdens could both adversely affect revenue.

**Third parties may claim we infringe their intellectual property rights.** From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. To resolve these claims we may enter into royalty and licensing agreements on less favorable terms, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

**We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code.** Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. This could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code also could increase the security risks described in the next paragraph.

**Security vulnerabilities in our products could lead to reduced revenues or to liability claims.** Maintaining the security of computers and computer networks is a critical issue for us and our customers. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products. Although this is an industry-wide problem that affects computers across all platforms, it affects our products in particular because hackers tend to focus their efforts on the most popular operating systems and programs and we expect them to continue to do so. We devote significant resources to address security vulnerabilities through:

- engineering more secure products;
- enhancing security and reliability features in our products;
- helping our customers make the best use of our products and services to protect against computer viruses and other attacks;
- improving the deployment of software updates to address security vulnerabilities;
- investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed; and
- providing customers online automated security tools, published security guidance, and security software such as firewalls, anti-virus, and other security software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges.

**We are subject to government litigation and regulatory activity that affects how we design and market our products.** As a leading global software maker, we receive close scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers to assert claims of anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints include limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. We believe we are in full compliance with these rules. However, if we fail to comply with them, additional restrictions could be imposed on us that would adversely affect our business.

The European Commission closely scrutinizes the design of high volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. In 2004, the Commission ordered us to create new versions of Windows that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. The Commission's impact on product design may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our own products which could result in decreased sales of our products.

Government regulatory actions and court decisions may hinder our ability to provide the benefits of our software to consumers and businesses, thereby reducing the attractiveness of our products and the revenues that come from them. New actions could be initiated at any time, either by these or other governments or private claimants, including with respect to new versions of Windows or other Microsoft products. The outcome of such actions, or steps taken to avoid them, could adversely affect us in a variety of ways, including:

- We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail removing functionality that customers want or developers rely on.
- We may be required to make available licenses to our proprietary technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.
- The rulings described above may be cited as a precedent in other competition law proceedings.

Our software and services online offerings are subject to government regulation of the Internet domestically and internationally in many areas, including user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear and sometimes may conflict. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop doing the alleged noncompliant activity.

**Our business depends largely on our ability to attract and retain talented employees.** Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

**Delays in product development schedules may adversely affect our revenues.** The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could adversely affect our revenue.

**We make significant investments in new products and services that may not be profitable.** We have made and will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including Windows Vista, the 2007 Microsoft Office system, Xbox 360, Live Search, Windows Server, Zune, and Windows Live. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

**Adverse economic conditions may harm our business.** Inflation, softness in corporate information technology spending, or other changes in economic conditions that affect demand for computer hardware or software could adversely affect our revenue or our investment portfolio. If demand for PCs, servers, and other computing devices declines significantly, or consumer or corporate spending for such products declines, our revenue will be adversely affected. In addition, our revenue may be unfavorably impacted if customers reduce their purchases of new software products or upgrades because new offerings such as Windows Vista and the 2007 Microsoft Office system are not perceived as providing significant new functionality or other value to prospective purchasers.

**We have claims and lawsuits against us that may result in adverse outcomes.** We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. Although management currently believes resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial position, results of operations, or cash flows, the litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. A material adverse impact on our financial position, results of operations, and cash flows also could occur for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

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

**Our consumer hardware products may experience quality or supply problems.** Our hardware products such as the Xbox 360 console are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We obtain some components of our hardware devices from sole suppliers. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Either component shortages or excess or obsolete inventory may require us to record charges to cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenues and operating margins.

**If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings.** Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is tested for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

**We operate a global business that exposes us to additional risks.** We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment; changes in regulatory requirements for software; social, political, labor or economic conditions in a specific country or region; and difficulties in staffing and managing foreign operations. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

**Catastrophic events or geo-political conditions may disrupt our business.** A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations and our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers.

**Acquisitions and joint ventures may have an adverse effect on our business.** We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don't realize a satisfactory return on our investment, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management's attention from our other businesses. These events could harm our operating results or financial condition. See Management's Discussion and Analysis – Overview, Proposed Acquisition of Yahoo (Part I, Item 2) for additional information.

**Improper disclosure of personal data could result in liability and harm our reputation.** We store and process large amounts of personally identifiable information. It is possible that our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information. Such disclosure could harm our reputation and subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products also enable our customers to store and process personal data. Perceptions that our products do not adequately protect the privacy of personal information could inhibit sales of our products.

**Other risks that may affect our business.** Other factors that may affect our performance may include sales channel disruption, such as the bankruptcy of a major distributor, and our ability to implement operating cost structures that align with revenue growth.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Items 2(a) and (b) are not applicable.

(c) STOCK REPURCHASES

| Period | (a) Total number of shares purchased | (b) Average price paid per share | (c) Total number of shares purchased as part of publicly announced plans or programs | (d) Maximum number of shares (or approximate dollar value of shares) that may yet be purchased under the plans or programs (in millions) |
|---|---|---|---|---|
| January 1, 2008 – January 31, 2008 | 30,160,464 | $ 33.82 | 30,160,464 | $ 7,688 |
| February 1, 2008 – February 29, 2008 | — | — | — | $ 7,688 |
| March 1, 2008 – March 31, 2008 | — | — | — | $ 7,688 |
| | 30,160,464 | | 30,160,464 | |

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program that expires on June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately

$16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. The repurchase program may be suspended or discontinued at any time without prior notice. During the third quarter of fiscal year 2008, we repurchased 30 million shares for $1.0 billion under the plans described in this paragraph. The transactions occurred in open market purchases and pursuant to a trading plan under Rule 10b5-1.

**Item 6. Exhibits**

| | |
|---|---|
| 15 | Letter re: unaudited interim financial information |
| 31.1 | Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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

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## SIGNATURE

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

| | |
|---|---|
| Date: April 24, 2008 | Microsoft Corporation |
| | By: /s/ Frank H. Brod |
| | **Frank H. Brod**<br>**Corporate Vice President, Finance and Administration;**<br>**Chief Accounting Officer**<br>**(Duly Authorized Officer)** |

**Exhibit 15**

April 24, 2008

Microsoft Corporation
One Microsoft Way
Redmond, Washington

We have reviewed, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the unaudited interim financial information of Microsoft Corporation and subsidiaries for the periods ended March 31, 2008 and 2007, as indicated in our report dated April 24, 2008; because we did not perform an audit, we expressed no opinion on that information.

We are aware that our report referred to above, which is included in your Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, is incorporated by reference in Registration Statements Nos. 333-120511, 333-109185, 333-06298, 333-16665, 333-118764, 333-91755, 333-52852, 333-102240, 33-36498, 33-45617 and 333-132100 of Microsoft Corporation on Forms S-8 and Registration Statement Nos. 333-43449, 333-110107, and 333-108843 of Microsoft Corporation on Forms S-3.

We also are aware that the aforementioned report, pursuant to Rule 436(c) under the Securities Act of 1933, is not considered a part of the Registration Statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of Sections 7 and 11 of that Act.

DELOITTE & TOUCHE LLP

/S/ DELOITTE & TOUCHE LLP
Seattle, Washington

**Exhibit 31.1**

## CERTIFICATIONS

I, Steven A. Ballmer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Microsoft Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 24, 2008

/S/ STEVEN A. BALLMER

**Steven A. Ballmer**
**Chief Executive Officer**

**Exhibit 31.2**

**CERTIFICATIONS**

I, Christopher P. Liddell, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Microsoft Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 24, 2008

/s/ CHRISTOPHER P. LIDDELL

**Christopher P. Liddell**
**Chief Financial Officer**

**Exhibit 32.1**

**CERTIFICATIONS PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**
**(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Microsoft Corporation, a Washington corporation (the "Company"), on Form 10-Q for the quarter ended March 31, 2008, as filed with the Securities and Exchange Commission (the "Report"), Steven A. Ballmer, Chief Executive Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/S/ STEVEN A. BALLMER

**Steven A. Ballmer**
**Chief Executive Officer**
**April 24, 2008**

[A signed original of this written statement required by Section 906 has been provided to Microsoft Corporation and will be retained by Microsoft Corporation and furnished to the Securities and Exchange Commission or its staff upon request.]

**Exhibit 32.2**

**CERTIFICATIONS PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**
**(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Microsoft Corporation, a Washington corporation (the “Company”), on Form 10-Q for the quarter ended March 31, 2008, as filed with the Securities and Exchange Commission (the “Report”), Christopher P. Liddell, Chief Financial Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/S/ CHRISTOPHER P. LIDDELL

**Christopher P. Liddell**
**Chief Financial Officer**
**April 24, 2008**

[A signed original of this written statement required by Section 906 has been provided to Microsoft Corporation and will be retained by Microsoft Corporation and furnished to the Securities and Exchange Commission or its staff upon request.]