United States Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-K

**☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED JUNE 30, 2003**

**☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM ______ TO ______**

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION

WASHINGTON **(STATE OF INCORPORATION)**	**91-1144442** **(I.R.S. ID)**

**ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399
(425) 882-8080**

Securities registered pursuant to Section 12(b) of the Act:
NONE

Securities registered pursuant to Section 12(g) of the Act:
COMMON STOCK

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

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

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

The aggregate market value of common stock held by non-affiliates of the registrant as of August 15, 2003 was $235,404,995,887.

The number of shares outstanding of the registrant's common stock as of August 15, 2003 was 10,813,984,831.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held November 11, 2003 are incorporated by reference into Part III.

Table of Contents

Microsoft Corporation

FORM 10-K

For The Fiscal Year Ended June 30, 2003

INDEX

PART I

ITEM 1. Business

GENERAL

Microsoft Corporation was founded as a partnership in 1975 and incorporated in 1981. Our mission is to enable people and businesses throughout the world to realize their full potential, and our vision is empowering people through great software – any time, any place, and on any device. We develop, manufacture, license, and support a wide range of software products for a multitude of computing devices. Our software products include scalable operating systems for servers, personal computers (PCs), and intelligent devices; server applications for client/server environments; information worker productivity applications; business solutions applications; and software development tools. We provide consulting services and product support services and we train and certify system integrators and developers. We sell the Xbox video game console, along with games and peripherals. Our online businesses include the MSN subscription and the MSN network of Internet products and services.

Microsoft also researches and develops advanced technologies for future software products. A significant portion of our focus is on our .NET architecture. Using common industry standards based on Extensible Markup Language (XML), a universal language for describing and exchanging data, our goal is to enable seamless sharing of information across many platforms and programming languages, and over the Internet, with XML Web services. In addition, we have embarked on a long-term initiative called Trustworthy Computing that aims to bring an enhanced level of security, privacy, reliability, and business integrity to computer systems.

PRODUCT SEGMENTS

We revised our product segments for fiscal year 2003. Our seven product segments are Client, Server and Tools, Information Worker, Microsoft Business Solutions, MSN, Mobile and Embedded Devices, and Home and Entertainment.

Changes in our segments are designed to provide management with a comprehensive financial view of our key businesses; promote better alignment of strategies and objectives among development, sales, marketing, and services organizations; provide for more timely and rational allocation of development, sales, and marketing resources within businesses; focus strategic planning efforts on key objectives and initiatives; and give business owners more autonomy in detailed planning.

See Note 21 of the Notes to Financial Statements for financial information regarding segment reporting. Prior year segment information has been restated to conform to the seven new segments.

Client

Client segment includes Windows XP, Windows 2000, and other standard Windows operating systems. Windows XP extends the personal computing experience by uniting PCs, devices, and services, while enhancing reliability, security, and performance. Windows XP Home Edition is designed for individuals or families and includes capabilities for digital photo, music, video, home networking, and communications. Windows XP Professional includes all the features of Home Edition, plus remote access, security, performance, manageability, and multilingual features to help users improve productivity and connectivity. Windows XP was the successor to Windows 2000.

Client has overall responsibility for product delivery, engineering and technical architecture for the Microsoft Windows operating system, and new media technology, as well as our relationships with manufacturers of personal computers and non-PC devices, including multinational and regional original equipment manufacturer (OEM) accounts. The segment includes sales and marketing expenses focused on business development efforts for the Windows platform, as well as integration of our technologies and products into non-PC devices.

Server and Tools

Server and Tools segment consists of server software licenses and client access licenses (CALs) for Windows Server, SQL Server, Exchange Server, and other servers. It also includes developer tools, training, certification, Microsoft Press, Premier product support services, and Microsoft consulting services. Microsoft server products offer a comprehensive range of solutions designed to meet the needs of developers and IT professionals, and are designed to flexibly run the programs and solutions that enable information workers to obtain, analyze, and share information quickly and easily. Microsoft servers provide capabilities ranging from messaging and collaboration to database management and ranging from e-commerce to mobile information access.

Windows Server 2003 is a multipurpose operating system capable of handling a diverse set of server roles in either a centralized or a distributed fashion. SQL Server is a Web-enabled database and data analysis package, providing core support for XML and the ability to query across the Internet. Microsoft Exchange delivers a reliable, scalable, and manageable infrastructure with 24×7 messaging and collaboration. Systems Management Server delivers cost-effective, scalable change and configuration management for Windows–based desktop and server systems. Small Business Server is a network solution that includes the Windows 2003 Server network operating system and is designed to help small businesses. Developer tools focus on coordinating the overall programming model for the client and server, creating tools for the .NET platform, and fostering synergies between Windows and the Windows Server System offerings.

Server and Tools segment includes the integrated product development and marketing that delivers Microsoft Windows Server System products. In addition, the segment provides information about the extended Microsoft platform through a variety of content offerings, such as web-based training for developers and IT managers. Through this segment, we offer a broad range of consulting services for advanced technology requirements, including custom solutions services, enterprise application planning, architecture and design services, and proof-of-concept services. We also provide product support services aligned to our enterprise customers. The Server and Tools segment includes our Enterprise and Partner Group, which is responsible for enterprise sales strategy, enterprise sales learning and readiness, enterprise solution selling, enterprise partner sales strategy, and enterprise field communications. This group is also responsible for technical selling, field competitive strategy, and all competitive sales engagements.

Information Worker

Information Worker segment is responsible for developing and delivering technologies that focus on improving productivity for information workers in corporations. It consists of the new Microsoft Office System of programs, servers, services, and solutions. Microsoft Office System is the successor of Microsoft Office XP and is expected to be released to market in the first half of fiscal 2004. The Microsoft Office System includes the Microsoft Office 2003 Editions, which include (depending on the edition): Microsoft Office Outlook 2003, Microsoft Office Excel 2003, Microsoft Office PowerPoint 2003, Microsoft Office Word 2003, and Microsoft Office Access 2003. Other products in the Microsoft Office System include Microsoft Office Visio 2003, Microsoft Office Project 2003, Microsoft Office Project Server 2003, Microsoft Office InfoPath 2003, Microsoft Office OneNote 2003, Microsoft Office Publisher 2003, Microsoft Office FrontPage 2003, and Microsoft Office SharePoint Portal Server 2003. Microsoft Office has evolved from a suite of personal productivity products to a more comprehensive and integrated system of products for information work designed to increase personal, team, and organization productivity. The Microsoft Office System features integration with Microsoft intranet collaboration technologies, Information Rights Management, and support for industry standard XML. The Information Worker segment also includes Microsoft Office Live Meeting, resulting from our acquisition of PlaceWare, Inc., Microsoft Office Live Communications Server 2003, and an allocation for CALs. The segment also includes professional product support.

The segment includes the Small and Mid-Market Solutions & Partners (SMS&P) organization, which is responsible for sales, partner management, partner programs, and customer segment marketing for the small and mid-market businesses. In fiscal year 2004, SMS&P group will integrate the sales and marketing assets of the Microsoft Business Solutions segment with the existing Worldwide Small and Medium Business groups. We believe this combined effort will lead to expanded opportunity for Microsoft and our customers and partners by making available the complete range of Microsoft products and services to small and mid-market businesses, creating increased growth opportunities for the independent software vendor (ISV) community.

Microsoft Business Solutions

Microsoft Business Solutions segment includes the businesses of Great Plains, Microsoft bCentral, and Navision. Microsoft Business Solutions develops and markets a wide range of business applications designed to help small and mid-market businesses become more connected with customers, employees, partners, and suppliers. Microsoft Business Solutions applications provide end-to-end automation for financial reporting, distribution, project accounting, electronic commerce, human resources and payroll, manufacturing, supply chain management, business intelligence, sales and marketing management, and customer service and support. Microsoft Business Solutions products are designed to meet the broad spectrum of business application needs of small to mid-market businesses, a group that generally consist of businesses with $1 million to $800 million in annual revenue. The business solutions are fully and seamlessly integrated across the application areas of enterprise resource management (ERM), customer relationship management (CRM), supply chain management (SCM) and business intelligence. These business solutions are sold, implemented, and supported through a partner network consisting of more than 4,500 value added resellers, systems integrators, consultants, ISVs, accounting firms (national, regional, and local), application service providers (ASPs), and eBuilders. Microsoft Business Solutions partners provide strong distribution, marketing, training, and support in the business application customer segment.

MSN

MSN segment includes MSN Subscriptions and MSN Network services. MSN Subscription services include MSN Internet access and premium services such as MSN Extra Storage, MSN Bill Pay, MSN Radio Plus and MSN Mobile, which are offered to consumers regardless of their Internet Service Provider. The MSN Network delivers online communication services such as email and online instant messaging through its MSN Hotmail and MSN Messenger products. It also delivers popular information services, such as MSN Search and content from top partners like MSNBC, ESPN, Expedia, and Access Hollywood.

The segment is responsible for building and operating the MSN Network and for delivering MSN Subscription services. Revenue is principally generated from subscribers to MSN’s Internet access and premium services and from advertisers on the MSN Network. MSN delivers its services direct via its MSN Network and through partnerships with network operators such as Verizon, Qwest, Charter Communications, and Bell Canada.

Mobile and Embedded Devices

Mobile and Embedded Devices segment consists of Windows Mobile software, Windows Embedded device operating systems, MapPoint, and Windows Automotive. Windows Mobile software powers Pocket PC, Pocket PC Phone Edition, and Smartphone products. Windows Embedded, including Windows CE.NET, Windows XP Embedded and Windows NT Embedded, is a family of operating system software used in non-PC computing devices. Windows Embedded software is used widely in advanced consumer electronics devices including digital televisions, IP-based set top boxes, network gateways, and portable media players, as well as in enterprise devices including industrial controllers, retail point of sale systems, and voice-over-IP phones. The MapPoint family of location-enabled products and services includes the MapPoint Web Service, a hosted programmable XML web service that allows developers to integrate location intelligence in applications, business processes and web sites, and business and consumer oriented mapping CD-ROM products. Windows Automotive is an automotive grade software platform that provides developers with the building blocks to quickly and reliably create a broad range of advanced telematics solutions.

Mobile and Embedded Devices segment develops and markets the product lines described above. Further, the segment manages relationships with device manufacturers and with network service providers, including telecommunications, cable and wireless companies and host and network equipment providers.

Home and Entertainment

Home and Entertainment segment includes the Microsoft Xbox video game system, PC games, the Home Products Division (HPD), and TV platform products. Microsoft Xbox, released in fiscal 2002, is our next-generation video game console system that delivers high quality graphics and audio experiences. We offer several types of entertainment products, including classic software games, online games, simulations, and sport and strategy games. HPD includes Microsoft's line of consumer hardware and software products, such as the Encarta line of learning products and services, the Picture It! consumer publishing and productivity line of products and services, the Macintosh applications business, and the Microsoft hardware products.

Home and Entertainment segment oversees development and business strategy for the Microsoft Xbox video game system, including hardware, third-party games development, games development published under the Microsoft label, Xbox and Xbox Live operations, marketing, research, and sales and support. The segment leads the development efforts of our HPD product lines. The segment also carries out all retail sales and marketing for Microsoft Office, the Windows operating systems, Xbox, games, and HPD products. The segment is responsible for the development, sales, and deployment of Microsoft's TV platform products for the interactive television industry.

INTERNATIONAL OPERATIONS

Microsoft develops and sells products throughout the world. Our three major geographic sales and marketing organizations are the Americas Region, the Europe, Middle East, and Africa Region, and the Japan and Asia-Pacific Region. Pressure to globalize our pricing structure might require that we reduce the sales price of our software in the United States and other countries. A number of other factors could also have a negative effect on our business and results from operations outside of the United States, including changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment; unexpected changes in regulatory requirements for software; social, political, labor, or economic conditions in a specific country or region, including foreign exchange rates; difficulties in staffing and managing foreign operations; and potential adverse foreign tax consequences. A portion of international revenue is hedged, thus offsetting a portion of the currency translation exposure.

EQUITY METHOD INVESTMENTS

We have entered into joint venture arrangements to take advantage of creative talent and content from other organizations. For example, we own 50 percent of MSNBC Cable L.L.C., a 24-hour cable news and information channel, and 50 percent of MSNBC Interactive News L.L.C., an interactive online news service. National Broadcasting Company (NBC) owns the remaining 50 percent of each of these joint ventures.

PRODUCT DEVELOPMENT

During fiscal years 2001, 2002, and 2003, research and development expense was $4.38 billion, $4.31 billion, and $4.66 billion, respectively. Those amounts represented 17.3%, 15.2%, and 14.5%, respectively, of revenue in each of those years. During fiscal year 2001, $272 million of goodwill amortization was included in research and development expense. No goodwill amortization is included in fiscal years 2002 and 2003, in accordance with Statement of Financial Accounting Standards (SFAS) 142, *Goodwill and Other Intangible Assets.* We plan to continue spending significant amounts for research and product development.

Most of our software products are developed internally. We also purchase technology, license intellectual property rights, and oversee third-party development and localization of certain products. We do not believe we are materially dependent upon licenses and other agreements with third parties relating to the development of our products. Internal development allows us to maintain closer technical control over our products and gives us the freedom to designate which modifications and enhancements are most important and when they should be implemented. We work to devise innovative solutions in computer science, such as making computers easier to use, designing software for the next generation of hardware, improving the software design process, and investigating the mathematical underpinnings of computer science. We have created a substantial body of development tools and have evolved development methodologies for creating and enhancing our products. These tools and methodologies are also designed to simplify a product's portability among different operating systems, microprocessors, and computing devices. Product documentation is generally created internally. We strive to obtain information at the earliest possible time about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide to application vendors a range of resources and guidelines for development, training, and testing.

Microsoft .NET is our strategy and implementation of connecting people, information, systems and devices through the use of Web services. It includes everything needed to develop and deploy a Web service-connected IT architecture: servers to host Web services (Windows Server System and Windows Server 2003), development tools to create them (Microsoft Visual Studio .NET 2003 and the .NET Framework), applications and smart devices that use them (Microsoft Office System, smart phones, Pocket PCs and PCs), and a worldwide network of more than 35,000 Microsoft Certified Partner organizations – people whose skills and experience can help businesses get the most from their IT investments. Built on industry standards, Web services enable applications to communicate and share data over the Internet or an intranet, regardless of operating system or programming language.

We believe that establishing trust in computing will be critical to our future success. Trustworthy Computing means helping ensure a safe and reliable computing experience that is both expected and taken for granted. Achieving Trustworthy Computing will require the collaboration of hardware and software companies, academic and government research institutions, and policy leaders. For us, Trustworthy Computing is a company-wide initiative aimed at changing how we do business that will take fundamental research and advances in engineering, as well as changes to business culture and business processes to accomplish. We think there are four factors that affect the level of trust that people place in computing: Security, Privacy, Reliability, and Business Integrity. Security means the customer can expect that systems are resilient to attack, and that the confidentiality, integrity, and availability of the system and its data are protected. Privacy means the customer is able to control personal information and feel confident it is not only safe and used appropriately, but in a way that provides value. A reliable system or service is one the customer can depend on to fulfill its functions. Business Integrity involves being responsive to customers, addressing problems effectively with products or services, and being transparent and responsive in customer interactions.

To serve the needs of users around the world, we "localize" many of our products to reflect local languages and conventions and to improve the quality and usability of the product in international markets. Localizing a product may require modifying the user interface, altering dialog boxes, and translating text.

MANUFACTURING

We contract out most of our manufacturing activities to third parties. Outside manufacturers produce the Xbox, various retail software packaged products, and hardware. Our products may include some components that are available from only one or from limited sources. Key components that are currently obtained from a single source include the Xbox central processing unit (CPU) from Intel Corporation and the Xbox graphics processing unit (GPU) from NVIDIA Corporation. With the exception of the Xbox CPU and GPU, we generally have the ability to use other custom manufacturers if the current manufacturing vendor becomes unavailable. We generally have multiple sources for raw materials, supplies, and components and are often able to acquire component parts and materials on a volume discount basis.

OPERATIONS

We have regional operations centers in Ireland, Singapore, and the greater Seattle area. The centers support all operations in their regions, including information processing and vendor management and logistics. The regional center in Dublin, Ireland supports the Europe, Middle East, and Africa region, the center in Singapore supports the Japan and Asia-Pacific region, and the center in the greater Seattle area supports North and South America. Microsoft Licensing, Inc., a wholly-owned subsidiary in Reno, Nevada, manages our original equipment manufacturer (OEM) and certain organizational licensing operations.

DISTRIBUTION, SALES AND MARKETING

We distribute our products primarily through the following channels: OEM; distributors and resellers; and online services and products. Our three major geographic sales and marketing organizations are the Americas Region; the Europe, Middle East, and Africa Region; and the Japan and Asia-Pacific Region.

OEM

Microsoft operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to distribute copies of our products with their computing devices, principally PCs. We also market and license certain server operating systems, desktop applications, hardware devices, and consumer software products to OEMs under similar arrangements. We have OEM agreements covering one or more of our products with virtually all of the major PC OEMs, including Acer, Actebis, Dell, eMachines, Fujitsu, Fujitsu Gateway, HP, IBM, NEC, Samsung, Siemens Computers, Sony, and Toshiba. A substantial amount of OEM business is also conducted with system builders, which are low-volume customized PC vendors.

Distributors and Resellers

We distribute our finished goods products primarily through independent non-exclusive distributors, authorized replicators, resellers and retail outlets. Organizations license our products primarily through Large Account Resellers (LARs), Direct Market Resellers (DMRs), and value added resellers. Many organizations that license products through Enterprise Agreements (EAs) now transact directly with us with sales support from our Enterprise Software Advisor channel partners. These Enterprise Software Advisors are also typically authorized as LARs and operate as resellers for our other licensing programs. Although all of our types of reselling partners reach organizations of all sizes, LARs are primarily engaged with large organizations and value added resellers typically reach the breadth of small and medium sized organizations. Some of our distributors include Ingram Micro and Tech Data, and some of our largest resellers include Software Spectrum, Software House International, Dell, CDW, and Insight Enterprises. Individual consumers obtain our products primarily through retail outlets including Best Buy, Wal-Mart, and Target. We have a network of field sales representatives and field support personnel who solicit orders from distributors and resellers and provide product training and sales support.

We license software to organizations under arrangements that allow the end-user customer to acquire multiple licenses of product. These arrangements are designed to provide organizations with a means of acquiring multiple licenses, without having to acquire separate packaged product through retail channels. In delivering organizational licensing arrangements to the market, we use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they are as follows:

Open. Targeted at small to medium organizations, this program allows customers to acquire perpetual licenses and, at the customer's election, rights to future versions of software products, over a specified time period (generally two years). The offering that conveys rights to future versions of software product is called Software Assurance. Software Assurance also provides support, tools, and training to help customers deploy and use software efficiently. Under the Open program, customers can acquire licenses only or licenses with Software Assurance. They can also renew Software Assurance upon the expiration of existing volume licensing agreements.

Select. Targeted at medium to large organizations, this program allows customers to acquire perpetual licenses and, at the customer's election, Software Assurance, which consists of rights to future versions of software products, support, tools, and training, over a specified time period (generally three years). Similar to the Open program, customers can acquire licenses only, acquire licenses with Software Assurance, or renew Software Assurance upon the expiration of existing volume licensing agreements.

Enterprise Agreement. The Enterprise Agreement is targeted at large organizations that want to acquire perpetual licenses to software products for their entire enterprise along with rights to future versions of software products over a three year period.

Enterprise Subscription Agreement. The Enterprise Subscription Agreement (ESA) is a time-based, multi-year licensing arrangement. Under an ESA, customers acquire the right to use the current version of software products and the future versions that are released during the three year term of the arrangement. At the end of the arrangement term, customers may either renew their ESA arrangement or exercise a buy-out option to obtain perpetual licenses for the latest version of the covered products. If they do not elect one of these options, then all covered software must be uninstalled.

Online Services and Products

We distribute online content and services through MSN Subscription services, MSN Network services, bCentral small business portal, and other online services. MSN Subscription services deliver Internet access and other premium services and tools to consumers. MSN Network services deliver online email and messaging communication services as well as information services such as online search and premium content. The bCentral portal provides tools and expertise for small business owners to build, market and manage their businesses online. Other services delivered online include Microsoft Developer Networks (MSDN) subscription content and updates, periodic product updates, and online technical and practice readiness resources to support our partners in developing and selling Microsoft products and solutions.

CUSTOMERS

Our customers include individual consumers, small- and medium-size organizations, enterprises, governmental institutions, educational institutions, Internet Service Providers, application developers, and OEMs. Consumers and small- and medium-size organizations obtain Microsoft products primarily through resellers and OEMs. No single customer accounted for 10% or more of revenue in 2001, 2002, or 2003. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

COMPETITION

The software business is intensely competitive and subject to rapid technological change, evolving customer requirements, and changing business models. We face significant competition in all areas of our current business activities. The rapid pace of technological change continually creates new opportunities for existing competitors and start-ups and can quickly render existing technologies less valuable. Customer requirements and preferences continually change as other information technologies emerge or become less expensive, and as emerging concerns such as security and privacy become of paramount concern. We face direct competition with firms adopting alternative business models to the commercial software model. Firms adopting the Open Source model typically provide customers with Open Source software at nominal cost and earn revenue on complimentary services and products, without having to bear the full costs of research and development for the Open Source software. Additionally, global software piracy – the unlawful copying and distribution of our copyrighted software products – deprives us of large amounts of revenue on an annual basis. Further, the existing versions of our products licensed to our installed base of users compete with future versions. This means that future versions must deliver significant additional value in order to induce existing customers to purchase a new version of our product.

Our competitive position may be adversely affected in the future by one or more of the factors described in this section.

Client

Although we are the leader in operating system software products, we face strong competition from well established companies and entities with differing approaches to the market. Competing commercial software products, including variants of Unix, are supplied by competitors, such as IBM, Hewlett-Packard, Apple Computer, Sun Microsystems and others, who are vertically integrated in both software development and hardware manufacturing and have developed operating systems that they preinstall on their own computers. Personal computer OEMs who preinstall third party operating systems may also license these firms' operating systems or Open Source software, especially offerings based on Linux. Variants of Unix run on a wide variety of computer platforms and have gained increasing acceptance as desktop operating systems, in part due to the increasing performance of standard hardware components at decreasing prices. The Linux open source operating system, which is also derived from Unix and is available without payment under a General Public License, has gained increasing acceptance as its feature set increasingly resembles the distinct and innovative features of Windows and as competitive pressures on personal computer OEMs to reduce costs continue to increase. The Microsoft Windows operating systems also face competition from alternative platforms such as those based on Internet browsing software and Java technology promoted by Sun Microsystems, as well as innovative form factors that may reduce consumer demand for traditional personal computers. We believe our operating system products compete effectively by delivering better innovation, overall value, an easy-to-use interface, compatibility with a broad range of hardware and software applications, and the largest support network for any operating system.

Server and Tools

Our server operating system products face intense competition from a wide variety of competing server operating systems and server applications offered by firms with a variety of market approaches. Several vertically integrated computer manufacturers, such as IBM, Hewlett-Packard, Apple Computer, Sun Microsystems and others offer their own variant of Unix preinstalled on server hardware, and virtually all computer manufacturers offer server hardware for the Linux operating system. IBM's endorsement of Linux has accelerated its acceptance as an alternative to both traditional Unix and Windows server operating systems. Linux's competitive position has also benefited from the large number of compatible applications now produced by many leading commercial software developers as well as Open Source community developers. A number of companies supply versions of Linux, including Red Hat and VA Linux.

We compete in the business of providing enterprise-wide computing solutions with several companies that provide competing solutions as well as middleware technology platforms. IBM and Sun Microsystems lead a group of companies focused on the Java 2 Platform Enterprise Edition (J2EE). Commercial software developers that provide competing server applications for the PC-based distributed client/server environments include Oracle, IBM, Computer Associates, Sybase, and Informix. There are also a number of Open Source server applications available.

Numerous commercial software vendors offer competing commercial software applications for connectivity (both Internet and intranet), security, hosting, and e-business servers. Additionally, IBM has a large installed base of Lotus Notes and cc:Mail, both of which compete with our collaboration and email products. There are also a significant number of Open Source software products that compete with Microsoft solutions, including Apache Web Server.

The Open Source model of Linux and other server programs enables both services and hardware companies to provide customers with Open Source software at nominal cost and earn revenue on complimentary services and products, without having to bear the full costs of research and development for the Open Source software. For example, IBM, with the largest hardware and services businesses in the industry, promotes Linux extensively and seeks to earn revenues and profits on the sale of its consulting services to implement the Linux server solution as well as related hardware and commercial software products that run on Linux.

Our developer products compete against offerings from BEA Systems, Borland, IBM, Macromedia, Oracle, Sun Microsystems, Sybase, and other companies.

We believe that our server products provide customers with significant advantages in innovation, performance (both relative to total costs of ownership and in absolute terms), productivity, applications development tools and environment, compatibility with a broad base of hardware and software applications, security, and manageability.

Information Worker

While we are the leader in business productivity software applications, competitors to the Microsoft Office System include many software application vendors, such as Apple, Corel, IBM, Oracle, QUALCOMM, Sun Microsystems, and local application developers in Europe and Asia. IBM and Corel have significant installed bases with their spreadsheet and word processor products, respectively, and both have aggressive pricing strategies. Also, Apple and IBM preinstall certain of their application software products on various models of their PCs, competing directly with our applications. Corel's suite and Sun Microsystems' Star Office are aggressively priced and attractive for OEMs to pre-install on low-priced PCs. The OpenOffice.org project provides a freely downloadable cross-platform application that is gaining popularity in certain market segments. In addition to traditional client-side applications, web-based applications hosting services such as SimDesk provide an alternative to Microsoft Office and are gaining some support. We believe that our products compete effectively by providing customers significant benefits, such as easy-to-use personal productivity, support for effective teaming and collaboration, and better information management and control.

Microsoft Business Solutions

The small and mid-market business applications market globally is highly fragmented and is intensely competitive in all sectors. We face competition from a large number of companies in this business. Well-known vendors focused on small and mid-market business, such as Intuit and Sage, compete against us for a portion of this segment. In addition, large-enterprise focused vendors, such as Oracle, Peoplesoft and SAP, also compete against us for a portion of this segment. However, the competition for a significant majority of the total business applications market includes thousands of much smaller vendors in specific localities or industries who offer their own enterprise resource planning, customer relationship management, and/or analytic solutions.

MSN

MSN competes with AOL-Time Warner, Google, Yahoo!, and a vast array of Web sites and portals that offer content of all types, such as email, instant messaging, calendaring, chat, search, and shopping services. As the broadband access market grows, we expect to have increasing opportunity to deliver premium subscription services for consumers. AOL and Yahoo! are both pursuing similar strategies and will be competitors in this emerging category. While the movement to broadband access may cause our Internet Access dial-up business to continue to decline, we will strive to convert customers to MSN premium subscription services via partnerships with network providers and Internet software services offered directly from MSN. We believe our strengths are our heritage of technology innovation, particularly in communication services, distribution partnerships, and the large base of users of our free MSN Network. Additionally, while our advertising business has grown considerably over the last year, evolving market conditions, particularly paid search, will impact our strategy over the next year. We currently are building our own search engine and investing to support the continued growth of our advertising business.

Mobile and Embedded Devices

Windows Mobile software faces substantial competition from Nokia, Openwave Systems, PalmSource, QUALCOMM, and Symbian. The embedded operating system market is highly fragmented with many competitive offerings. Key competitors include IBM, Wind River, and versions of embeddable Linux from commercial Linux vendors, such as Metrowerks and MontaVista Software. MapPoint competitors include DeLorme, MapInfo, Mapquest.com, Rand McNally, Webraska Mobile Technologies, and Yahoo!. The telematics market is also highly fragmented, with competitive offerings from IBM and automotive suppliers building on various real-time operating system platforms from commercial Linux vendors, QNX Software Systems, Wind River, and others.

Home and Entertainment

The home and entertainment business is highly competitive and is characterized by limited platform life cycles, frequent introductions of new products and titles, and the development of new technologies. The markets for our products are characterized by significant price competition, and we anticipate continued pricing pressure from our competitors. These pressures have, from time to time, required us to reduce prices on certain products. Our competitors vary in size from very small companies with limited resources to very large, diversified corporations with substantial financial and marketing resources. We compete primarily on the basis of price, product quality and variety, timing of product releases, and effectiveness of distribution and marketing.

Our Xbox hardware business competes with console platforms from Nintendo and Sony, both of which have a large established base of users. In addition to competing against software published for non-Xbox platforms, our games business also competes with numerous companies that have been licensed by Microsoft to develop and publish software for the Xbox console. These competitors include Acclaim Entertainment, Activision, Atari, Capcom, Eidos, Electronic Arts, Sega, Take-Two Interactive, Tecmo, THQ, and Ubi Soft, among others. Success in the games business is increasingly driven by hit titles, which are difficult to develop and require substantial investments in development and marketing. In addition, other forms of entertainment, such as music, motion pictures, and television, compete against our entertainment software for consumer spending. Our PC hardware products face aggressive competition from computer and other hardware manufacturers, many of which are also current or potential partners.

EMPLOYEES

As of June 30, 2003, we employed approximately 55,000 people on a full-time basis, 36,500 in the United States and 18,500 internationally. Of the total, 23,200 were in product research and development, 25,100 in sales, marketing, and support, 2,400 in manufacturing and distribution, and 4,300 in finance and administration. Our success is highly dependent on our ability to attract and retain qualified employees. Competition for employees is intense in the software industry. We believe we have been successful in our efforts to recruit qualified employees, but we cannot guarantee that we will continue to be as successful in the future. None of our employees are subject to collective bargaining agreements. We believe that our relations with our employees are excellent.

AVAILABLE INFORMATION

Our Internet address is www.microsoft.com. There we make available, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our SEC reports can be accessed through the investor relations section of our Web site. The information found on our Web site is not part of this or any other report we file with or furnish to the SEC.

ITEM 2. Properties

Our corporate offices consist of approximately 9.0 million square feet of office building space located in King County, Washington, of which 6.1 million square feet is corporate campus space situated on slightly more than 300 acres of land which is owned and approximately 2.9 million square feet which is leased. We are constructing one building with approximately 302,000 square feet of space that will be occupied in the second quarter of fiscal year 2004. To accommodate future expansion needs we purchased approximately 38 acres, and have an option to purchase approximately 112 additional acres, of land in Issaquah, Washington, which can accommodate 2.9 million square feet of additional office space. We own approximately 594,000 square feet of office building space domestically (outside of the Puget Sound corporate campus) and lease many sites domestically totaling approximately 3.4 million square feet of office building space.

We lease many sites internationally totaling approximately 5.4 million square feet, including our European Operations Center and localization division that leases a 411,000 square-foot campus in Dublin, Ireland, a 54,000 square-foot disk duplication facility in Humacao, Puerto Rico, and a 36,000 square-foot facility in Singapore for our Asia Pacific Operations Center. Leased office building space includes the following locations: Tokyo, Japan 343,000 square feet; Unterschleissheim, Germany 381,000 square feet; United Kingdom campus 242,000 square feet; Les Ulis, France 229,000 square feet; Vedbaek, Denmark 186,000 square feet; Mississauga, Canada 160,000 square feet; Taipei, Taiwan 116,000 square feet; Sydney, Australia 116,000 square feet; and Beijing, China 115,000 square feet.

Our facilities are fully used for current operations of all segments and suitable additional space is available to accommodate expansion needs.

ITEM 3. Legal Proceedings

See Note 20—Contingencies of the Notes to Financial Statements (Item 8) for information regarding legal proceedings.

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

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2003.

Part I, Item 4

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of September 4, 2003 were as follows:

Name	Age	Position with the Company
William H. Gates III	47	Chairman, Chief Software Architect
Steven A. Ballmer	47	Chief Executive Officer
James E. Allchin	51	Group Vice President, Platforms Group
Robert J. (Robbie) Bach	41	Senior Vice President, Home and Entertainment
Douglas J. Burgum	47	Senior Vice President, Microsoft Business Solutions
David W. Cole	41	Senior Vice President, MSN and Personal Services Group
John G. Connors	44	Senior Vice President, Chief Financial Officer
Jean-Philippe Courtois	43	Senior Vice President, Chief Executive Officer, Microsoft Europe, Middle East, and Africa
Kenneth A. DiPietro	44	Corporate Vice President, Human Resources
Kevin R. Johnson	42	Group Vice President, Worldwide Sales, Marketing and Services
Michelle (Mich) Mathews	36	Corporate Vice President, Marketing
Craig J. Mundie	54	Senior Vice President, Chief Technical Officer, Advanced Strategies and Policy
Jeffrey S. Raikes	45	Group Vice President, Productivity and Business Services
Eric D. Rudder	36	Senior Vice President, Server and Tools
Bradford L. Smith	44	Senior Vice President, General Counsel and Secretary
David Vaskevitch	51	Senior Vice President, Chief Technical Officer, Business Platforms

Mr. Gates co-founded Microsoft in 1975 and served as its Chief Executive Officer from the time the original partnership was incorporated in 1981 until January 2000, when he resigned as Chief Executive Officer and assumed the position of Chief Software Architect. Mr. Gates has served as Chairman since our incorporation.

Mr. Ballmer was named Chief Executive Officer and a director of the Company in January 2000. He served as President from July 1998 to February 2001. Previously, he had served as Executive Vice President, Sales and Support since February 1992. He joined Microsoft in 1980.

Mr. Allchin was named Group Vice President, Platforms Group in December 1999. He had been Senior Vice President, Platforms since March 1999. He was previously Senior Vice President, Personal and Business Systems since February 1996. Mr. Allchin joined Microsoft in 1990.

Mr. Bach was named Senior Vice President, Home and Entertainment in March 2000. He had been Vice President, Home and Retail since March 1999. Before holding that position, he had been Vice President, Learning, Entertainment and Productivity and Vice President, Desktop Applications Marketing since 1996. Mr. Bach joined Microsoft in 1988.

Mr. Burgum joined the Company upon Microsoft's acquisition of Great Plains Software, Inc. in April 2001. Mr. Burgum became Great Plains' first outside investor in March 1983. He was named President of Great Plains in 1984 and subsequently named Chairman and Chief Executive Officer.

Mr. Cole was named Senior Vice President, MSN and Personal Services Group in November 2001. Before holding that position, he had been Senior Vice President, Services Platform Division since August 2000. He had been Senior Vice President, Consumer Services since December 1999 and Vice President, Consumer Windows since March 1999. Previously, he was Vice President, Web Client and Consumer Experience and Vice President, Internet Client and Collaboration. Mr. Cole joined Microsoft in 1986.

Mr. Connors was named Senior Vice President and Chief Financial Officer in December 1999. He had been Vice President, Worldwide Enterprise Group since March 1999. Mr. Connors had been Vice President, Information Technology Group, and Chief Information Officer since July 1996. He joined Microsoft in 1989.

Mr. Courtois was named Senior Vice President and Chief Executive Officer, Microsoft Europe, Middle East, and Africa in March 2003. He had been Senior Vice President and President, Microsoft Europe, Middle East, and Africa since July 2000. Before holding that position, he had been Vice President, Worldwide Customer Marketing since July 1998. Mr. Courtois joined Microsoft in 1984.

Mr. DiPietro joined Microsoft in January 2003 as Corporate Vice President, Human Resources. Prior to joining Microsoft, he was Vice President of Human Resources for the Americas at Dell Computer Corporation. Before joining Dell, he was Senior Vice President of Human Resources at Pepsi-Cola International.

Mr. Johnson was named Group Vice President, Worldwide Sales, Marketing and Services in March 2003. He had been Senior Vice President, Microsoft Americas since February 2002. Mr. Johnson had been Senior Vice President, U.S. Sales, Marketing, and Services since August 2001, and before that, Vice President, U.S. Sales, Marketing and Services. He joined Microsoft in 1992.

Ms. Mathews was named Corporate Vice President, Marketing in August 2001. Before holding her current position, Ms. Mathews had been Vice President Corporate Public Relations since 1999. Ms. Mathews joined Microsoft in 1993.

Mr. Mundie was named Senior Vice President and Chief Technical Officer, Advanced Strategies and Policy in August 2001. He was named Senior Vice President, Consumer Platforms in February 1996. He joined Microsoft in 1992.

Mr. Raikes was named Group Vice President, Productivity and Business Services in August 2000. He had been Group Vice President, Sales and Support since July 1998. Mr. Raikes joined Microsoft in 1981.

Mr. Rudder was named Senior Vice President, Developer and Platform Evangelism in October 2001. He had been Vice President, Technical Strategy. Mr. Rudder joined Microsoft in 1988.

Mr. Smith was named Senior Vice President, General Counsel and Secretary in November 2001. He had been Deputy General Counsel for Worldwide Sales and previously was responsible for managing our European Law and Corporate Affairs Group, based in Paris. He joined Microsoft in 1993.

Mr. Vaskevitch was named Senior Vice President and Chief Technical Officer, Business Platform in August 2001. He had been Senior Vice President, Business Applications since March 2000. Mr. Vaskevitch had been Senior Vice President, Developer since December 1999. Before holding that position, he had been Vice President, Distributed Applications Platform. He joined Microsoft in 1986.

PART II

ITEM 5. Market for Registrant's Common Stock and Related Stockholder Matters

Our common stock is traded on The NASDAQ Stock Market under the symbol MSFT. On August 15, 2003, there were 131,580 registered holders of record of our common stock. The high and low common stock prices per share were as follows:

Quarter Ended	Sept. 30	Dec. 31	Mar. 31	June 30	Year
Fiscal 2002					
Common stock price per share(1):					
High	$ 36.29	$ 34.75	$ 34.93	$ 30.19	$ 36.29
Low	24.86	25.90	29.00	24.31	24.31
Fiscal 2003					
Common stock price per share(1):					
High	**$ 27.43**	**$ 29.12**	**$ 28.49**	**$ 26.37**	**$ 29.12**
Low	**21.42**	**21.89**	**22.80**	**23.67**	**21.42**

(1) Amounts have been restated to reflect a two-for-one stock split in February 2003.

In January 2003, our Board of Directors declared our first annual common stock dividend, of $0.08 per share, which was paid in March 2003. Our dividend policy is impacted by, among other items, 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.

In connection with Microsoft's acquisition of Navision a/s, pursuant to a voluntary offer to acquire all Navision ordinary shares, Microsoft issued 29.1 million shares of its common stock to Navision shareholders on July 12, 2002, in exchange for 19.4 million Navision ordinary shares, nominal value DKK 1 per share. The price paid by Microsoft in connection with the offer was DKK 300 per each Navision share, payable at each Navision shareholder's election in either cash or Microsoft shares, on the basis of an exchange ratio of 1.49982 shares of Microsoft common stock for each Navision ordinary share. These issuances of Microsoft common stock were not registered under the Securities Act of 1933 on the basis of the exemption provided by Rule 802 thereunder. Rule 802 exempts offers and sales in an exchange offer for a class of securities of a foreign private issuer in a business combination transaction, if certain conditions are met. Since the completion of the acquisition, we have issued 23,009 shares of our common stock to 16 employees in exchange for 10,136 ordinary shares of Navision that were acquired upon exercise of warrants and stock options issued to employees of Navision and its subsidiaries that were outstanding at the time of the acquisition. The issuances were not registered under the Securities Act.

ITEM 6. Selected Financial Data

Financial Highlights

(In millions, except earnings per share)

Year Ended June 30	1999	2000	2001(2)	2002(3)	2003(4)
Revenue	$ 19,747	$ 22,956	$ 25,296	$ 28,365	**$ 32,187**
Operating income	10,010	11,006	11,720	11,910	**13,217**
Income before accounting change	7,785	9,421	7,721	7,829	**9,993**
Net income	7,785	9,421	7,346	7,829	**9,993**
Diluted earnings per share before accounting change(1)	0.71	0.85	0.69	0.70	**0.92**
Diluted earnings per share(1)	0.71	0.85	0.66	0.70	**0.92**
Cash dividends per share	–	–	–	–	**0.08**
Cash and short-term investments	17,236	23,798	31,600	38,652	**49,048**
Total assets	38,321	51,694	58,830	67,646	**79,571**
Stockholders' equity	28,438	41,368	47,289	52,180	**61,020**

(1) Earnings per share have been restated to reflect a two-for-one stock split in February 2003.
(2) Fiscal year 2001 includes an unfavorable cumulative effect of accounting change of $375 million or $0.03 per diluted share, reflecting the adoption of SFAS No. 133, and $4.80 billion (pre-tax) in impairments of certain investments, primarily cable and telecommunication investments.
(3) Fiscal year 2002 includes $4.32 billion (pre-tax) in impairments of certain investments, primarily related to our AT&T investment and further declines in the fair values of European cable and telecommunications holdings, and a $1.25 billion (pre-tax) gain on the sale of Expedia, Inc.
(4) Fiscal year 2003 includes $1.15 billion (pre-tax) in impairments of certain investments.

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations for 2001, 2002, and 2003

Management's Discussion and Analysis (MD&A) contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in "Issues and Uncertainties" and elsewhere in this report.

REVENUE

Our revenue growth rate was 10% in fiscal 2001, 12% in fiscal 2002, and 13% in fiscal 2003. Revenue growth in fiscal 2003 was driven primarily by multi-year licensing that occurred before the transition to our new licensing program (Licensing 6.0) in the first quarter of fiscal 2003. Prior to the July 31, 2002 transition date to Licensing 6.0, we experienced significant growth in multi-year licensing arrangements as customers enrolled in our maintenance programs, including Upgrade Advantage and Software Assurance. The revenue growth also reflected a $933 million or 13% increase associated with OEM licensing of Microsoft Windows operating systems and a $309 million or 23% increase in revenue from Microsoft Xbox video game consoles. Revenue growth in fiscal 2002 was led by the addition of $1.35 billion of Xbox video game system revenue and $1.20 billion of revenue growth from Microsoft Windows XP Professional and Home operating systems. Revenue growth in fiscal 2001 was driven primarily by licensing of Microsoft Windows 2000 Professional with $1.01 billion growth in revenue from Professional operating systems, and Server and Tools revenue growth of $852 million.

During the second quarter of fiscal 2002, we launched a new licensing program, Licensing 6.0, for volume licensing customers. Licensing 6.0 simplifies and improves our volume licensing program with Software Assurance, which gives customers the right to install any new release of products covered in the licensing agreement during the term of their coverage. The level of customer adoption of our new volume licensing programs will affect the mix of multi-year licensing agreements with a resulting impact on the timing of revenue recognition. In addition, the timing and extent of a recovery in consumer and corporate spending on PCs and information technology will be factors affecting revenue growth.

CONSOLIDATED OPERATING INCOME

Operating income grew 6% in fiscal 2001, 2% in fiscal 2002, and 11% in fiscal 2003. In fiscal 2003, the growth in operating income reflected an increase of $3.82 billion in revenue, partially offset by an increase of $2.52 billion in operating expenses, primarily related to employee and related costs associated with additional headcount and increased legal settlement expenses. In fiscal 2002, the growth in operating income reflected an increase of $3.07 billion in revenue, substantially offset by an increase of $2.88 billion in operating expenses, which included the onset of costs related to Xbox video game systems. In fiscal 2001, the growth in operating income reflected an increase of $2.34 billion in revenue, partially offset by an increase of $1.63 billion in operating expenses.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

We revised our segments for fiscal year 2003. Our seven segments are:

- Client
- Server and Tools
- Information Worker
- Microsoft Business Solutions
- MSN
- Mobile and Embedded Devices
- Home and Entertainment

The revenue and operating income/(loss) amounts in this MD&A are presented in accordance with U.S. GAAP. Segment Information appearing in Note 21 of the Notes to Financial Statements are presented in accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*.

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

(In millions)	**Revenue**		**Operating Income/(Loss)**	
Year Ended June 30	**2002**	**2003**	**2002**	**2003**
Client	$ 9,360	**$ 10,394**	$ 7,576	**$ 8,400**
Server and Tools	6,157	**7,140**	2,048	**2,457**
Information Worker	8,212	**9,229**	6,448	**7,037**
Microsoft Business Solutions	308	**567**	(176)	**(254)**
MSN	1,571	**1,953**	(641)	**(299)**
Mobile and Embedded Devices	112	**156**	(157)	**(157)**
Home and Entertainment	2,453	**2,748**	(874)	**(924)**
Other	192	**—**	(2,314)	**(3,043)**
Consolidated	$ 28,365	**$ 32,187**	$ 11,910	**$ 13,217**

Client

Client revenue was $8.17 billion, $9.36 billion, and $10.39 billion in 2001, 2002, and 2003. Client includes revenue from Windows XP Professional and Home, Windows 2000 Professional, and other standard Windows operating systems. In 2003, Client revenue growth was driven by OEM licensing revenue growth of $933 million and a 9 percentage point increase of the mix of the higher priced Windows Professional operating systems, the majority of which was in the OEM channel. Windows Professional revenue growth for fiscal 2003 was $1.59 billion or 31% compared to fiscal 2002, partially offset by a $573 million decline in revenue of earlier versions of Windows operating systems. Client operating profit for fiscal 2003 increased 11% primarily as a result of the 11% growth in revenue, partially offset by an increase in operating expenses, largely attributed to headcount additions and related costs.

In fiscal 2002, the growth in Client revenue reflected strong multi-year licensing revenue growth and a continued shift of sales to the higher priced Windows 2000 and Windows XP Professional operating system licensed through OEMs. OEM revenue grew $939 million, despite a 5% decline in reported OEM unit shipments. Fiscal 2001 revenue growth reflected the strong adoption of Windows 2000 Professional with professional operating systems revenue growth of $1.01 billion and a 7 percentage point mix increase to the higher priced Windows 2000 Professional and Windows NT Workstation operating systems, and a $91 million increase in revenue from Windows Me and Windows 98 operating systems.

We do not expect the revenue growth attributed to the mix toward the higher priced Windows Professional operating system to continue at previous levels into fiscal 2004. Additionally, variability between the reported OEM unit shipments and the underlying PC Market may continue as a result of the transition to new OEM licensing terms at the beginning of fiscal year 2003, under which OEMs are billed upon their acquisition of Certificates of Authenticity (COAs) rather than upon the shipment of PCs to their customers.

Server and Tools

Server and Tools revenue was $5.84 billion, $6.16 billion, and $7.14 billion in 2001, 2002, and 2003. Server and Tools consists of server software licenses and client access licenses (CALs) for Windows Server, SQL Server, Exchange Server, and other servers. It also includes developer tools, training, certification, Microsoft Press, Premier product support services, and Microsoft consulting services. Total Server and Tools revenue grew $983 million or 16% in fiscal 2003, driven by an increase in Windows-based server shipments and growth in SQL Server and Exchange revenue. Server revenue, including CALs, grew $787 million or 18% from fiscal 2002 as a result of increased new and anniversary multi-year licensing agreements. Consulting and Premier product support services increased $91 million or 10% compared to fiscal 2002. Revenue from developer tools, training, certification, Microsoft Press and other services increased $105 million or 13%. Server operating profit for fiscal 2003 grew 20%, primarily as a result of the 16% increase in revenue.

In fiscal 2002, Server and Tools revenue increased 5% compared to fiscal 2001. Server revenue, including CALs, increased 9% versus fiscal 2001, driven by a 5% overall increase in Windows-based server shipments and increased deployment of Windows 2000 Server. Consulting and Premier product support services revenue was up $137 million or 17% compared to fiscal 2001, while revenue from developer tools, training, certification, Microsoft Press and other services was down $183 million or 18% from fiscal 2001. In fiscal 2001, Server and Tools revenue increased $852 million or 17% versus the prior year, as a result of the continued adoption of the Microsoft Enterprise Server offerings.

Information Worker

Information Worker revenue was $8.42 billion, $8.21 billion, and $9.23 billion in 2001, 2002, and 2003. Information Worker includes revenue from Microsoft Office, Microsoft Project, Visio, other information worker products, SharePoint Portal Server CALs, and professional product support services. The $1.02 billion or 12% increase in Information Worker revenue in fiscal year 2003 compared to fiscal 2002, was primarily due to growth in Office suites revenue associated with new and anniversary multi-year licensing agreements and a $264 million or 28% increase in revenue from the combined total of Project, Visio, and other standalone applications. Information Worker operating profit for fiscal year 2003 grew 9% compared to fiscal year 2002 led by the 12% increase in revenue, partially offset by a 24% growth in operating expenses related to headcount additions and marketing expenses.

In fiscal 2002, Information Worker licensing revenue declined $228 million or 3% during the year due to a shift in the sales mix to multi-year licensing agreements, which deferred revenue recognition to future years, and a $294 million or 14% decrease in consumer purchases in the Asia-Pacific region, most notably Japan, partially offset by a $189 million or 22% growth in OEM licensing revenue. In fiscal 2001, Information Worker revenue growth was less than 1% or $30 million.

Microsoft Business Solutions

Microsoft Business Solutions revenue was $106 million, $308 million, and $567 million in 2001, 2002, and 2003. Microsoft Business Solutions includes Microsoft Great Plains, Navision, and bCentral. Microsoft Business Solutions revenue for fiscal 2003 grew $259 million from fiscal 2002, of which $246 million was attributable to the acquisition of Navision at the beginning of the fiscal year. Microsoft Business Solutions operating loss for fiscal 2003 increased 44%, primarily due to operating losses associated with Navision, increases in sales and marketing expenses, research and development expenses, and acquisition related costs.

MSN

MSN revenue was $1.32 billion, $1.57 billion, and $1.95 billion in 2001, 2002, and 2003. MSN includes MSN Subscriptions and MSN Network services. Although total MSN subscribers at the end of fiscal 2003 were flat compared to the end of fiscal 2002, MSN Subscriptions revenue grew $112 million or 11% in fiscal year 2003 reflecting an increase in the number of non-promotion subscribers. MSN Network services revenue grew $270 million or 48% in fiscal 2003 as a result of growth in paid search and strong general advertising sales across all geographic regions. MSN operating loss for fiscal 2003 decreased 53%, primarily as a result of the growth in revenue and lower relative subscription acquisition and support costs.

In fiscal 2002, MSN Subscriptions revenue increased $229 million or 29% as a result of both a higher subscriber base and higher average revenue per subscriber due to a reduction in promotional subscriber programs. Revenue from MSN Network services increased $27 million or 5% led by online advertising. In fiscal 2001, revenue from MSN Network services grew $197 million or 58% led by online advertising. MSN Subscriptions revenue also grew $141 million or 22% from fiscal 2000 as a result of an increased subscriber base, partially offset by a decline in the average revenue per subscriber due to a larger mix of subscribers contracted under rebate programs.

Mobile and Embedded Devices

Mobile and Embedded Devices revenue was $86 million, $112 million, and $156 million in 2001, 2002, and 2003. Mobile and Embedded Devices includes Windows Mobile software, Windows Embedded device operating systems, MapPoint, and Windows Automotive. Revenue for fiscal 2003 grew $44 million driven by increased Pocket PC shipments and MapPoint licensing. Operating loss for fiscal 2003 was flat with the prior year as higher marketing expenses and headcount-related costs associated with product development offset the growth in revenue. Prior year revenue and operating loss for Mobile and Embedded Devices have been restated to reflect the reorganizations of MapPoint from Information Worker and Windows embedded device operating systems from Client to Mobile and Embedded Devices.

Home and Entertainment

Home and Entertainment revenue was $1.14 billion, $2.45 billion, and $2.75 billion in 2001, 2002, and 2003. Home & Entertainment includes the Xbox video game system, PC games, consumer software and hardware, and TV platform. Home and Entertainment revenue increased $295 million, as a result of sales of Xbox video game systems and related games which were available for all of fiscal 2003. Xbox revenue grew $309 million or 23% in fiscal 2003 reflecting a $779 million increase from higher volumes for Xbox consoles, games, and peripherals partially offset by a $470 million decrease due to price changes. Revenue from consumer hardware and software and PC games declined $14 million or 1% in fiscal 2003. Operating loss for fiscal 2003 increased 6% from the prior year as the product costs associated with the increased Xbox console sales and increased marketing expense more than offset the 12% increase in revenue.

In fiscal 2002, Home and Entertainment revenue growth from fiscal 2001 stemmed from $1.35 billion of sales of the Xbox video game system released in fiscal 2002. Learning and productivity software revenue and PC and online games declined $39 million or 3% in fiscal 2002 compared to fiscal 2001. In fiscal 2001, Home and Entertainment revenue declined $214 million or 16% from fiscal 2002.

Other

Revenue in the Other segment represents our majority ownership of Expedia, Inc., which was sold in February 2002, resulting in a decline in revenue from fiscal 2001. Acquisitions of Travelscape.com and VacationSpot.com by Expedia, Inc. in fiscal 2001 and increased product offerings from Expedia led to the strong revenue growth in fiscal 2001.

Operating loss includes Expedia, Inc. revenue and operating expenses, general and administrative expenses ($1.55 billion in 2002 and $2.10 billion in 2003), broad-based research and development expenses ($202 million in 2002 and $210 million in 2003), and certain corporate level sales and marketing costs ($526 million in 2002 and $688 million in 2003).

Foreign Currencies Impact

Our operating results are affected by foreign exchange rates. Approximately 27%, 25%, and 28% of our revenue was collected in foreign currencies during 2001, 2002, and 2003. Had the rates from fiscal 2002 been in effect in fiscal 2003, translated international revenue billed in local currencies would have been approximately $700 million lower. Certain manufacturing, selling distribution and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

OPERATING EXPENSES

Cost of Revenue

Cost of revenue includes manufacturing and distribution costs for products and programs sold, operation costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, and costs associated with the delivery of consulting services. Cost of revenue as a percent of revenue was 13.7% in 2001, 18.3% in 2002, and 17.7% in 2003. For fiscal 2003, cost of revenue was $5.69 billion compared to $5.19 billion in fiscal 2002. The primary driver of the decrease as a percentage of revenue in fiscal 2003 was a 0.2 percentage point decrease from Home and Entertainment products due to lower volumes and improved margins of Xbox video game consoles and a 0.4 percentage point decrease from MSN product and service costs in fiscal 2003 compared to fiscal 2002.

Cost of revenue in fiscal 2002 was $5.19 billion compared to $3.46 billion in fiscal 2001. The increase as a percentage of revenue in fiscal 2002 was due to an increase of 5.3 percentage points from Home and Entertainment primarily due to costs related to Xbox, partially offset by a 0.7 percentage point decrease due to a higher mix of revenue from licensing business. In fiscal 2001, cost of revenue was $3.46 billion, an increase of $453 million compared to fiscal 2000. The higher sales associated with MSN Subscription and MSN Network services resulting in increased support and service costs drove 0.4 of the 0.6 percentage point increase in total costs as a percentage of revenue.

Research and Development

Research and development expenses include payroll, employee benefits, and other headcount-related costs associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Research and development expenses for fiscal 2003 were $4.66 billion, an increase of 8% compared to fiscal 2002. The increase reflects a 7% increase in headcount-related costs, a 25% increase in third-party product development costs, and a 29% increase in testing laboratory equipment and expense. In fiscal 2002, research and development expenses were $4.31 billion compared to $4.38 billion in fiscal 2001. The decrease from fiscal 2001 was due to the discontinuation of amortization of goodwill in accordance with SFAS 142, *Goodwill and Other Intangible Assets,* $272 million which offset the 15% growth in headcount-related costs. In fiscal 2001, research and development expenses were $4.38 billion, an increase of 16% compared to fiscal 2000. The increase in research and development expenses resulted from a 11% increase in headcount-related costs and a 23% increase in investments in new product development.

Sales and Marketing

Sales and marketing expenses include payroll, employee benefits, and other headcount-related costs associated with sales and marketing personnel and advertising, promotions, tradeshows, seminars, and other programs. Sales and marketing expense as a percentage of revenue was 19.3% in 2001, 19.1% in 2002, and 20.3% in 2003. Sales and marketing expenses were $6.52 billion in 2003, compared to $5.41 billion in fiscal 2002. The increase in absolute dollars was due to a 20% increase in sales expenses related to headcount additions, principally related to the Enterprise and Small/Medium Business sales forces, and a 21% increase in marketing expenses.

In fiscal 2002, sales and marketing expenses were $5.41 billion, an increase of 11% from fiscal 2001. The sales and marketing expenses in absolute dollars increased due to a 20% increase in headcount-related costs partially offset by a 25% decline in MSN customer acquisition marketing costs and a 4% decline in all other marketing costs. In fiscal 2001, sales and marketing expenses were $4.89 billion compared to $4.13 billion in fiscal 2000. The 18% increase in sales and marketing from fiscal 2000 was primarily due to a 21% growth in headcount-related costs, and to a lesser extent, a 3% growth in higher marketing and sales expenses associated with MSN and other new sales initiatives.

General and Administrative

General and administrative costs include payroll, employee benefits, and other headcount-related costs associated with the finance, legal, facilities, certain human resources, other administrative headcount, and legal and other administrative fees. General and administrative costs in fiscal 2003 increased $554 million due to a charge of $750 million related to a settlement with AOL/Time Warner in the fourth quarter of 2003 and also due to a $256 million charge reflecting an increase in our estimate of costs related to resolving pending state antitrust and unfair competition consumer class action lawsuits. General and administrative expenses in fiscal 2002 increased due to a charge of approximately $660 million for estimated expenses related to resolving pending state antitrust and unfair competition consumer class action lawsuits and a 10% increase in headcount-related costs. In fiscal 2001, general and administrative costs decreased due to a lawsuit settlement charge recorded in fiscal 2000, partially offset by a 3% growth in headcount-related costs.

NON-OPERATING ITEMS, INVESTMENT INCOME/(LOSS), AND INCOME TAXES

Non-operating items

Losses on equity investees and other consist of our share of income or loss from investments accounted for using the equity method, and income or loss attributable to minority interests. The decrease in losses on equity investees and other in fiscal 2003 and 2002 was due to the divestiture of certain equity investments in fiscal 2002 in conjunction with the underlying performance of such entities. The increase in losses on equity investees and other in fiscal 2001 reflected an increase in the number of such investments during the year.

Investment Income/(Loss)

We recorded net investment income/(loss) in each year as follows:

(In millions)

Year Ended June 30	2001	2002	2003
Dividends	$ 377	$ 357	**$ 260**
Interest	1,808	1,762	**1,697**
Net recognized gains/(losses) on investments:			
Net gains on the sales of investments	3,175	2,379	**909**
Other-than-temporary impairments	(4,804)	(4,323)	**(1,148)**
Net unrealized losses attributable to derivative instruments	(592)	(480)	**(141)**
Net recognized gains/(losses) on investments	(2,221)	(2,424)	**(380)**
Investment income/(loss)	$ (36)	$ (305)	**$ 1,577**

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. We employ a systematic methodology that considers available 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, as well as 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.

In fiscal 2003, other-than-temporary impairments decreased mainly due to the lack of significant continued impairments in the cable and telecommunications sectors. Interest income decreased $65 million due to declining interest rates partially offset by a larger investment portfolio. Dividend income decreased $97 million primarily related to the exchange of AT&T 5% convertible preferred debt for common shares of AT&T Corporation during the year.

In fiscal 2002, other-than-temporary impairments primarily related to our investment in AT&T and other cable and telecommunication investments. Net gains on the sales of investments included a $1.25 billion gain on sale of our share of Expedia. Interest and dividend income decreased $66 million from fiscal 2001 as a result of lower interest rates and dividend income.

In fiscal 2001, other-than-temporary impairments primarily related to cable and telecommunication investments. Net gains from the sales of investments in fiscal 2001 included a gain from our investment in Titus Communications (which was merged with Jupiter Telecommunications) and the closing of the sale of Transpoint to CheckFree Holdings Corp. Interest and dividend income increased $591 million from fiscal 2000, reflecting a larger investment portfolio.

Income Taxes

Our effective tax rate for fiscal 2003 was 32%, reflecting a one-time benefit in the second quarter of $126 million from the reversal of previously accrued taxes. The tax reversal stems from a 9th Circuit Court of Appeals ruling in December 2002 overturning a previous Tax Court ruling that had denied tax benefits on certain revenue earned from the distribution of software to foreign customers. Excluding this reversal, the effective tax rate would have been 33%. The effective tax rate for fiscal 2001 and fiscal 2002 was 33% and 32%, respectively.

ACCOUNTING CHANGES

Effective July 1, 2001, we adopted SFAS 141, *Business Combinations,* and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 141 requires business combinations to be accounted for using the purchase method of accounting. It also specifies the types of acquired intangible assets that are required to be recognized and reported separate from goodwill. SFAS 142 requires that goodwill and certain intangibles no longer be amortized, but instead tested for impairment at least annually. There was no impairment of goodwill upon adoption of SFAS 142. Goodwill amortization (on a pre-tax basis) was $311 million in fiscal 2001.

Effective July 1, 2000, we adopted SFAS 133, *Accounting for Derivative Instruments and Hedging Activities,* which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The adoption of SFAS 133 resulted in a cumulative pre-tax reduction to income of $560 million ($375 million after-tax) and a cumulative pre-tax reduction to other comprehensive income (OCI) of $112 million ($75 million after-tax). The reduction to income was mostly attributable to a loss of approximately $300 million reclassified from OCI for the time value of options and a loss of approximately $250 million reclassified from OCI for derivatives not designated as hedging instruments. The reduction to OCI was mostly attributable to losses of approximately $670 million on cash flow hedges offset by the reclassifications out of OCI of the approximately $300 million loss for the time value of options and the approximately $250 million loss for derivative instruments not designated as hedging instruments.

STOCK-BASED COMPENSATION

On July 8, 2003, we announced changes in employee compensation designed to help us continue to attract and retain the best employees, and to better align employee interests with those of our shareholders. Employees will be granted Stock Awards instead of stock options. The Stock Award program offers employees the opportunity to earn actual shares of our stock over time, rather than options that give employees the right to purchase stock at a set price. As part of the changes, we announced that a significant portion of stock-based compensation for more than 600 of our senior leaders will depend on growth in the number and satisfaction of our customers. We also indicated that we are working on a plan to enable employees to realize some value on the portion of their stock options that are currently out-of-the-money, by selling their options to a third-party financial institution. If approved, we expect to implement this plan by the end of 2003.

In addition to announcing changes to our employee compensation arrangements, we also indicated that we will adopt the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation,* effective July 1, 2003, and will report that change in accounting principle using the retroactive restatement method described in SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*. Note 16 of the Notes to the Financial Statements provides pro forma income statements for 2001, 2002, and 2003 as if compensation cost for our stock option and employee stock purchase plans had been determined as prescribed by SFAS 123.

FINANCIAL CONDITION

Our cash and short-term investment portfolio totaled $49.05 billion at June 30, 2003, an increase of $10.40 billion from fiscal year 2002. The portfolio consists 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 currency positions, in order to diversify financial risk. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment for immediate cash needs.

Unearned revenue as of June 30, 2003 was $9.02 billion, increasing $1.27 billion from June 30, 2002, reflecting the addition of new and anniversary multi-year licensing agreements, partially offset by continued recognition of unearned revenue from multi-year licensing in prior periods.

Cash flow from operations was $15.80 billion for fiscal 2003, an increase of $1.29 billion from fiscal 2002. The increase reflects a $2.16 billion increase in net income from fiscal year 2002 and an increase of $1.37 billion in unearned revenue, offset by an increase of $2.36 billion in recognition of unearned revenue. Cash used for financing was $5.22 billion in fiscal 2003, an increase of $651 million from the prior year. The increase reflects a cash dividend payment of $857 million in 2003 and an increase of $417 million in common stock repurchase, offsetting $623 million received for common stock issued. We repurchased 238.2 million shares of common stock under our share repurchase program in fiscal 2003. Cash used for investing was $7.21 billion in fiscal 2003, a decrease of $3.63 billion from fiscal 2002, due to stronger portfolio performance on sold and matured investments.

Cash flow from operations was $14.51 billion for fiscal 2002, an increase of $1.09 billion from fiscal 2001. The increase reflected strong growth in unearned revenue as a result of the significant number of customers that purchased Upgrade Advantage during the Licensing 6.0 transition period. This resulted in an increase in billings and a corresponding increase in the unearned revenue amount. Cash used for financing was $4.57 billion in fiscal 2002, a decrease of $1.01 billion from the prior year. The decrease reflected the repurchase of put warrants in the prior year. We repurchased 245.6 million shares of common stock under our share repurchase program in fiscal 2002. In addition, 10.2 million shares of common stock were acquired in fiscal 2002 under a structured stock repurchase transaction. We entered into the structured stock repurchase transaction in fiscal 2001, which gave us the right to acquire 10.2 million of our shares in exchange for an up-front net payment of $264 million. Cash used for investing was $10.85 billion in fiscal 2002, an increase of $2.11 billion from fiscal 2001.

Cash flow from operations was $13.42 billion in fiscal 2001, an increase of $2.00 billion from the prior year. The increase was primarily attributable to the growth in revenue and other changes in working capital, partially offset by a decrease in the stock option income tax benefit, reflecting decreased stock option exercises by employees. Cash used for financing was $5.59 billion in fiscal 2001, an increase of $3.39 billion from the prior year. The increase primarily reflected the repurchase of put warrants in fiscal 2001, compared to the sale of put warrants in the prior fiscal year, as well as an increase in common stock repurchased. All outstanding put warrants were either retired or exercised during fiscal 2001. During fiscal 2001, we repurchased 178.1 million shares. Cash used for investing was $8.73 billion in fiscal 2001, a decrease of $658 million from the prior year.

We have no material long-term debt. Stockholders' equity at June 30, 2003 was $61.02 billion. We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities and computer systems for R&D, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $117 million on June 30, 2003. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of or requirements for capital resources.

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

Off-balance sheet arrangements

We have operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $281 million, $318 million, and $290 million in 2001, 2002, and 2003, respectively. Future minimum rental commitments under noncancellable leases, in millions of dollars, are: 2004, $218; 2005, $202; 2006, $172; 2007, $134; 2008, $116; and thereafter, $429.

We have unconditionally guaranteed the repayment of certain Japanese yen denominated bank loans and related interest and fees of Jupiter Telecommunication, Ltd., a Japanese cable company (Jupiter). These guarantees arose on February 1, 2003 in conjunction with the expiration of prior financing arrangements, including previous guarantees by us. The financing arrangements were entered into by Jupiter as part of financing its operations. As part of Jupiter's new financing agreement, we agreed to guarantee repayment by Jupiter of the loans of approximately $51 million. The estimated fair value and the carrying value of the guarantees was $10.5 million and did not result in a charge to operations. The guarantees are in effect until the earlier of repayment of the loans, including accrued interest and fees, or February 1, 2009. The maximum amount of the guarantees is limited to the sum of the total due and unpaid principal amounts, accrued and unpaid interest, and any other related expenses. Additionally, the maximum amount of the guarantees, denominated in Japanese yen, will vary based on fluctuations in foreign exchange rates. If we were required to make payments under the guarantees, we may recover all or a portion of those payments upon liquidation of Jupiter's assets. The proceeds from such liquidation cannot be accurately estimated due to the multitude of factors that would affect the valuation and realization of the proceeds in the event of liquidation.

In connection with various operating leases, we issued residual value guarantees, which provide that if we do not purchase the leased property from the lessor at the end of the lease term, then we are liable to the lessor for an amount equal to the shortage (if any) between the proceeds from the sale of the property and an agreed value. As of June 30, 2003, the maximum amount of the residual value guarantees was approximately $271 million. We believe that proceeds from the sale of properties under operating leases would exceed the payment obligation and therefore no liability to us currently exists.

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. We evaluate estimated losses for such indemnifications under SFAS 5, *Accounting for Contingencies*, as interpreted by FIN 45. We consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnifications in our financial statements.

RECENTLY ISSUED ACCOUNTING STANDARDS

In January 2003, the FASB issued Interpretation 46, *Consolidation of Variable Interest Entities.* In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to transactions entered into prior to February 1, 2003 in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The adoption of the Interpretation on July 1, 2003 did not have a material impact on our financial statements.

In April 2003, the FASB issued SFAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, which amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS 133. The Statement is effective (with certain exceptions) for contracts entered into or modified after June 30, 2003. We do not believe the adoption of this Statement will have a material impact on our financial statements.

In May 2003, the FASB issued SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.* The Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). It is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. While we do not believe the adoption of this Statement will have a material impact on our financial statements, we continue to assess the impact this Statement will have on certain of our share repurchase programs.

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 legal contingencies, and accounting for income taxes.

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

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

SFAS 142, *Goodwill and Other Intangible Assets*, requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (July 1st for Microsoft) and between annual tests in certain circumstances. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit.

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

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

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

ISSUES AND UNCERTAINTIES

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

Challenges to our Business Model

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

Intellectual Property Rights

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

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

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

New Products and Services

We have made significant investments in research, development and marketing for new products, services and technologies, including Microsoft .NET, Xbox, business applications, MSN, mobile and wireless technologies, and television. Significant revenue from new product and service investments may not be achieved for a number of years, if at all. Moreover, these products and services may never be profitable, and even if they are profitable, operating margins for these businesses are not expected to be as high as the margins historically experienced by us.

Litigation

As discussed in Note 20 – Contingencies of the Notes to Financial Statements, we are subject to a variety of claims and lawsuits. While we believe that none of the litigation matters in which we are currently involved will have a material adverse impact on our financial position or results of operations, it is possible that one or more of these matters could be resolved in a manner that ultimately would have a material adverse impact on our business, and could negatively impact our revenues, operating margins, and net income.

Declines in Demand for Software

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

Product Development Schedule

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

General Economic and Geo-Political Risks

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

Competition

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

Taxation of Extraterritorial Income

In August 2001, a World Trade Organization (“WTO”) dispute panel determined that the tax provisions of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (“ETI”) constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures. The U.S. government appealed the panel's decision and lost its appeal. If the ETI provisions are repealed and financially comparable replacement tax legislation is not enacted, the loss of the ETI tax benefit to us could be significant.

Other Potential Tax Liabilities

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

Finite Insurance Programs

In addition to conventional third party insurance arrangements, we have entered into captive insurance arrangements for the purpose of protecting against possible catastrophic and other risks not covered by traditional insurance markets. As of June 30, 2003, potential coverage available under captive insurance arrangements was $1.0 billion, subject to deductibles, exclusions, and other restrictions. While we believe these arrangements are an effective way to insure against such risks, the potential liabilities associated with certain of the issues and uncertainties discussed herein could exceed the coverage provided by such arrangements.

Other

Other issues and uncertainties may include:

- warranty and other claims for hardware products such as Xbox;
- the effects of the Consent Decree in *U.S. v. Microsoft* and Final Judgment in State of *New York v. Microsoft* on the Windows operating system and server business, including those associated with protocol and other disclosures required by the Decree and Final Judgment and the ability of PC manufacturers to hide end user access to certain new Windows features;
- the continued availability of third party distribution channels for MSN service and other online services;
- factors associated with our international operations, as described under International Operations in Part I, Item 1 of this report; and
- financial market volatility or other changes affecting the value of our investments, such as the Comcast Corporation securities held by us, that may result in a reduction in carrying value and recognition of losses including impairment charges.

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk

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

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

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

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

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

The following table sets forth the VAR calculations for substantially all of our positions:

(In millions)	As of June 30		Year ended June 30, 2003		
Risk Categories	**2002**	**2003**	**Average**	**High**	**Low**
Interest rates	$ 472	**$ 448**	**$ 609**	**$ 762**	**$ 448**
Currency rates	$ 310	**$ 141**	**$ 156**	**$ 333**	**$ 41**
Equity prices	$ 602	**$ 869**	**$ 838**	**$ 1,083**	**$ 523**

The total VAR for the combined risk categories is $987 million at June 30, 2003 and $908 million at June 30, 2002. The total VAR is 32% less at June 30, 2003 and 34% less at June, 30 2002 than the sum of the separate risk categories for each of those years in the above table, due to the diversification benefit of the combination of risks. The reasons for the change in risk in portfolios include: larger investment portfolio size, asset allocation shifts, and changes in foreign exchange exposures relative to the U.S. dollar.

ITEM 8. Financial Statements and Supplementary Data

INCOME STATEMENTS

(In millions, except earnings per share)

Year Ended June 30	**2001**	**2002**	**2003**
Revenue	$ 25,296	$ 28,365	**$ 32,187**
Operating expenses:			
Cost of revenue	3,455	5,191	**5,686**
Research and development	4,379	4,307	**4,659**
Sales and marketing	4,885	5,407	**6,521**
General and administrative	857	1,550	**2,104**
Total operating expenses	13,576	16,455	**18,970**
Operating income	11,720	11,910	**13,217**
Losses on equity investees and other	(159)	(92)	**(68)**
Investment income/(loss)	(36)	(305)	**1,577**
Income before income taxes	11,525	11,513	**14,726**
Provision for income taxes	3,804	3,684	**4,733**
Income before accounting change	7,721	7,829	**9,993**
Cumulative effect of accounting change (net of income taxes of $185)	(375)	–	**–**
Net income	$ 7,346	$ 7,829	**$ 9,993**
Basic earnings per share(1):			
Before accounting change	$ 0.72	$ 0.72	**$ 0.93**
Cumulative effect of accounting change	(0.03)	–	**–**
	$ 0.69	$ 0.72	**$ 0.93**
Diluted earnings per share(1):			
Before accounting change	$ 0.69	$ 0.70	**$ 0.92**
Cumulative effect of accounting change	(0.03)	–	**–**
	$ 0.66	$ 0.70	**$ 0.92**
Weighted average shares outstanding(1):			
Basic	10,683	10,811	**10,723**
Diluted	11,148	11,106	**10,882**

(1) Earnings per share and weighted average shares outstanding have been restated to reflect a two-for-one stock split in February 2003.

See accompanying notes.

Part II, Item 8

BALANCE SHEETS

(In millions)

June 30	2002	2003
Assets		
Current assets:		
Cash and equivalents	$ 3,016	**$ 6,438**
Short-term investments	35,636	**42,610**
Total cash and short-term investments	38,652	**49,048**
Accounts receivable, net	5,129	**5,196**
Inventories	673	**640**
Deferred income taxes	2,112	**2,506**
Other	2,010	**1,583**
Total current assets	48,576	**58,973**
Property and equipment, net	2,268	**2,223**
Equity and other investments	14,191	**13,692**
Goodwill	1,426	**3,128**
Intangible assets, net	243	**384**
Other long-term assets	942	**1,171**
Total assets	$ 67,646	**$ 79,571**
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 1,208	**$ 1,573**
Accrued compensation	1,145	**1,416**
Income taxes	2,022	**2,044**
Short-term unearned revenue	5,920	**7,225**
Other	2,449	**1,716**
Total current liabilities	12,744	**13,974**
Long-term unearned revenue	1,823	**1,790**
Deferred income taxes	398	**1,731**
Other long-term liabilities	501	**1,056**
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; Shares issued and outstanding 10,718 and 10,771	31,647	**35,344**
Retained earnings, including accumulated other comprehensive income of $583 and $1,840	20,533	**25,676**
Total stockholders' equity	52,180	**61,020**
Total liabilities and stockholders' equity	$ 67,646	**$ 79,571**

See accompanying notes.

Part II, Item 8

CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30	2001	2002	2003
Operations			
Net income	$ 7,346	$ 7,829	**$ 9,993**
Cumulative effect of accounting change, net of tax	375	–	**–**
Depreciation, amortization, and other noncash items	1,536	1,084	**1,439**
Net recognized losses on investments	2,221	2,424	**380**
Stock option income tax benefits	2,066	1,596	**1,376**
Deferred income taxes	(420)	(416)	**336**
Unearned revenue	6,970	11,152	**12,519**
Recognition of unearned revenue	(6,369)	(8,929)	**(11,292)**
Accounts receivable	(418)	(1,623)	**187**
Other current assets	(482)	(264)	**412**
Other long-term assets	(330)	(9)	**(28)**
Other current liabilities	774	1,449	**35**
Other long-term liabilities	153	216	**440**
Net cash from operations	13,422	14,509	**15,797**
Financing			
Common stock issued	1,620	1,497	**2,120**
Common stock repurchased	(6,074)	(6,069)	**(6,486)**
Repurchases of put warrants	(1,367)	–	**–**
Common stock dividends	–	–	**(857)**
Other, net	235	–	**–**
Net cash used for financing	(5,586)	(4,572)	**(5,223)**
Investing			
Additions to property and equipment	(1,103)	(770)	**(891)**
Acquisitions of companies, net of cash acquired	–	–	**(1,063)**
Purchases of investments	(66,346)	(89,386)	**(89,621)**
Maturities of investments	5,867	8,654	**9,205**
Sales of investments	52,848	70,657	**75,157**
Net cash used for investing	(8,734)	(10,845)	**(7,213)**
Net change in cash and equivalents	(898)	(908)	**3,361**
Effect of exchange rates on cash and equivalents	(26)	2	**61**
Cash and equivalents, beginning of year	4,846	3,922	**3,016**
Cash and equivalents, end of year	$ 3,922	$ 3,016	**$ 6,438**

See accompanying notes.

Part II, Item 8

STOCKHOLDERS' EQUITY STATEMENTS

(In millions)

Year Ended June 30	2001	2002	2003
Common stock and paid-in capital			
Balance, beginning of year	$ 23,195	$ 28,390	**$ 31,647**
Common stock issued	5,154	1,801	**3,012**
Common stock repurchased	(394)	(676)	**(691)**
Repurchases of put warrants	(1,367)	–	**–**
Stock option income tax benefits	2,066	1,596	**1,376**
Other, net	(264)	536	**–**
Balance, end of year	28,390	31,647	**35,344**
Retained earnings			
Balance, beginning of year	18,173	18,899	**20,533**
Net income	7,346	7,829	**9,993**
Other comprehensive income:			
Cumulative effect of accounting change	(75)	–	**–**
Net gains/(losses) on derivative instruments	634	(91)	**(102)**
Net unrealized investment gains/(losses)	(1,460)	5	**1,243**
Translation adjustments and other	(39)	82	**116**
Comprehensive income	6,406	7,825	**11,250**
Common stock repurchased	(5,680)	(6,191)	**(5,250)**
Common stock dividends	–	–	**(857)**
Balance, end of year	18,899	20,533	**25,676**
Total stockholders' equity	$ 47,289	$ 52,180	**$ 61,020**

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

Note 1—Accounting Policies

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America.

Principles of Consolidation

The financial statements include the accounts of Microsoft Corporation and its subsidiaries (Microsoft). Intercompany transactions and balances have been eliminated. Equity investments in which we own at least 20% of the voting securities are accounted for using the equity method, except for investments in which the Company is not able to exercise significant influence over the investee, in which case, the cost method of accounting is used.

Estimates and Assumptions

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include estimates of loss contingencies and product life cycles, and assumptions such as the elements comprising a software arrangement, including the distinction between upgrade/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; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

Foreign Currencies

Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the year. Translation adjustments resulting from this process are charged or credited to other comprehensive income (OCI).

Revenue Recognition

Revenue for retail packaged products, products licensed to original equipment manufacturers (OEMs), and perpetual licenses for current products under our Open and Select volume licensing programs is generally recognized as products are shipped, with a portion of the revenue recorded as unearned due to undelivered elements including, in some cases, 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 amount of revenue allocated to undelivered elements is based on the sales price of those elements when sold separately (vendor-specific objective evidence) using the residual method. Under the residual method, the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is recorded as unearned, and the difference between the total arrangement fee and the amount recorded as unearned for the undelivered elements is recognized as revenue related to delivered elements. Unearned revenue due to undelivered elements is recognized ratably on a straight-line basis over the related product's life cycle, which is currently estimated at three and a half years for Windows operating systems and two years for desktop applications (primarily Office).

Revenue from multi-year licensing arrangements are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the billing coverage period. Certain multi-year licensing arrangements include rights to receive future versions of software product on a when-and-if-available basis under Open and Select volume licensing programs (currently named Software Assurance and, previously, Upgrade Advantage). In addition, other multi-year licensing arrangements include a perpetual license for current products combined with rights to receive future versions of software products on a when-and-if-available basis under Open, Select, and Enterprise Agreement volume licensing programs. MSN Internet Access subscriptions, Microsoft bCentral subscriptions, and Microsoft Developer Network subscriptions are also accounted for as subscriptions.

Revenue related to our Xbox game console is recognized upon shipment of the product to retailers. Online advertising revenue is recognized as advertisements are displayed. Consulting services revenue is recognized as services are rendered, generally based on the negotiated hourly rate in the consulting arrangement and the number of hours worked during the period.

Costs related to insignificant obligations, which include telephone support for developer tools software, PC games, computer hardware, and Xbox, are accrued when the related revenue is recognized. Provisions are recorded for estimated returns, concessions, and bad debts.

Cost of Revenue

Cost of revenue includes manufacturing and distribution costs for products and programs sold, operation costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, and costs associated with the delivery of consulting services.

Research and Development

Research and development expenses include payroll, employee benefits, and other headcount-related costs associated with product development. Technological feasibility for our software products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established are not material, and accordingly, we expense all research and development costs when incurred.

Sales and Marketing

Sales and marketing expenses include payroll, employee benefits, and other headcount-related costs as well as expenses related to advertising, promotions, tradeshows, seminars, and other programs. Advertising costs are expensed as incurred. Advertising expense was $1.02 billion in 2001, $1.13 billion in 2002, and $1.06 billion in 2003.

Income Taxes

Income tax expense includes U.S. and international income taxes, plus the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes.

Financial Instruments

We consider all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months to nine years from the purchase date. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash and short-term investments are classified as available for sale and are recorded at market value using the specific identification method; unrealized gains and losses are reflected in OCI.

Equity and other investments include debt and equity instruments. Debt securities and publicly traded equity securities are classified as available for sale and are recorded at market using the specific identification method. Unrealized gains and losses (excluding other-than-temporary impairments) are reflected in OCI. All other investments, excluding those accounted for using the equity method, are recorded at cost.

We lend certain fixed income and equity securities to enhance investment income. Collateral and/or security interest is determined based upon the underlying security and the creditworthiness of the borrower. The fair value of collateral that we are permitted to sell or repledge was $499 million at both June 30, 2002 and 2003.

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. We employ a systematic methodology that considers available 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, as well as 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.

We use derivative instruments to manage exposures to foreign currency, security price, interest rate, and credit risks. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the impact of these exposures as effectively as possible.

Foreign Currency Risk. Certain forecasted transactions and assets are exposed to foreign currency risk. 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. Non U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments under SFAS 133. Options used to hedge a portion of forecasted international revenue for up to three years in the future are designated as cash flow hedging instruments. Certain options and forwards not designated as hedging instruments under SFAS 133 are also used to hedge the impact of the variability in exchange rates on accounts receivable and collections denominated in certain foreign currencies.

Securities Price Risk. Strategic equity investments are subject to market price risk. From time to time, we use and designate options to hedge fair values and cash flows on certain equity securities. We determine the security, or forecasted sale thereof, selected for hedging by market conditions, up-front costs, and other relevant factors. Once established, the hedges are not dynamically managed or traded, and are generally not removed until maturity.

Interest Rate Risk. Fixed-income securities are subject to interest rate risk. The fixed-income portfolio is diversified and consists primarily of investment grade securities to minimize credit risk. We use exchange-traded option and future contracts, not designated as hedging instruments under SFAS 133, to hedge interest rate risk. In addition, we routinely use options, not designated as hedging instruments under SFAS 133, to hedge our exposure to interest rate risk in the event of a catastrophic increase in interest rates.

Other Derivatives. Swap contracts, not designated as hedging instruments under SFAS 133, are used to manage exposures to credit risks. In addition, we may invest in warrants to purchase securities of other companies as a strategic investment. Warrants that can be net share settled are deemed derivative financial instruments and are not designated as hedging instruments. To Be Announced forward purchase commitments of mortgage-backed assets are also considered derivatives in cases where physical delivery of the assets are not taken at the earliest available delivery date.

For options designated either as fair value or cash flow hedges, changes in the time value are excluded from the assessment of hedge effectiveness.

Allowance for Doubtful Accounts

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the account receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence. Activity in the allowance for doubtful accounts is as follows:

(In millions)

Year Ended June 30	Balance at beginning of period	Charged to costs and expenses	Write-offs and other	Balance at end of period
2001	$ 186	$ 157	$ 169	$ 174
2002	174	192	157	209
2003	**209**	**118**	**85**	**242**

Inventories

Inventories are stated at the lower of cost or market, using the average cost method. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories.

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated life of the asset or the lease term, ranging from one to 15 years. Computer software developed or obtained for internal use is depreciated using the straight-line method over the estimated useful life of the software, generally three years or less.

Goodwill

Beginning in fiscal 2002 with the adoption of SFAS 142, *Goodwill and Other Intangible Assets,* goodwill is no longer amortized, but instead tested for impairment at least annually. Prior to fiscal 2002, goodwill was amortized using the straight-line method over its estimated period of benefit.

Intangible Assets

Intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from one to ten years. We periodically evaluate the recoverability of intangible assets and take into account events or circumstances that warrant revised estimates of useful lives or that indicate that an impairment exists. All of our intangible assets are subject to amortization.

Employee Stock Plans

We follow Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees,* to account for stock option and employee stock purchase plans, which generally does not require income statement recognition of options granted at the market price on the date of issuance. However, certain events, such as the accelerated vesting of options and the exchange of options in a business combination, can trigger recording an expense. In addition to announcing changes to our employee compensation arrangements in July 2003, we also indicated that we will adopt the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation,* effective July 1, 2003 and will report that change in accounting principle using the retroactive restatement method described in SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*.

The following table illustrates the effect on net income and earnings per share as if we had applied the fair value recognition provisions of SFAS 123:

(In millions, except earnings per share)

Year Ended June 30	2001	2002	2003
Net income, as reported	$ 7,346	$ 7,829	**$ 9,993**
Add: Stock-based employee compensation expense included in reported net income, net of tax	144	99	**52**
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(2,406)	(2,573)	**(2,514)**
Pro forma net income	$ 5,084	$ 5,355	**$ 7,531**
Earnings per share:			
Basic – as reported	$ 0.69	$ 0.72	**$ 0.93**
Basic – pro forma	$ 0.48	$ 0.50	**$ 0.70**
Diluted – as reported	$ 0.66	$ 0.70	**$ 0.92**
Diluted – pro forma	$ 0.46	$ 0.48	**$ 0.69**

Note 2—Stock Split

In February 2003, outstanding shares of our common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split.

Note 3—Accounting Changes

Effective July 1, 2000, we adopted SFAS 133 which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The adoption of SFAS 133 on July 1, 2000, resulted in a cumulative pre-tax reduction to income of $560 million ($375 million after-tax) and a cumulative pre-tax reduction to OCI of $112 million ($75 million after-tax). The reduction to income was mostly attributable to a loss of approximately $300 million reclassified from OCI for the time value of options and a loss of approximately $250 million reclassified from OCI for derivatives not designated as hedging instruments. The reduction to OCI was mostly attributable to losses of approximately $670 million on cash flow hedges offset by reclassifications out of OCI of the approximately $300 million loss for the time value of options and the approximately $250 million loss for derivative instruments not designated as hedging instruments. The net derivative losses included in OCI as of July 1, 2000 were reclassified into earnings during the twelve months ended June 30, 2001. The change in accounting from the adoption of SFAS 133 did not materially affect net income in 2001.

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

Net income and earnings per share for fiscal 2001 adjusted to exclude amortization expense (net of taxes) is as follows:

(In millions, except earnings per share)

Year Ended June 30	2001
Net income:	
Reported net income	$ 7,346
Goodwill amortization	252
Equity method goodwill amortization	26
Adjusted net income	$ 7,624
Basic earnings per share:	
Reported basic earnings per share	$ 0.69
Goodwill amortization	0.02
Equity method goodwill amortization	–
Adjusted basic earnings per share	$ 0.71
Diluted earnings per share:	
Reported diluted earnings per share	$ 0.66
Goodwill amortization	0.02
Equity method goodwill amortization	–
Adjusted diluted earnings per share	$ 0.68

Note 4—Unearned Revenue

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

The components of unearned revenue were as follows:

(In millions)

June 30	2002	2003
Volume licensing programs	$ 4,158	**$ 5,472**
Undelivered elements	2,830	**2,847**
Other	755	**696**
Unearned revenue	$ 7,743	**$ 9,015**

Unearned revenue by segment was as follows:

(In millions)

June 30	2002	2003
Client	$ 3,023	**$ 3,165**
Server and Tools	1,595	**2,185**
Information Worker	2,757	**3,305**
Other segments	368	**360**
Unearned revenue	$ 7,743	**$ 9,015**

Table of Contents

Of the $9.02 billion of unearned revenue at June 30, 2003, $2.65 billion is expected to be recognized in the first quarter of fiscal 2004, $2.05 billion in the second quarter of fiscal 2004, $1.53 billion in the third quarter of fiscal 2004, $1.00 billion in the fourth quarter of fiscal 2004, and $1.79 billion thereafter.

Note 5—Cash and Short-Term Investments

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
June 30, 2002				
Cash and equivalents:				
Cash	$ 1,114	$ –	$ –	$ 1,114
Commercial paper	260	–	–	260
Certificates of deposit	31	–	–	31
Money market mutual funds	714	–	–	714
Corporate notes and bonds	560	–	–	560
Municipal securities	337	–	–	337
Cash and equivalents	3,016	–	–	3,016
Short-term investments:				
Commercial paper	552	–	—	552
U.S. government and agency securities	8,745	91	(12)	8,824
Corporate notes and bonds	14,577	255	(241)	14,591
Mortgage-backed securities	6,226	23	(1)	6,248
Municipal securities	4,462	86	–	4,548
Certificates of deposit	873	–	–	873
Short-term investments	35,435	455	(254)	35,636
Cash and short-term investments	$ 38,451	$ 455	$ (254)	$ 38,652

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
June 30, 2003				
Cash and equivalents:				
Cash	**$ 1,308**	**$ –**	**$ –**	**$ 1,308**
Commercial paper	**774**	**–**	**–**	**774**
U.S. government and agency securities	**1,889**	**–**	**–**	**1,889**
Certificates of deposit	**28**	**–**	**–**	**28**
Money market mutual funds	**1,263**	**–**	**–**	**1,263**
Corporate notes and bonds	**744**	**95**	**(11)**	**828**
Municipal securities	**348**	**–**	**–**	**348**
Cash and equivalents	**6,354**	**95**	**(11)**	**6,438**
Short-term investments:				
Commercial paper	**100**	**–**	**–**	**100**
U.S. government and agency securities	**5,316**	**126**	**(28)**	**5,414**
Foreign government bonds	**5,364**	**79**	**(16)**	**5,427**
Corporate notes and bonds	**15,440**	**735**	**(86)**	**16,089**
Mortgage-backed securities	**6,257**	**65**	**(3)**	**6,319**
Municipal securities	**8,733**	**265**	**(6)**	**8,992**
Certificates of deposit	**269**	**–**	**–**	**269**
Short-term investments	**41,479**	**1,270**	**(139)**	**42,610**
Cash and short-term investments	**$ 47,833**	**$ 1,365**	**$ (150)**	**$ 49,048**

Realized gains and (losses) from cash and short-term investments (excluding impairments) were $541 million and $(369) million in 2001, $816 million and $(558) million in 2002 and $1.42 billion and $(957) million in 2003.

Note 6—Inventories

(In millions)

June 30	2002	2003
Finished goods	$ 505	**$ 393**
Raw materials and work in process	168	**247**
Inventories	$ 673	**$ 640**

Table of Contents

Note 7—Property and Equipment

(In millions)

June 30	2002	2003
Land	$ 197	**$ 248**
Buildings	1,701	**1,854**
Computer equipment and software	2,621	**2,464**
Other	1,372	**1,512**
Property and equipment – at cost	5,891	**6,078**
Accumulated depreciation	(3,623)	**(3,855)**
Property and equipment – net	$ 2,268	**$ 2,223**

During 2001, 2002, and 2003, depreciation expense, the majority of which related to computer equipment, was $764 million, $820 million, and $929 million.

Note 8—Equity and Other Investments

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
June 30, 2002				
Debt securities recorded at market, maturing:				
Within one year	$ 485	$ 26	$ –	$ 511
Between 2 and 10 years	893	46	(4)	935
Between 10 and 15 years	541	19	(2)	558
Beyond 15 years	3,036	–	–	3,036
Debt securities recorded at market	4,955	91	(6)	5,040
Common stock and warrants	6,580	1,287	(617)	7,250
Preferred stock	1,382	–	–	1,382
Other investments	519	–	–	519
Equity and other investments	$ 13,436	$ 1,378	$ (623)	$ 14,191

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
June 30, 2003				
Debt securities recorded at market, maturing:				
Within one year	**$ 293**	**$ 9**	**$ –**	**$ 302**
Between 2 and 10 years	**1,436**	**194**	**(73)**	**1,557**
Debt securities recorded at market	**1,729**	**203**	**(73)**	**1,859**
Common stock and warrants	**8,395**	**1,686**	**(3)**	**10,078**
Preferred stock	**1,262**	**–**	**–**	**1,262**
Other investments	**493**	**–**	**–**	**493**
Equity and other investments	**$ 11,879**	**$ 1,889**	**$ (76)**	**$ 13,692**

Debt securities include corporate and government notes and bonds and derivative securities. In connection with the definitive agreement to combine AT&T Broadband with Comcast into a new company called Comcast Corporation, Microsoft exchanged its AT&T 5% convertible preferred debt for 115 million shares of Comcast Corporation on November 18, 2002, resulting in a $20 million net recognized loss.

Common and preferred stock and other investments that are restricted for more than one year or are not publicly traded are recorded at cost. At June 30, 2002 the recorded basis of these investments was $2.31 billion, and their estimated fair value was $2.28 billion. At June 30, 2003, the recorded basis of these investments was $2.15 billion, and their estimated fair value was $2.56 billion. The estimate of fair value is based on publicly available market information or other estimates determined by management. Realized gains and (losses) from equity and other investments (excluding impairments) were $3.03 billion and $(23) million in 2001, $2.24 billion and $(121) million in 2002, and $540 million and $(88) million in 2003.

Note 9—Goodwill

During fiscal 2003, goodwill increased by approximately $1.7 billion. The increase related principally to the following acquisitions: Navision a/s with $1.2 billion allocated to Microsoft Business Solutions, $281 million for the Rare, Ltd. acquisition allocated to Home and Entertainment, and Placeware, Inc. with $180 million allocated to Information Worker. No impairment was charged to goodwill during fiscal 2003. During fiscal 2002, goodwill was reduced by $85 million, principally in connection with our exchange of all of the 33.7 million shares and warrants we owned of Expedia, Inc. to USA Networks, Inc. No goodwill was acquired or impaired during fiscal 2002. Goodwill by segment was as follows:

(In millions)

June 30	2002	2003
Client	$ 26	**$ 37**
Server and Tools	97	**106**
Information Worker	–	**180**
Microsoft Business Solutions	1,021	**2,219**
MSN	160	**154**
Mobile and Embedded Devices	5	**28**
Home and Entertainment	117	**404**
Goodwill	$ 1,426	**$ 3,128**

Note 10—Intangible Assets

During fiscal 2003, we recorded additions of $306 million in intangible assets, primarily related to the acquisition of Navision a/s and Rare, Ltd., with $19 million allocated to marketing related assets, $97 million to technology-based assets, $162 million to contract based assets, and $28 million to customer-related assets. Acquired intangibles are amortized over weighted average periods of five years for contract-based assets, four years for technology-based assets, four years for marketing-related assets, and nine years for customer-related assets. No significant residual value is estimated for these assets. Through the fiscal year 2003 acquisitions, $17 million was assigned to research and development assets that were written off in accordance with FASB Interpretation No. 4 (FIN 4), *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.* Those write-offs are included in Research and Development expenses. During fiscal 2002, changes in intangible assets primarily related to our acquisition of $25 million in contracts and $27 million in technology, which will be amortized over approximately three years. No significant residual value is estimated for these intangible assets. Intangible assets amortization expense was $194 million for fiscal 2002 and $161 million for fiscal 2003. The components of intangible assets were as follows:

(In millions)	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
June 30	2002		2003	
Contract-based	$ 421	$ (290)	**$ 584**	**$ (376)**
Technology-based	172	(71)	**261**	**(137)**
Marketing-related	15	(4)	**34**	**(9)**
Customer-related	–	–	**28**	**(1)**
Total Intangible Assets	$ 608	$ (365)	**$ 907**	**$ (523)**

Amortization expense is estimated to be $151 million for fiscal 2004, $103 million for fiscal 2005, $56 million for fiscal 2006, $39 million for fiscal 2007, and $23 million for fiscal 2008.

Note 11—Derivatives

For fiscal 2001, investment income included a net unrealized loss of $592 million, comprised of a $214 million gain for changes in the time value of options for fair value hedges, $211 million loss for changes in the time value of options for cash flow hedges, and $595 million loss for changes in the fair value of derivative instruments not designated as hedging instruments. For fiscal 2002, investment income included a net unrealized loss of $480 million, comprised of a $30 million gain for changes in the time value of options for fair value hedges, a $331 million loss for changes in the time value of options for cash flow hedges, and a $179 million net loss for changes in the fair value of derivative instruments not designated as hedging instruments. For fiscal 2003, investment income included a net unrealized loss of $141 million, comprised of a $74 million loss for changes in the time value of options for fair value hedges, a $229 million loss for changes in the time value of options for cash flow hedges, and a $162 million gain for changes in the fair value of derivative instruments not designated as hedging instruments.

Derivative gains and losses included in OCI are reclassified into earnings at the time forecasted revenue or the sale of an equity investment is recognized. During fiscal 2001, $214 million of derivative gains were reclassified to revenue and $416 million of derivative losses were reclassified to investment income/(loss). During fiscal 2002, $234 million of derivative gains were reclassified to revenue and $10 million of derivative losses were reclassified to investment income/(loss). During fiscal 2003, $40 million of derivative gains were reclassified to revenue and $2 million of derivative gains were reclassified to investment income/(loss). We estimate that $22 million of net derivative gains included in other comprehensive income will be reclassified into earnings within the next twelve months.

For instruments designated as hedges, hedge ineffectiveness, determined in accordance with SFAS 133, had no significant impact on earnings for the fiscal years 2001, 2002, and 2003. No significant fair value hedges or cash flow hedges were derecognized or discontinued for fiscal years 2001, 2002, and 2003.

Part II, Item 8

Note 12—Investment Income/(Loss)

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

(In millions)

Year Ended June 30	2001	2002	2003
Dividends	$ 377	$ 357	**$ 260**
Interest	1,808	1,762	**1,697**
Net recognized gains/(losses) on investments:			
Net gains on the sales of investments	3,175	2,379	**909**
Other-than-temporary impairments	(4,804)	(4,323)	**(1,148)**
Net unrealized losses attributable to derivative instruments	(592)	(480)	**(141)**
Net recognized gains/(losses) on investments	(2,221)	(2,424)	**(380)**
Investment income/(loss)	$ (36)	$ (305)	**$ 1,577**

Other than temporary impairments were recorded as follows for the three most recent fiscal years:

(In millions)

Year Ended June 30	2001	2002	2003
Due to general market conditions	$ 1,692	$ 2,793	**$ 943**
Due to specific adverse conditions	3,112	1,530	**205**
Total Impairments	$ 4,804	$ 4,323	**$ 1,148**

Note 13—Income Taxes

The provision for income taxes consisted of:

(In millions)

Year Ended June 30	2001	2002	2003
Current taxes:			
U.S. and state	$ 3,243	$ 3,644	**$ 3,861**
International	514	575	**808**
Current taxes	3,757	4,219	**4,669**
Deferred taxes	47	(535)	**64**
Provision for income taxes	$ 3,804	$ 3,684	**$ 4,733**

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

(In millions)

Year Ended June 30	2001	2002	2003
U.S.	$ 9,189	$ 8,920	**$ 11,346**
International	2,336	2,593	**3,380**
Income before income taxes	$ 11,525	$ 11,513	**$ 14,726**

In 2001, the effective tax rate was 33.0% and included the effect of a 3.1% reduction from the U.S. statutory rate for tax credits and a 1.1% increase for other items. The effective tax rate in 2002 was 32.0% and included the effect of a 2.4% reduction from the U.S. statutory rate for the extraterritorial income exclusion tax benefit and a 0.6% reduction for other items. The effective tax rate in 2003 was 32.1% and included the effect of a one-time benefit of $126 million from the reversal of previously accrued taxes related to a favorable tax court ruling and a 2.0% reduction from the U.S. statutory rate for other items. Excluding this reversal, the effective tax rate in 2003 would have been 33.0%.

Deferred income taxes were:

(In millions)

June 30	2002	2003
Deferred income tax assets:		
Revenue items	$ 2,261	**$ 2,556**
Expense items	945	**1,048**
Impaired investments	2,016	**1,525**
Deferred income tax assets	$ 5,222	**$ 5,129**
Deferred income tax liabilities:		
Unrealized gain on investments	$ (887)	**$ (1,584)**
International earnings	(1,818)	**(1,809)**
Other	(803)	**(961)**
Deferred income tax liabilities	$ (3,508)	**$ (4,354)**

We have not provided for U.S. deferred income taxes or foreign withholding taxes on $1.64 billion of our undistributed earnings for certain non-U.S. subsidiaries, all of which relate to fiscal 2002 and 2003 earnings, because these earnings are intended to be reinvested indefinitely.

On September 15, 2000, the U.S. Tax Court issued an adverse ruling with respect to our claim that the Internal Revenue Service (IRS) incorrectly assessed taxes for 1990 and 1991. On December 3, 2002, the Ninth Circuit Court of Appeals substantially reversed the U.S. Tax Court decision. Income taxes, except for one issue remanded to the U.S. Tax Court by the Ninth Circuit Court of Appeals for additional consideration, have been settled with the IRS for all years through 1996. The IRS is examining our 1997 through 1999 U.S. income tax returns. Management believes any adjustments which may be required will not be material to the financial statements. Income taxes paid were $1.3 billion in 2001, $1.9 billion in 2002, and $2.8 billion in 2003.

Note 14—Stockholders' Equity

Shares of common stock outstanding were as follows:

(In millions)

Year Ended June 30	2001	2002	2003
Balance, beginning of year	10,566	10,766	**10,718**
Issued	378	208	**291**
Repurchased	(178)	(256)	**(238)**
Balance, end of year	10,766	10,718	**10,771**

We repurchase our common shares primarily to manage the dilutive effects of our stock option and stock purchase plans, and other issuances of common shares. In 2002, we acquired 10.2 million of our shares as a result of a structured stock repurchase transaction entered into in 2001, which gave us the right to acquire such shares in exchange for an up-front net payment of $264 million. To enhance our stock repurchase program, we have sold put warrants to independent third parties. These put warrants entitled the holders to sell shares of our common stock to us on certain dates at specified prices. In the third quarter of fiscal 2001, we issued 5.6 million shares to settle a portion of the outstanding put warrants. At June 30, 2001, 2002, and 2003 no put warrants were outstanding. In any period, cash used in financing activities related to common stock repurchased may differ from the comparable change in Stockholders' Equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

On January 16, 2003, our Board of Directors declared an annual dividend on our common stock of $0.08 per share, payable March 7, 2003 to shareholders of record at the close of business on February 21, 2003.

Note 15—Other Comprehensive Income

(In millions)

Year Ended June 30	**2001**	**2002**	**2003**
Cumulative effect of accounting change, net of tax effect of $(37)	$ (75)	$ –	**$ –**
Net gains/(losses) on derivative instruments:			
Unrealized gains/(losses), net of tax effect of $246 in 2001, $30 in 2002, and $(69) in 2003	499	55	**(129)**
Reclassification adjustment for (gains)/losses included in net income, net of tax effect of $67 in 2001, $(79) in 2002, and $15 in 2003	135	(146)	**27**
Net gains/(losses) on derivative instruments	634	(91)	**(102)**
Net unrealized investment gains/(losses):			
Unrealized holding gains/(losses), net of tax effect of $(351) in 2001, $(955) in 2002, and $610 in 2003	(1,200)	(1,774)	**1,132**
Reclassification adjustment for (gains)/losses included in net income, net of tax effect of $(128) in 2001, $958 in 2002, and $60 in 2003	(260)	1,779	**111**
Net unrealized investment gains/(losses)	(1,460)	5	**1,243**
Translation adjustments and other	(39)	82	**116**
Other comprehensive income/(loss)	$ (940)	$ (4)	**$ 1,257**

The components of accumulated other comprehensive income were:

(In millions)

June 30	**2002**	**2003**
Net gains/(losses) on derivative instruments	$ 86	**$ (16)**
Net unrealized investment gains	603	**1,846**
Translation adjustments and other	(106)	**10**
Accumulated other comprehensive income	$ 583	**$ 1,840**

Note 16—Employee Stock and Savings Plans

Employee Stock Purchase Plan

We have an employee stock purchase plan for all eligible employees. Under the plan, shares of our common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 15% of their gross compensation during an offering period. During 2001, 2002, and 2003 employees purchased 11.4 million, 10.8 million shares and 15.2 million shares at average prices of $18.43, $25.26, and $22.56 per share. At June 30, 2003, 192.2 million shares were reserved for future issuance.

Savings Plan

We have a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may contribute up to 25% of their pretax salary, but not more than statutory limits. We contribute fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were $63 million, $77 million, and $88 million in 2001, 2002, and 2003.

Stock Option and Stock Plans

We have a stock option plan for directors and a stock plan for officers, and employees, which provide for nonqualified and incentive stock options and in the case of the stock plan, stock awards. Options granted prior to 1995 generally vest over four and one-half years and expire ten years from the date of grant. Options granted between 1995 and 2001 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire ten years from the date of grant. Options granted during and after 2002 vest over four and one-half years and expire ten years from the date of grant. We have issued stock awards under the plan for officers and employees whereby employees earn actual shares of stock. In fiscal 2003, the company granted 4 million stock awards, which vest over five years.

At June 30, 2003, stock options for 774 million shares were vested and 866 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

(In millions, except earnings per share)

		Price per Share	
	Shares	Range	Weighted Average
Balance, June 30, 2000	1,664	$ 0.28 – $59.57	$ 20.62
Granted	448	20.75 – 40.00	30.42
Exercised	(246)	0.30 – 42.91	5.57
Canceled	(70)	6.92 – 59.57	31.79
Balance, June 30, 2001	1,796	0.28 – 59.57	24.77
Granted	82	24.31 – 36.29	31.25
Exercised	(198)	0.51 – 34.91	6.41
Canceled	(76)	0.58 – 58.28	34.34
Balance, June 30, 2002	1,604	0.40 – 59.57	26.88
Granted	**254**	**21.42 – 29.12**	**24.27**
Exercised	**(234)**	**0.51 – 28.22**	**6.89**
Canceled	**(75)**	**2.13 – 59.56**	**34.33**
Balance, June 30, 2003	**1,549**	**0.40 – 59.56**	**29.30**

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 2003 were as follows:

(In millions, except earnings per share)

	Outstanding Options			Exercisable Options	
Range of Exercise Prices	Shares	Remaining Life (Years)	Weighted Average Price	Shares	Weighted Average Price
$ 0.39 – $15.00	**124**	**3.7**	**$ 6.29**	**117**	**$ 6.23**
15.01 – 25.00	**359**	**5.6**	**21.30**	**131**	**16.54**
25.01 – 33.00	**415**	**5.8**	**28.24**	**177**	**27.92**
33.01 – 41.00	**387**	**3.2**	**34.26**	**196**	**34.34**
41.01 – 59.56	**264**	**2.4**	**44.90**	**153**	**44.73**

We follow Accounting Principles Board Opinion 25 to account for stock option and employee stock purchase plans. An alternative method of accounting for stock options is SFAS 123. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and this compensation cost is recognized ratably over the vesting period. In addition to announcing changes to our employee compensation arrangements in July 2003, we also indicated that we will adopt the fair value recognition provisions of SFAS 123 effective July 1, 2003 and will report that change in accounting principle using the retroactive restatement method described in SFAS 148.

Had compensation cost for our stock option and employee stock purchase plans been determined as prescribed by SFAS 123, pro forma income statements for 2001, 2002, and 2003 would have been as follows:

(In millions, except earnings per share)

Year Ended June 30	2001		2002		2003	
	Reported	Pro Forma	Reported	Pro Forma	Reported	Pro Forma
Revenue	$ 25,296	$ 25,296	$ 28,365	$ 28,365	**$ 32,187**	**$ 32,187**
Operating expenses:						
Cost of revenue	3,455	3,775	5,191	5,699	**5,686**	**6,059**
Research and development	4,379	6,106	4,307	6,299	**4,659**	**6,595**
Sales and marketing	4,885	5,888	5,407	6,252	**6,521**	**7,562**
General and administrative	857	1,184	1,550	1,843	**2,104**	**2,426**
Total operating expenses	13,576	16,953	16,455	20,093	**18,970**	**22,642**
Operating income	11,720	8,343	11,910	8,272	**13,217**	**9,545**
Losses on equity investees and other	(159)	(159)	(92)	(92)	**(68)**	**(68)**
Investment income/(loss)	(36)	(36)	(305)	(305)	**1,577**	**1,577**
Income before income taxes	11,525	8,148	11,513	7,875	**14,726**	**11,054**
Provision for income taxes	3,804	2,689	3,684	2,520	**4,733**	**3,523**
Income before accounting change	7,721	5,459	7,829	5,355	**9,993**	**7,531**
Cumulative effect of accounting change	(375)	(375)	–	–	**–**	**–**
Net income	$ 7,346	$ 5,084	$ 7,829	$ 5,355	**$ 9,993**	**$ 7,531**
Basic earnings per share	$ 0.69	$ 0.48	$ 0.72	$ 0.50	**$ 0.93**	**$ 0.70**
Diluted earnings per share	$ 0.66	$ 0.46	$ 0.70	$ 0.48	**$ 0.92**	**$ 0.69**

The weighted average Black-Scholes value of options granted under the stock option plans during 2001, 2002, and 2003 was $14.66, $15.79, and $12.08. Value was estimated using a weighted average expected life of 6.4 years in 2001 and 7.0 years in 2002 and 2003, no dividends in 2001 and 2002, a $0.08 per share dividend in 2003, volatility of .39 in 2001, .39 in 2002, and .42 in 2003, and risk-free interest rates of 5.3%, 5.4%, and 3.9% in 2001, 2002, and 2003.

Note 17—Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding put warrants using the “reverse treasury stock” method and outstanding stock options using the “treasury stock” method.

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

(In millions, except earnings per share)

Year Ended June 30	2001	2002	2003
Income before accounting change	$ 7,721	$ 7,829	**$ 9,993**
Weighted average outstanding shares of common stock	10,683	10,811	**10,723**
Dilutive effect of:			
Put warrants	42	–	**–**
Employee stock options	423	295	**159**
Common stock and common stock equivalents	11,148	11,106	**10,882**
Earnings per share before accounting change:			
Basic	$ 0.72	$ 0.72	**$ 0.93**
Diluted	$ 0.69	$ 0.70	**$ 0.92**

For the years ended June 30, 2001, 2002 and 2003; 702 million, 746 million, and 1.09 billion shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

Note 18—Acquisitions

In fiscal year ended June 30, 2003, we acquired all of the outstanding equity interests of Navision a/s, Rare Ltd., and Placeware, Inc. Navision, headquartered in Vedbaek, Denmark, is a provider of integrated business solutions software for small and mid-sized businesses in the European market and will play a key role in the future development of the Microsoft Business Solutions segment. We acquired Navision on July 12, 2002 for $1.465 billion consisting primarily of $662 million in cash and the issuance of 29.1 million common shares of Microsoft stock valued at $773 million. The value of the common shares issued was determined based on the average market price of our common shares over the 2-day period before and after terms of the acquisition were agreed to and approved. Rare is a video game developer located outside Leicestershire, England, that is expected to broaden the portfolio of games available for the Xbox video game system. Rare was acquired on September 24, 2002 for $377 million consisting primarily of $375 million in cash. Placeware, located in Mountain View, CA, facilitates secure, highly reliable, cross-firewall web conferencing experiences allowing users to conduct business meetings online from a PC, and will become a part of Microsoft’s Real Time Collaboration business unit within the Information Worker segment. Placeware was acquired on April 30, 2003 for $202 million, consisting primarily of $189 million in cash. Navision, Rare, and Placeware have been consolidated into our financial statements since their respective acquisition dates. None of the acquisitions, individually or in the aggregate, are material to our consolidated results of operations. Accordingly, pro forma financial information is not included in this note.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisitions (in millions):

	Navision a/s At July 12, 2002	Rare, Ltd. At September 24, 2002	Placeware, Inc. At April 30, 2003
Current assets	$ 240	$ 25	**$ 30**
Property, plant, and equipment	8	8	**7**
Intangible assets	169	75	**30**
Goodwill	1,197	281	**180**
Total assets acquired	1,614	389	**247**
Current Liabilities	(148)	(12)	**(32)**
Long-term liabilities	(1)	–	**(13)**
Total liabilities assumed	(149)	(12)	**(45)**
Net Assets Acquired	$ 1,465	$ 377	**$ 202**

Of the $169 million of acquired intangible assets in the Navision acquisition, $2 million was assigned to research and development assets that were written off in accordance with FIN 4. Those write-offs are included in Research and Development expenses. The remaining $167 million of acquired intangible assets have a weighted average useful life of approximately five years. The intangible assets that make up that amount include technology of $48 million (four-year weighted-average useful life), contracts of $115 million (six-year weighted-average useful life), and marketing of $4 million (three-year weighted-average useful life). The $1,197 million of goodwill was assigned to the Microsoft Business Solutions segment. Of that total amount, approximately $900 million is expected to be deductible for tax purposes.

Of the $75 million of acquired intangible assets in the Rare acquisition, $13 million was assigned to research and development assets that were written off in accordance with FIN 4. Those write-offs are included in Research and Development expenses. The remaining $62 million of acquired intangible assets have a weighted average useful life of approximately five years. The intangible assets that make up that amount include technology of $36 million (five-year weighted average useful life), contracts of $16 million (five-year weighted average useful life), and marketing of $10 million (five-year weighted average useful life). The $281 million of goodwill was assigned to the Home and Entertainment segment. Of that total amount, approximately $270 million is expected to be deductible for tax purposes.

The $30 million of acquired intangible assets in the Placeware acquisition have a weighted average useful life of approximately eight years. The intangible assets that make up that amount include technology of $4 million (four-year weighted-average useful life), customers of $23 million (ten-year weighted-average useful life), contracts of $1 million (six-year weighted-average useful life), and marketing of $2 million (one-year weighted average useful life). The $180 million of goodwill was assigned to the Information Worker segment. None of the goodwill is expected to be deductible for tax purposes.

Note 19—Commitments and Guarantees

We have operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $281 million, $318 million, and $290 million in 2001, 2002, and 2003. Future minimum rental commitments under noncancellable leases, in millions of dollars, are: 2004, $218; 2005, $202; 2006, $172; 2007, $134; 2008, $116; and thereafter, $429. We have committed $117 million for constructing new buildings.

In November 2002, the FASB issued Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). FIN 45 elaborates on previously existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under the guarantee and must disclose that information in its interim and annual financial statements. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations does not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002.

We have unconditionally guaranteed the repayment of certain Japanese yen denominated bank loans and related interest and fees of Jupiter Telecommunication, Ltd., a Japanese cable company (Jupiter). These guarantees arose on February 1, 2003 in conjunction with the expiration of prior financing arrangements, including previous guarantees by us. The financing arrangements were entered into by Jupiter as part of financing its operations. As part of Jupiter's new financing agreement, we agreed to guarantee repayment by Jupiter of the loans of approximately $51 million. The estimated fair value and the carrying value of the guarantees was $10.5 million and did not result in a charge to operations. The guarantees are in effect until the earlier of repayment of the loans, including accrued interest and fees, or February 1, 2009. The maximum amount of the guarantees is limited to the sum of the total due and unpaid principal amounts, accrued and unpaid interest, and any other related expenses. Additionally, the maximum amount of the guarantees, denominated in Japanese yen, will vary based on fluctuations in foreign exchange rates. If we were required to make payments under the guarantees, we may recover all or a portion of those payments upon liquidation of the Jupiter's assets. The proceeds from such liquidation cannot be accurately estimated due to the multitude of factors that would affect the valuation and realization of the proceeds in the event of liquidation.

In connection with various operating leases, we issued residual value guarantees, which provide that if we do not purchase the leased property from the lessor at the end of the lease term, then we are liable to the lessor for an amount equal to the shortage (if any) between the proceeds from the sale of the property and an agreed value. As of June 30, 2003, the maximum amount of the residual value guarantees was approximately $271 million. We believe that proceeds from the sale of properties under operating leases would exceed the payment obligation and therefore no liability to us currently exists.

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. We evaluate estimated losses for such indemnifications under SFAS 5, *Accounting for Contingencies*, as interpreted by FIN 45. We consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnifications in our financial statements.

Our product warranty accrual reflects management's best estimate of probable liability under its product warranties (primarily relating to the Xbox console). We determine the warranty accrual based on known product failures (if any), historical experience, and other currently available evidence. Changes in the product warranty accrual for the fiscal year ended June 30, 2003 were as follows (in millions):

Balance, beginning of period	$ 8
Payments made	–
Change in liability for warranties issued during the period	29
Change in liability for preexisting warranties	(25)
Balance, end of period	$ 12

Note 20—Contingencies

We are a defendant in *U.S. v. Microsoft* and *New York v. Microsoft*, companion lawsuits filed by the Antitrust Division of the U.S. Department of Justice (DOJ) and a group of eighteen state Attorneys General alleging violations of the Sherman Act and various state antitrust laws. After the trial, the District Court entered Findings of Fact and Conclusions of Law stating that we had violated Sections 1 and 2 of the Sherman Act and various state antitrust laws. A Judgment was entered on June 7, 2000 ordering, among other things, our breakup into two companies. The Judgment was stayed pending an appeal. On June 28, 2001, the U.S. Court of Appeals for the District of Columbia Circuit affirmed in part, reversed in part, and vacated the Judgment in its entirety and remanded the case to the District Court for a new trial on one Section 1 claim and for entry of a new judgment consistent with its ruling. In its ruling, the Court of Appeals substantially narrowed the bases of liability found by the District Court, but affirmed some of the District Court's conclusions that we had violated Section 2. We entered into a settlement with the United States on November 2, 2001. Nine states (New York, Ohio, Illinois, Kentucky, Louisiana, Maryland, Michigan, North Carolina and Wisconsin) agreed to settle on substantially the same terms on November 6, 2001. On November 1, 2002, the Court approved the settlement as being in the public interest, conditioned upon the parties' agreement to a modification to one provision related to the Court's ongoing jurisdiction. Nine states and the District of Columbia continued to litigate the remedies phase of *New York v. Microsoft*. The non-settling states sought remedies that would have imposed much broader restrictions on our business than the settlement with the DOJ and nine other states. On November 1, 2002, the Court entered a Final Judgment in this part of the litigation that largely mirrored the settlement between us, the DOJ and the settling states, with some modifications and a different regime for enforcing compliance. The Court declined to impose other and broader remedies sought by the non-settling states. Two states, Massachusetts and West Virginia, appealed from this decision of the trial court, and West Virginia dismissed its appeal as part of a settlement with us of several other cases.

The European Commission has instituted proceedings in which it alleges that we have failed to disclose information that our competitors claim they need to interoperate fully with Windows 2000 clients and servers and that we have engaged in discriminatory licensing of such technology, as well as improper bundling of multimedia playback technology in the Windows operating system. The remedies sought, though not fully defined, include mandatory disclosure of our Windows operating system technology, either the removal of Windows Media technology from Windows or a “must carry” obligation requiring OEMs to install competitive media players with Windows, and imposition of fines in an amount that could be as large as 10% of our worldwide annual revenue. We deny the European Commission's allegations and intend to contest the proceedings vigorously. In other ongoing investigations, various foreign governments and several state Attorneys General have requested information from us concerning competition, privacy, and security issues.

A large number of antitrust and unfair competition class action lawsuits have been filed against us in various state and Federal courts. The Federal cases have been consolidated in the U.S. District Court for Maryland. These cases allege that we have competed unfairly and unlawfully monopolized alleged markets for operating systems and certain software applications, and they seek to recover on behalf of variously defined classes of direct and indirect purchasers overcharges we allegedly charged for these products. To date, courts have dismissed all claims for damages against us by indirect purchasers under Federal law and in 16 different states. Nine of those state court decisions have been affirmed on appeal. Claims on behalf of foreign purchasers have also been dismissed. Appeals of several of these rulings are still pending. No trials have been held concerning any liability issues. Courts in ten states have ruled that these cases may proceed as class actions, while courts in two states have denied class certification status, and another court has ruled that no class action is available for antitrust claims in that state. The Federal District Court has certified a class of direct purchasers of our operating system software that acquired the software from the shop.Microsoft.com Web site or pursuant to a direct marketing campaign and otherwise denied certification of the proposed classes. Members of the certified class licensed fewer than 550,000 copies of operating system software from Microsoft. In 2003, we reached an agreement with counsel for the California plaintiffs to settle all claims in 27 consolidated cases in that state. Under the proposed settlement, class members will be able to obtain vouchers with a total face value of up to $1.1 billion that may be redeemed for cash against purchases of a wide variety of platform-neutral computer hardware and software. Two-thirds of the amount unclaimed or unredeemed by class members then will be made available to certain schools in California in the form of vouchers that also may be redeemed for cash against purchased of a wide variety of platform-neutral computer hardware, software and related services. The court in California preliminarily approved this proposed settlement, but it still requires final approval by the court. In 2003, we also reached similar agreements to settle all claims in Montana, Florida, West Virginia and North Carolina. The total face value of the Montana settlement is $12.3 million, the Florida settlement, $202 million, the West Virginia settlement, $21 million, and the North Carolina settlement, $89.2 million. These proposed settlements are structured similar to the California settlement, except that, among other differences, one-half of the amounts unclaimed by class members will be made available to certain schools in Montana, Florida, West Virginia and North Carolina. The proposed settlements in Montana, Florida and West Virginia have been preliminarily approved by the courts in those states, but still require final approval. The parties have filed a motion for preliminary approval of the settlement in North Carolina and the Court has scheduled a hearing for later this year. We intend to continue vigorously defending the remaining lawsuits. We estimate the total cost to resolve all of these cases will range between $916 million and $1.1 billion with the actual cost dependent upon many unknown factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims process. In accordance with SFAS 5 and FIN 14, *Reasonable Estimation of the Amount of a Loss*, the Company has recorded a contingent liability of $916 million.

Netscape Communications Inc., a subsidiary of AOL-Time Warner Inc., filed suit against us on January 22, 2002 in U.S. District Court for the District of Columbia, alleging violations of antitrust and unfair competition laws and other tort claims relating to Netscape and its Navigator browser. The case was transferred for pretrial purposes to the District Court in Baltimore, Maryland and was being coordinated with the antitrust and unfair competition class actions described above. On May 29, 2003, we and AOL Time Warner announced an agreement to settle the case. As part of the settlement, we paid $750 million to AOL Time Warner and provided AOL Time Warner a royalty-free, seven-year license to use Microsoft Internet Explorer technologies with the AOL client. The parties agreed on various other technical provisions and entered into a separate agreement to collaborate on long-term digital media initiatives designed to accelerate the adoption of digital content. The two companies entered into a long-term, non-exclusive license agreement allowing AOL Time Warner to use our Windows Media 9 Series and future software for creating, distributing and playing back high-quality digital media. As a result of the settlement, the case has been dismissed with prejudice.

Be Incorporated, a former software development company whose assets were acquired by Palm, Inc. in August 2001, filed suit against us on February 18, 2002 in the U.S. District Court for Northern California, alleging violations of Federal and state antitrust and unfair competition laws and other tort claims. Be alleges that our license agreements with computer manufacturers, pricing policies, and business practices interfered with Be's relationships with computer manufacturers and discouraged them from adopting Be's own operating system for their products. We believe the total cost to resolve this case will not be material to our financial position or results of operations.

On March 8, 2002, Sun Microsystems, Inc. filed suit against us alleging violations of Federal and state antitrust and unfair competition laws as well as claims under the Federal Copyright Act. Sun seeks injunctive relief and unspecified treble damages along with its fees and costs. We deny these allegations and will vigorously defend this action. The case has been transferred for pretrial purposes to the U.S. District Court in Baltimore, Maryland and is being coordinated with the antitrust and unfair competition class actions described above. On January 21, 2003, the Court granted Sun's motion for a preliminary injunction and entered an injunction requiring us to distribute certain Sun Java software with Microsoft Windows XP and certain other products. The injunction also prohibits us from distributing our version of Java software in a variety of ways. The U.S. Court of Appeals for the Fourth Circuit granted our request for a stay of the preliminary injunction order. On June 26, 2003, a three judge panel of the Fourth Circuit issued a unanimous opinion vacating the preliminary injunction requiring us to distribute Sun Java software and upheld the preliminary injunction prohibiting us from distributing our version of Java software in certain ways.

We are the defendant in more than 30 patent infringement cases. Several of these cases are approaching trial. In the case of *Eolas Technologies, Inc. and University of California v. Microsoft*, filed in the U.S. District Court for the Northern District of Illinois on February 2, 1999, the plaintiffs accused the browser functionality of Windows of infringement. On August 11, 2003, the jury awarded the plaintiffs approximately $520 million in damages for infringement from the date the plaintiffs' patent issued through September 2001. The plaintiffs are seeking an equitable accounting for damages from September 2001 to the present. We will appeal the jury award and any award on the equitable accounting issue upon conclusion of those aspects of the case that remain to be completed before the trial court. While it is not currently possible to estimate the range of possible loss, we believe the total cost to resolve this case will not be material to our financial position or results of operations. However, the actual costs are dependent upon many unknown factors such as the outcome of issues remaining to be decided by the trial court, success on appeal, and the events of a retrial of the case should the case be remanded to trial following appeal. The trial of *InterTrust v. Microsoft*, filed in the U.S. District Court for Northern California on April 26, 2001, is anticipated in 2005. The plaintiff in this case has accused a large number of products, including Windows and Office, of infringement. In each of *Eolas* and *InterTrust*, injunctive relief also may be awarded that could adversely impact distribution of Windows or Office. Adverse outcomes in some or all of the pending cases may result in significant monetary damages or injunctive relief against us.

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

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

Note 21—Segment Information

(In millions)

Year Ended June 30	**2002**	**2003**
Revenue		
Client	$ 9,350	**$ 10,286**
Server and Tools	5,632	**6,519**
Information Worker	8,328	**9,718**
Microsoft Business Solutions	308	**577**
MSN	1,924	**2,363**
Mobile and Embedded Devices	124	**153**
Home and Entertainment	2,411	**2,779**
Reconciling Amounts	288	**(208)**
Consolidated Revenue	$ 28,365	**$ 32,187**
Operating Income/(Loss)		
Client	$ 7,529	**$ 8,281**
Server and Tools	1,409	**1,848**
Information Worker	6,440	**7,393**
Microsoft Business Solutions	(196)	**(308)**
MSN	(746)	**(394)**
Mobile and Embedded Devices	(240)	**(175)**
Home and Entertainment	(866)	**(940)**
Reconciling Amounts	(1,420)	**(2,488)**
Consolidated Operating Income/(Loss)	$ 11,910	**$ 13,217**

Segment information is presented in accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information.* This standard is based on a management approach, which requires segmentation based upon our internal organization and reporting of revenue and operating income based upon internal accounting methods. Our financial reporting systems present various data for management to run the business, including internal profit and loss statements (P&Ls) prepared on a basis not consistent with U.S. GAAP. Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each segment and it is impracticable for the Company to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

On July 1, 2002, we revised our segments. These changes are designed to promote better alignment of strategies and objectives between development, sales, marketing, and services organizations; provide for more timely and rational allocation of development, sales, and marketing resources within businesses; and focus long-term planning efforts on key objectives and initiatives. Our seven new segments are: Client; Server and Tools; Information Worker; Microsoft Business Solutions; MSN; Mobile and Embedded Devices; and Home and Entertainment. Prior year segment information has been restated to conform to the seven new segments. It is not practical to discern operating income for 2001 for the current segments or operating income for 2003 for the previous segments due to reorganizations.

The segments are designed to allocate resources internally and provide a framework to determine management responsibility. Due to our integrated business structure, operating costs included in one segment may benefit other segments, and therefore 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 development, sales organizations, and inter-segment commissions for segment reporting purposes, which may result in changes to segment allocations in future periods.

The Client segment includes revenue and operating expenses associated with Windows XP, Windows 2000, and other standard Windows operating systems. Server and Tools segment consists of revenue and operating expenses associated with server software licenses and client access licenses (CALs) for Windows Server, SQL Server, Exchange Server, and other servers. It also includes developer tools, training, certification, Microsoft Press, Premier product support services, and Microsoft consulting services. Information Worker segment includes Microsoft Office, Microsoft Project, Visio, other information worker products, SharePoint Portal Server CALs, an allocation for CALs, and professional product support services. Microsoft Business Solutions includes Microsoft Great Plains, Navision, and bCentral. MSN includes MSN Subscription and MSN Network services. Mobile and Embedded Devices includes Windows Mobile software, Windows Embedded device operating systems, MapPoint, and Windows Automotive. Home and Entertainment includes the Xbox video game system, PC games, consumer software and hardware, and TV platform.

Reconciling amounts include adjustments to state revenue and operating income in accordance with U.S. GAAP and corporate level expenses not specifically attributed to a segment. For revenue, reconciling items include certain undelivered elements of unearned revenue and allowances for certain sales returns and rebates. Reconciling items for operating income/(loss) include general and administrative expenses ($1.55 billion in 2002 and $2.10 billion in 2003), broad-based research and development expenses ($202 million in 2002 and $210 million in 2003), and certain corporate level sales and marketing costs ($526 million in 2002 and $688 million in 2003). The internal segment operating income or loss also includes non-GAAP accelerated methods of depreciation and amortization. Additionally, losses on equity investees and minority interest are classified in operating income for internal reporting presentations.

Revenue attributable to U.S. operations includes shipments to customers in the United States, licensing to OEMs and certain multinational organizations, and exports of finished goods, primarily to Asia, Latin America, and Canada. Revenue from U.S. operations totaled $17.8 billion, $20.9 billion, and $22.1 billion in 2001, 2002, and 2003. Revenue from outside the United States, excluding licensing to OEMs and certain multinational organizations and U.S. exports, totaled $7.5 billion, $7.5 billion, and $10.1 billion in 2001, 2002, and 2003. No single customer accounted for 10% or more of revenue in 2001, 2002, or 2003.

Long-lived assets (principally property and equipment) totaled $2.0 billion and $1.9 billion in the United States in 2002 and 2003 and $220 million, and $294 million in other countries in 2002 and 2003.

Part II, Item 8

QUARTERLY INFORMATION

(In millions, except earnings per share) (Unaudited)	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
Fiscal 2001					
Revenue	$ 5,766	$ 6,550	$ 6,403	$ 6,577	$ 25,296
Gross profit	4,941	5,686	5,504	5,710	21,841
Net income	2,206(2)	2,624	2,451	65(3)	7,346
Basic earnings per share(1)	0.21(2)	0.25	0.23	0.01	0.69
Diluted earnings per share(1)	0.20(2)	0.24	0.22	0.01	0.66
Fiscal 2002					
Revenue	$ 6,126	$ 7,741	$ 7,245	$ 7,253	$ 28,365
Gross profit	5,242	6,197	5,850	5,885	23,174
Net income	1,283(4)	2,283	2,738(5)	1,525(6)	7,829
Basic earnings per share(1)	0.12	0.21	0.25	0.14	0.72
Diluted earnings per share(1)	0.12	0.21	0.25	0.14	0.70
Fiscal 2003					
Revenue	**$ 7,746**	**$ 8,541**	**$ 7,835**	**$ 8,065**	**$ 32,187**
Gross profit	**6,547**	**6,507**	**6,620**	**6,827**	**26,501**
Net income	**2,726**	**2,552**	**2,794**	**1,921**	**9,993**
Basic earnings per share	**0.25**	**0.24**	**0.26**	**0.18**	**0.93**
Diluted earnings per share	**0.25**	**0.23**	**0.26**	**0.18**	**0.92**

(1) Earnings per share have been restated to reflect a two-for-one stock split in February 2003.
(2) Includes an unfavorable cumulative effect of accounting change of $375 million or $0.03 per basic share and diluted share, reflecting the adoption of SFAS No. 133.
(3) Includes $3.92 billion (pre-tax) in impairments of certain investments.
(4) Includes $1.82 billion (pre-tax) in impairments of certain investments.
(5) Includes $1.25 billion (pre-tax) gain on the sale of Expedia, Inc. and $1.19 billion (pre-tax) in impairments of certain investments.
(6) Includes $1.19 billion (pre-tax) in impairments of certain investments.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 2002 and 2003, and the related consolidated statements of income, cash flows, and stockholders' equity for each of the three years in the period ended June 30, 2003. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 2002 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2003 in conformity with accounting principles generally accepted in the United States of America.

As described in Note 3 to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, effective July 1, 2000, and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, effective July 1, 2001.

/s/ DELOITTE & TOUCHE LLP

Deloitte & Touche LLP
Seattle, Washington
July 17, 2003 (September 3, 2003 as to certain information in Note 20)

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None.

ITEM 9A. 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 the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2003 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART III

ITEM 10. Directors and Executive Officers of the Registrant

Information with respect to Directors may be found under the caption “Election of Directors and Management Information” of our Proxy Statement for the Annual Meeting of Shareholders to be held November 11, 2003 (the “Proxy Statement”). Such information is incorporated herein by reference.

The information in the Proxy Statement set forth under the caption “Section 16(a) Beneficial Ownership Reporting Compliance” is incorporated herein by reference.

We have adopted the Microsoft Finance Code of Professional Conduct (the “finance code of ethics”), a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, Corporate Controller and other finance organization employees. The finance code of ethics is publicly available on our website at www.microsoft.com/msft. If we make any substantive amendments to the finance code of ethics or grant any waiver, including any implicit waiver, from a provision of the code to our Chief Executive Officer, Chief Financial Officer or Corporate Controller, we will disclose the nature of such amendment or waiver on that website or in a report on Form 8-K.

ITEM 11. Executive Compensation

The information in the Proxy Statement set forth under the captions “Information Regarding Executive Officer Compensation” and “Information Regarding the Board and its Committees – Director Compensation” is incorporated herein by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information in the Proxy Statement set forth under the captions “Equity Compensation Plan Information” and “Information Regarding Beneficial Ownership of Principal Shareholders, Directors, and Management” is incorporated herein by reference.

ITEM 13. Certain Relationships and Related Transactions

The information set forth under the captions “Certain Relationships and Related Transactions” of the Proxy Statement is incorporated herein by reference.

ITEM 14. Principal Accounting Fees and Services

Information concerning principal accountant fees and services appears in the proxy statement under the heading “Fees Paid to Deloitte & Touche LLP” and is incorporated herein by reference.

Table of Contents

PART IV

ITEM 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) Financial Statements and Schedules

The financial statements are set forth under Item 8 of this Annual Report on Form 10-K. Financial statement schedules have been omitted since they are either not required, not applicable, or the information is otherwise included.

(b) Reports on Form 8-K

We did not file any reports on Form 8-K during the quarter ended June 30, 2003. We furnished to the SEC reports on Form 8-K on April 15, 2003 and May 12, 2003. The April 15, 2003 Form 8-K was for the purpose of furnishing the press release announcing our financial results for the fiscal quarter ended March 31, 2003. The May 12, 2003 Form 8-K was for the purpose of furnishing our consolidated balance sheets as of June 30, 2002 and March 31, 2003, and the related consolidated statements of income, cash flows, and stockholders' equity for the three and nine months ended March 31, 2002 and 2003 formatted in XBRL (Extensible Business Reporting Language).

(c) Exhibit Listing

Exhibit Number	Description
3.1	Amended and Restated Articles of Incorporation of Microsoft Corporation(1)
3.2	Bylaws of Microsoft Corporation(2)
10.1	Microsoft Corporation 2001 Stock Plan, as amended and restated
10.2	Microsoft Corporation 1991 Stock Option Plan(3)
10.3	Microsoft Corporation 1981 Stock Option Plan(4)
10.4	Microsoft Corporation 1999 Stock Option Plan for Non-Employee Directors(5)
10.5	Microsoft Corporation Stock Option Plan for Consultants and Advisors(6)
10.6	Microsoft Corporation 2003 Employee Stock Purchase Plan(7)
10.7	Trust Agreement dated June 1, 1993 between Microsoft Corporation and BNY Western Trust Company as trustee (formerly with First Interstate Bank of Washington as trustee)(6)
10.8	Trust Agreement dated as of June 30, 2003 between Microsoft Corporation and BNY Western Trust Company as trustee
10.9	Form of Indemnification Agreement(6)
21.	Subsidiaries of Registrant
23.	Independent Auditors' Consent
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to Quarterly Report on Form 10-Q for the Quarterly Period Ended December 31, 2002.
(2) Incorporated by reference to Quarterly Report on Form 10-Q for the Quarterly Period Ended March 31, 2003.
(3) Incorporated by reference to Annual Report on Form 10-K for the Fiscal Year Ended June 30, 1997.
(4) Incorporated by reference to Registration Statement 33-37623 on Form S-8.
(5) Incorporated by reference to Registration Statement 333-91755 on Form S-8.
(6) Incorporated by reference to Annual Report on Form 10-K for the Fiscal Year Ended June 30, 2002.
(7) Incorporated by reference to Registration Statement 333-102240 on Form S-8.

[Table of Contents](#)

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned; thereunto duly authorized, in the City of Redmond, State of Washington, on September 4, 2003.

MICROSOFT CORPORATION

By: /s/ JOHN G. CONNORS

John G. Connors
Senior Vice President, Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on September 4, 2003.

Signature	Title
/s/ WILLIAM H. GATES III William H. Gates III	Chairman of the Board of Directors and Chief Software Architect
/s/ STEVEN A. BALLMER Steven A. Ballmer	Chief Executive Officer
/s/ JAMES I. CASH, JR., Ph.D. James I. Cash, Jr., Ph.D.	Director
/s/ RAYMOND V. GILMARTIN Raymond V. Gilmartin	Director
/s/ ANN MCLAUGHLIN KOROLOGOS Ann McLaughlin Korologos	Director
/s/ DAVID F. MARQUARDT David F. Marquardt	Director
/s/ WM. G. REED, JR. Wm. G. Reed, Jr.	Director
/s/ JON A. SHIRLEY Jon A. Shirley	Director
/s/ JOHN G. CONNORS John G. Connors	Senior Vice President, Chief Financial Officer (Principal Financial and Accounting Officer)

MICROSOFT CORPORATION

2001 STOCK PLAN
(as amended and restated effective June 12, 2003)

1. Purpose of the Plan. The purposes of this Stock Plan are to attract and retain the best available individuals for positions of substantial responsibility, to provide additional incentive to such individuals, and to promote the success of the Company's business by aligning the financial interests of Employees and Consultants providing personal services to the Company or to any Parent or Subsidiary of the Company with long-term shareholder value.

Awards granted hereunder may be Incentive Stock Options, Nonqualified Stock Options, Stock Awards, or SARs, at the discretion of the Board and as reflected in the terms of the Award Agreement.

2. Definitions. As used herein, the following definitions shall apply:

(a) "Award" shall mean any award or benefits granted under the Plan, including Options, Stock Awards, and SARs.

(b) "Award Agreement" shall mean a written or electronic agreement between the Company and the Awardee setting forth the terms of the Award.

(c) "Awardee" shall mean the holder of an outstanding Award.

(d) "Board" shall mean (i) the Board of Directors of the Company or (ii) both the Board and the Committee, if a Committee has been appointed in accordance with Section 4(a) of the Plan.

(e) "Code" shall mean the Internal Revenue Code of 1986, as amended.

(f) "Committee" shall mean the Compensation Committee appointed by the Board of Directors in accordance with Section 4(a) of the Plan, if one is appointed; provided, however, if the Board of Directors appoints more than one Committee pursuant to Section 4(a), then "Committee" shall refer to the appropriate Committee, as indicated by the context of the reference.

(g) "Common Shares" shall mean the common shares of Microsoft Corporation.

(h) "Company" shall mean Microsoft Corporation, a Washington corporation and any successor thereto.

(i) “Consultant” shall mean any person, except an Employee, engaged by the Company or any Parent or Subsidiary of the Company, to render personal services to such entity, including as an advisor.

(j) “Continuous Status as a Participant” shall mean (1) for Employees, the absence of any interruption or termination of service as an Employee, and (2) for Consultants, the absence of any interruption, expiration, or termination of such person’s consulting or advisory relationship with the Company or the occurrence of any termination event as set forth in such person’s Award Agreement. Continuous Status as a Participant shall not be considered interrupted (i) for an Employee in the case of sick leave, maternity leave, infant care leave, medical emergency leave, military leave, or any other leave of absence authorized in writing by a Vice President of the Company prior to its commencement, and (ii) for a Consultant, in the case of any temporary interruption in such person’s availability to provide services to the Company which has been authorized in writing by a Vice President of the Company prior to its commencement.

(k) “Conversion Options” shall mean the Options described in Section 6(c) of the Plan.

(l) “Employee” shall mean any person, including an officer, who is a common law employee of, receives remuneration for personal services to, is reflected on the official human resources database as an employee of, and is on the payroll of the Company or any Parent or Subsidiary of the Company. A person is on the payroll if he or she is paid from the payroll department of the Company, or any Parent or Subsidiary of the Company. Persons providing services to the Company, or to any Parent or Subsidiary of the Company, pursuant to an agreement with a staff leasing organization, temporary workers engaged through or employed by temporary or leasing agencies, and workers who hold themselves out to the Company, Parent, or Subsidiary to which they are providing services as being independent contractors, or as being employed by or engaged through another company while providing the services are not Employees for purposes of this Plan, whether or not such persons are, or may be reclassified by the courts, the Internal Revenue Service, the U. S. Department of Labor, or other person or entity as, common law employees of the Company, Parent, or Subsidiary, either solely or jointly with another person or entity.

(m) “Effective Date” shall mean January 1, 2001.

(n) “Exchange Act” shall mean the Securities Exchange Act of 1934, as amended.

(o) “FLSA” shall mean the Fair Labor Standards Act of 1938, as amended.

(p) “Incentive Stock Option” shall mean any Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code.

(q) “Maximum Annual Participant Award” shall have the meaning set forth in Section 5(b).

(r) “Nonqualified Stock Option” shall mean an Option not intended to qualify as an Incentive Stock Option.

(s) “Option” shall mean a stock option granted pursuant to Section 6 of the Plan.

(t) “Parent” shall mean a “parent corporation,” whether now or hereafter existing, as defined in Section 424(e) of the Code.

(u) “Participant” shall mean an Employee or Consultant.

(v) “Plan” shall mean this 2001 Stock Plan, including any amendments thereto.

(w) “Share” shall mean one Common Share, as adjusted in accordance with Section 14 of the Plan.

(x) “SAR” shall mean a stock appreciation right awarded pursuant to Section 8 of the Plan.

(y) “Stock Award” shall mean a grant of Shares or of a right to receive Shares or their cash equivalent (or both) pursuant to Section 7 of the Plan.

(z) “Subsidiary” shall mean (i) in the case of an Incentive Stock Option a “subsidiary corporation,” whether now or hereafter existing, as defined in Section 424(f) of the Code, and (ii) in the case of a Nonqualified Stock Option, a Stock Award or an SAR, in addition to a subsidiary corporation as defined in (i), a limited liability company, partnership or other entity in which the Company controls 50 percent or more of the voting power or equity interests.

3. Shares Subject to the Plan. Subject to the provisions of Sections 14 and 16 of the Plan, the maximum aggregate number of Shares (increased, proportionately, in the event of any stock split or stock dividend with respect to the Shares) which may be awarded and delivered under the Plan shall not exceed the sum of (a) any Shares available for future awards, as of the Effective Date, under the Microsoft Corporation 1991 Stock Option Plan, as amended (“1991 Stock Plan”) and (b) any Shares that are represented by awards under the 1991 Stock Plan which, after the Effective Date, are forfeited, expire, are cancelled without delivery of Shares, or otherwise result in the return of Shares to the Company. The Shares may be authorized, but unissued, or reacquired Common Shares.

If an Award should expire or become unexercisable for any reason without having been exercised in full, the undelivered Shares which were subject thereto shall, unless the Plan shall have been terminated, become available for future Awards under the Plan.

4. Administration of the Plan.

(a) Procedure. The Plan shall be administered by the Board of Directors of the Company.

(i) The Board of Directors may appoint one or more Committees each consisting of not less than two members of the Board of Directors to administer the Plan on behalf of the Board of Directors, subject to such terms and conditions as the Board of Directors may prescribe. Once appointed, such Committees shall continue to serve until otherwise directed by the Board of Directors.

(ii) From time to time the Board of Directors may increase the size of the Committee(s) and appoint additional members thereof, remove members (with or without cause) and appoint new members in substitution therefor, or fill vacancies however caused.

(b) Powers of the Board. Subject to the provisions of the Plan, the Board shall have the authority, in its discretion: (i) to grant Incentive Stock Options, Nonqualified Stock Options, Stock Awards, and SARs; (ii) to determine, in accordance with Section 11(b) of the Plan, the fair market value of the Shares; (iii) to determine, in accordance with Section 11(a) of the Plan, the exercise price per share of Awards to be granted; (iv) to determine the Participants to whom, and the time or times at which, Awards shall be granted and the number of Shares to be represented by each Award; (v) to interpret the Plan; (vi) to prescribe, amend, and rescind rules and regulations relating to the Plan; including the form of Award Agreement, and manner of acceptance of an Award, (vii) to determine the terms and provisions of each Award to be granted (which need not be identical) and, with the consent of the Awardee, modify or amend each Award; (viii) to authorize conversion or substitution under the Plan of any or all Conversion Options; (ix) to accelerate or defer (with the consent of the Awardee) the exercise date of any Option; (x) to authorize any person to execute on behalf of the Company any instrument required to effectuate the grant of an Award previously granted by the Board; and (xi) to make all other determinations deemed necessary or advisable for the administration of the Plan.

(c) Effect of Board's Decision. All decisions, determinations, and interpretations of the Board shall be final and binding on all Participants and Awardees.

5. Eligibility.

(a) Awards may be granted to Participants and to persons to whom offers of employment as an Employee have been extended; provided that Incentive Stock Options may only be granted to Employees. For avoidance of doubt, directors are not eligible to participate in the Plan unless they are Employees or Consultants.

(b) The maximum number of Shares with respect to which an Award or Awards may be granted to any Participant in any one taxable year of the Company (the "Maximum Annual Participant Award") shall not exceed 20,000,000 Common Shares (increased, proportionately, in the event of any stock split or stock dividend with respect to the Shares). If an Option is in tandem with an SAR, such that the exercise of the Option or SAR with respect to a Share cancels the tandem SAR or Option right, respectively, with respect to each Share, the tandem Option and SAR rights with respect to each Share shall be counted as covering but one Share for purposes of the Maximum Annual Participant Award.

6. Options.

(a) Each Option shall be designated in the written or electronic option agreement as either an Incentive Stock Option or a Nonqualified Stock Option. However, notwithstanding such designations, to the extent that the aggregate fair market value of the Shares with respect to which Options designated as Incentive Stock Options are exercisable for the first time by any Employee during any calendar year (under all plans of the Company) exceeds $100,000, such Options shall be treated as Nonqualified Stock Options.

(b) For purposes of Section 6(a), Options shall be taken into account in the order in which they were granted, and the fair market value of the Shares shall be determined as of the time the Option with respect to such Shares is granted.

(c) Options converted or substituted under the Plan for any or all outstanding stock options and stock appreciation rights held by employees, consultants, advisors or other option holders granted by entities subsequently acquired by the Company ("Conversion Options") shall be effective as of the close of the respective mergers and acquisitions of such entities by the Company. The Conversion Options may be Incentive Stock Options or Nonqualified Stock Options, as determined by the Committee; provided, however, that stock appreciation rights in the acquired entity shall only be converted to or substituted with Nonqualified Stock Options. The Conversion Options shall be options to purchase the number of Common Shares determined by multiplying the number of shares of the acquired entity's common stock underlying each such stock option or stock appreciation right immediately prior to the closing of such merger or acquisition by the number specified in the applicable merger or acquisition agreement for conversion of each share of such entity's common stock to a Common Share (the "Merger Ratio"). Such Conversion Options shall be exercisable at an exercise price per Common Share (increased to the nearest whole cent) equal to the exercise price per share of the acquired entity's common stock under each such stock option or stock appreciation right immediately prior to closing divided by the Merger Ratio. No fractional Common Shares will be issued upon exercise of Conversion Options. In lieu of such issuance, the Common Shares issued pursuant to each such exercise shall be rounded to the closest whole Share. All other terms and conditions applicable to such stock options and stock appreciation rights prior to closing of the acquisition, including vesting, shall remain unchanged under the Conversion Options.

7. Stock Awards.

(a) Stock Awards may be granted either alone, in addition to, or in tandem with other Awards granted under the Plan. The maximum aggregate number of Shares underlying all such Stock Awards shall not exceed 80,000,000 Common Shares (increased, proportionately, in the event of any stock split or stock dividend with respect to the Shares). Any Stock Award granted to an Employee who is non-exempt for purposes of the FLSA shall include a vesting period of not less than six (6) months. After the Committee determines that it will offer a Stock Award, it will advise the Awardee in writing or electronically, by means of an Award Agreement, of the terms, conditions and restrictions, including vesting, if any, related to the offer, including the number of Shares that the Awardee shall be entitled to receive or purchase, the price to be paid, if any, and, if applicable, the time within which the Awardee must accept the offer. The offer shall be accepted by execution of an Award Agreement in the manner determined by the Committee.

(b) Unless the Committee determines otherwise, the Award Agreement shall provide for the forfeiture of the non-vested Common Shares underlying such Stock Award upon the Awardee ceasing to be a Participant. To the extent that the Awardee purchased the Shares granted under such Stock Award and any such Shares remain non-vested at the time the Awardee ceases to be a Participant, the cessation of Participant status shall cause an immediate sale of such non-vested Shares to the Company at the original price per Common Share paid by the Awardee.

8. SARs.

(a) The Committee shall have the full power and authority, exercisable in its sole discretion, to grant SARs to selected Awardees. The Committee is authorized to grant both tandem stock appreciation rights (“Tandem SARs”) and stand-alone stock appreciation rights (“Stand-Alone SARs”) as described below.

(b) Tandem SARs.

(i) Awardees may be granted a Tandem SAR, exercisable upon such terms and conditions as the Committee shall establish, to elect between the exercise of the underlying Section 6 Option for Common Shares or the surrender of the Option in exchange for a distribution from the Company in an amount equal to the excess of (A) the fair market value (on the Option surrender date) of the number of Shares in which the Awardee is at the time vested under the surrendered Option (or surrendered portion thereof) over (B) the aggregate exercise price payable for such vested Shares.

(ii) No such Option surrender shall be effective unless it is approved by the Committee, either at the time of the actual Option surrender or at any earlier time. If the surrender is so approved, then the distributions to which the Awardee shall become entitled under this Section 8(b) may be made in Common Shares valued at fair market value on the Option surrender date, in cash, or partly in Shares and partly in cash, as the Committee shall deem appropriate.

(iii) If the surrender of an Option is not approved by the Committee, then the Awardee shall retain whatever rights he or she had under the surrendered Option (or surrendered portion thereof) on the Option surrender date and may exercise such rights at any time prior to the later of (A) five (5) business days after the receipt of the rejection notice or (B) the last day on which the Option is otherwise exercisable in accordance with the terms of the instrument evidencing such Option, but in no event may such rights be exercised more than ten (10) years after the date of the Option grant.

(c) Stand-Alone SARs.

(i) An Awardee may be granted a Stand-Alone SAR not tied to any underlying Option under Section 6 of the Plan. The Stand-Alone SAR shall cover a specified number of Common Shares and shall be exercisable upon such terms and conditions as the Committee shall establish. Upon exercise of the Stand-Alone SAR, the holder shall be entitled to receive a distribution from the Company in an amount equal to the excess of (A) the aggregate fair market value (on the exercise date) of the Common Shares underlying the exercised right over (B) the aggregate base price in effect for those Shares.

(ii) The number of Common Shares underlying each Stand-Alone SAR and the base price in effect for those Shares shall be determined by the Committee at the time the Stand-Alone SAR is granted. In no event, however, may the base price per Share be less than the fair market value per underlying Common Share on the grant date.

(iii) The distribution with respect to an exercised Stand-Alone SAR may be made in Common Shares valued at fair market value on the exercise date, in cash, or partly in Shares and partly in cash, as the Committee shall deem appropriate.

(d) The Common Shares underlying any SARs exercised under this Section 8 shall not be available for subsequent issuance under the Plan.

9. Term of Plan. The Plan shall become effective as of the Effective Date. It shall continue in effect until terminated under Section 17 of the Plan.

10. Term of Award. The term of each Award shall be no more than ten (10) years from the date of grant. However, in the case of an Incentive Stock Option granted to a

Participant who, at the time the Option is granted, owns Shares representing more than ten percent (10%) of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the term of the Option shall be no more than five (5) years from the date of grant.

11. Exercise Price and Consideration.

(a) The per Share exercise price under each Award shall be such price as is determined by the Board, subject to the following:

(i) In the case of an Incentive Stock Option

(A) granted to an Employee who, at the time of the grant of such Incentive Stock Option, owns shares representing more than ten percent (10%) of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the per Share exercise price shall be no less than 110% of the fair market value per Share on the date of grant.

(B) granted to any other Employee, the per Share exercise price shall be no less than 100% of the fair market value per Share on the date of grant.

(ii) Except for Conversion Options under Section 6(c), the per Share exercise price under a Nonqualified Stock Option or SAR shall be no less than seventy-five percent (75%) of the fair market value per Share on the date of grant. Notwithstanding the foregoing (or any other provision of the Plan), Options and SARs that are granted to Employees who are non-exempt for purposes of the FLSA, shall satisfy the requirements for exclusion from regular rate of pay for purposes of the FLSA and shall have an exercise price that is at least eighty-five percent (85%) of the fair market value of the underlying Shares at the time of grant; furthermore, such Options or SARs shall not be exercisable within the six (6) month period immediately following the date of grant, except, if so provided in the Award Agreement, in the event of the Awardee's death, disability, or retirement, upon a change in corporate control of the Company, or under such other circumstances as are permitted under the FLSA or rules and regulations thereunder.

(iii) The maximum aggregate number of Shares underlying all Nonqualified Stock Options and SARs with a per Share exercise price of less than fair market value on any grant date that may be granted under this Plan is 50,000,000 Shares (increased, proportionately, in the event of any stock split or stock dividend with respect to the Shares).

(iv) The maximum aggregate number of Shares underlying all Stock Awards with a per Share price of less than fair market value on any grant date that may be granted under this Plan is 80,000,000 Shares (increased, proportionately, in the event of any stock split or stock dividend with respect to the Shares).

(b) The fair market value per Share shall be the closing price per share of the Common Share on the Nasdaq Stock Market (“Nasdaq”) on the date of grant. If the Shares cease to be listed on Nasdaq, the Board shall designate an alternative method of determining the fair market value of the Shares.

(c) The consideration to be paid for the Shares to be issued upon exercise of an Award, including the method of payment, shall be determined by the Board at the time of grant and may consist of cash and/or check. Payment may also be made by delivering a properly executed exercise notice together with irrevocable instructions to a broker to promptly deliver to the Company the amount of sale proceeds necessary to pay the exercise price. If the Awardee is an officer of the Company within the meaning of Section 16 of the Exchange Act, he may, in addition, be allowed to pay all or part of the purchase price with Shares which, as of the exercise date, the officer has owned for six (6) months or more. If the Awardee is a participant in the 1998 Microsoft Corporation Stock Option Gain And Bonus Deferral Program, he may in addition be allowed to pay all or part of the purchase price of any deferred Option with Shares. Shares used by officers to pay the exercise price shall be valued at their fair market value on the exercise date.

(d) Prior to issuance of the Shares upon exercise of an Award, the Awardee shall pay any federal, state, and local income and employment tax withholding obligations applicable to such Award. If an Awardee is an officer of the Company within the meaning of Section 16 of the Exchange Act, he may elect to pay such withholding tax obligations by having the Company withhold Shares having a value equal to the amount required to be withheld, and any Award under the Plan may permit or require that such withholding tax obligations be paid by having the Company withhold Shares having a value equal to the amount required to be withheld. The value of the Shares to be withheld shall equal the fair market value of the Shares on the day the Award is exercised. The right of an officer to dispose of Shares to the Company in satisfaction of withholding tax obligations shall be deemed to be approved as part of the initial grant of an Award, unless thereafter rescinded, and shall otherwise be made in compliance with Rule 16b-3 and other applicable regulations.

12. <u>Exercise of Award</u>.

(a) <u>Procedure for Exercise; Rights as a Shareholder</u>. Any Award granted hereunder shall be exercisable at such times and under such conditions as determined by the Board at the time of grant, and as shall be permissible under the terms of the Plan.

An Award may not be exercised for a fraction of a Share.

An Award shall be deemed to be exercised when written or electronic notice of such exercise has been given to the Company in accordance with the terms of the Award by the person entitled to exercise the Award and full payment for the Shares with respect to which the Award is exercised has been received by the Company. Full payment may, as authorized by the

Board, consist of any consideration and method of payment allowable under Section 11(c) of the Plan. Until the issuance (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company) of the share certificate evidencing such Shares, no right to vote or receive dividends or any other rights as a shareholder shall exist with respect to the Shares subject to the Award, notwithstanding the exercise of the Award. The Company shall issue (or cause to be issued) such share certificate promptly upon exercise of the Award. In the event that the exercise of an Award is treated in part as the exercise of an Incentive Stock Option and in part as the exercise of a Nonqualified Stock Option pursuant to Section 6(a), the Company shall issue a share certificate evidencing the Shares treated as acquired upon the exercise of an Incentive Stock Option and a separate share certificate evidencing the Shares treated as acquired upon the exercise of a Nonqualified Stock Option, and shall identify each such certificate accordingly in its share transfer records. No adjustment will be made for a dividend or other right for which the record date is prior to the date the share certificate is issued, except as provided in Section 14 of the Plan.

Exercise of an Award in any manner and delivery of the Shares subject to such Award shall result in a decrease in the number of Shares which thereafter may be available, both for purposes of the Plan and for sale under the Award, by the number of Shares as to which the Award is exercised.

(b) Termination of Status as a Participant. In the event of termination of an Awardee's Continuous Status as a Participant, such Awardee may exercise his or her rights under any outstanding Awards to the extent exercisable on the date of termination (but in no event later than the date of expiration of the term of such Award as set forth in the Award Agreement). To the extent that the Awardee was not entitled to exercise his or her rights under such Awards at the date of such termination, or does not exercise such rights within the time specified in the individual Award Agreements, the Awards shall terminate.

(c) Disability of Awardee. Notwithstanding the provisions of Section 12(b) above, in the event of termination of an Awardee's Continuous Status as a Participant as a result of total and permanent disability (i.e., the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of twelve (12) months), the Awardee may exercise the Award, but only to the extent of the right to exercise that would have accrued had the Awardee remained in Continuous Status as a Participant for a period of twelve (12) months after the date on which the Participant ceased performing services as a result of the total and permanent disability. Such exercise must occur within eighteen (18) months (or such shorter time as is specified in the grant) from the date on which the Participant ceased performing services as a result of the total and permanent disability (but in no event later than the date of expiration of the term of such Award as set forth in the Award Agreement). To the extent that the Awardee was not entitled to exercise such Award within the time specified herein, the Award shall terminate.

(d) Death of Awardee. Notwithstanding the provisions of Section 12(b) above, in the event of the death of an Awardee:

(i) who is at the time of death a Participant, the Award may be exercised, at any time within twelve (12) months following the date of death, by the Awardee's estate or by a person who acquired the right to exercise the Award by bequest or inheritance, but only to the extent of the right to exercise that would have accrued had the Awardee continued living and remained in Continuous Status as a Participant twelve (12) months after the date of death; or

(ii) whose Award has not yet expired but whose Continuous Status as a Participant terminated prior to the date of death, the Award may be exercised, at any time within twelve (12) months following the date of death, by the Awardee's estate or by a person who acquired the right to exercise the Award by bequest or inheritance, but only to the extent of the right to exercise that had accrued at the date of termination.

(e) Notwithstanding subsections (b), (c), and (d) above, the Board shall have the authority to extend the expiration date of any outstanding option in circumstances in which it deems such action to be appropriate (provided that no such extension shall extend the term of an Award beyond the date on which the Award would have expired if no termination of the Employee's Continuous Status as a Participant had occurred).

13. Non-Transferability of Awards. An Award may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution and may be exercised, during the lifetime of the Awardee, only by the Awardee; provided that the Board may permit further transferability, on a general or specific basis, and may impose conditions and limitations on any permitted transferability.

14. Adjustments to Shares Subject to the Plan.

The number of Shares covered by each outstanding Award, the Maximum Annual Employee Award and the number of Shares which have been authorized for issuance under the Plan but as to which no Awards have yet been granted or which have been returned to the Plan upon cancellation or expiration of an Award, as well as the price per Share covered by each such outstanding Award, shall be proportionately adjusted for any increase or decrease in the number of issued Shares resulting from a stock split, reverse stock split, stock dividend, combination, or reclassification of the Shares, or any other increase or decrease in the number of issued Shares effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been "effected without receipt of consideration." Such adjustment shall be made by the Board, whose determination in that respect shall be final, binding, and conclusive. Except as expressly provided herein, no issuance by the Company of shares of any class, or securities convertible into shares of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of Shares subject to an Award.

In the event of the proposed dissolution or liquidation of the Company, the Award will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Board. The Board may, in the exercise of its sole discretion in such instances, declare that any Award shall terminate as of a date fixed by the Board and give each Awardee the right to exercise an Award as to all or any part of the Shares subject to an Award, including Shares as to which the Award would not otherwise be exercisable. In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, each Award shall be assumed or an equivalent award shall be substituted by such successor corporation or a parent or subsidiary of such successor corporation, unless such successor corporation does not agree to assume the Award or to substitute an equivalent award, in which case the Board shall, in lieu of such assumption or substitution, provide for the Awardee to have the right to exercise the Award as to all of the Shares subject to Awards, including Shares as to which the Award would not otherwise be exercisable. If the Board makes an Award fully exercisable in lieu of assumption or substitution in the event of a merger or sale of assets, the Board shall notify the Awardee that the Award shall be fully exercisable for a period of fifteen (15) days from the date of such notice, and the Award will terminate upon the expiration of such period.

15. Time of Granting Awards. The date of grant of an Award shall, for all purposes, be the date on which the Company completes the corporate action relating to the grant of such Award and all conditions to the grant have been satisfied, provided that conditions to the exercise of an Award shall not defer the date of grant. Notice of a grant shall be given to each Participant to whom an Award is so granted within a reasonable time after the determination has been made.

16. Substitutions and Assumptions. The Board shall have the right to substitute or assume Awards in connection with mergers, reorganizations, separations, or other transactions to which Section 424(a) of the Code applies, provided such substitutions and assumptions are permitted by Section 424 of the Code and the regulations promulgated thereunder. The number of Shares reserved pursuant to Section 3 may be increased by the corresponding number of Awards assumed and, in the case of a substitution, by the net increase in the number of Shares subject to Awards before and after the substitution.

17. Amendment and Termination of the Plan.

(a) Amendment and Termination. The Board may amend or terminate the Plan from time to time in such respects as the Board may deem advisable (including, but not limited to amendments which the Board deems appropriate to enhance the Company’s ability to claim deductions related to stock option exercises); provided that any increase in the number of Shares subject to the Plan, other than in connection with an adjustment under Section 14 of the Plan, shall require approval of or ratification by the shareholders of the Company.

(b) Participants in Foreign Countries. The Board shall have the authority to adopt such modifications, procedures, and subplans as may be necessary or desirable to comply with provisions of the laws of foreign countries in which the Company or its Subsidiaries may operate to assure the viability of the benefits from Awards granted to Participants performing services in such countries and to meet the objectives of the Plan.

(c) Effect of Amendment or Termination. Any such amendment or termination of the Plan shall not affect Awards already granted and such Awards shall remain in full force and effect as if this Plan had not been amended or terminated, unless mutually agreed otherwise between the Awardee and the Board, which agreement must be in writing and signed by the Awardee and the Company.

18. Conditions Upon Issuance of Shares. Shares shall not be issued pursuant to the exercise of an Award unless the exercise of such Award and the issuance and delivery of such Shares pursuant thereto shall comply with all relevant provisions of law, including, without limitation, the Securities Act of 1933, as amended, the Exchange Act, the rules and regulations promulgated thereunder, and the requirements of any stock exchange upon which the Shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

19. Reservation of Shares. The Company, during the term of this Plan, will at all times reserve and keep available such number of Shares as shall be sufficient to satisfy the requirements of the Plan.

20. No Employment/Service Rights. Nothing in the Plan shall confer upon any Participant the right to an Award or to continue in service as an Employee or Consultant for any period of specific duration, or interfere with or otherwise restrict in any way the rights of the Company (or any Parent or Subsidiary employing or retaining such person), or of any Participant or Awardee, which rights are hereby expressly reserved by each, to terminate such person's services at any time for any reason, with or without cause.

21. Shareholder Approval. The Plan is subject to approval by the shareholders of the Company at the Annual Meeting of Shareholders to be held on November 9, 2000.

*All share numbers in the Plan reflect the 2-for-1 stock split effected February 2003.

2003 INDEMNIFICATION TRUST AGREEMENT

This 2003 INDEMNIFICATION TRUST AGREEMENT ("**Trust**" or "**Agreement**") is established as of June 30, 2003, between MICROSOFT CORPORATION, a Washington corporation ("**Grantor**"), and BNY WESTERN TRUST COMPANY ("**Trustee**"), whose address is Two Union Square, Suite 1720, 601 Union Street, Seattle, Washington 98101-2321, and, as an additional party, William G. Reed, Jr. (the "**Beneficiaries' Representative**").

RECITALS

A. The Grantor has established this Trust to be a source of indemnification for the Grantor's directors who are eligible for such indemnification as stated in this Trust as it is in effect from time to time.

B. The Grantor has determined, after due diligence, that it has and will derive substantial economic benefits of this Trust, including economic terms that are more favorable to the Grantor than obtaining protection for its directors through the current director insurance market.

C. The Grantor's Articles of Incorporation (the "**Articles**") provide for mandatory indemnification of the Grantor's directors to the maximum extent provided by law, and as such, this Trust is not an exclusive source of indemnification for such directors.

D. The Grantor has determined that the Trust is necessary in order for the Grantor to attract and retain the most qualified directors.

E. The capitalized terms have the meaning ascribed to them in the body of this Trust.

AGREEMENT

NOW, THEREFORE, the Grantor transfers to the Trustee funds as stated on **Exhibit A** of this Agreement and the Trustee acknowledges receipt of the funds and accepts the trust created hereby and agrees that it will hold all property which it may receive hereunder, as custodian IN TRUST, for the purposes and upon the terms and conditions hereinafter stated, and Grantor, Trustee and Beneficiaries' Representative agree as follows:

ARTICLE 1
DEFINITIONS

"**Act**" means the Washington Business Corporation Act RCW 23B or succession legislation.

“**Cash**” means (a) currency of the United States, and (b) certificates of deposit or time deposits having, in each case, a tenor of not more than six (6) months, issued by any U.S. commercial bank or any branch or agency of a non-U.S. bank licensed to conduct business in the U.S. having combined capital and surplus of not less than $250,000,000 (including the Trustee and its affiliates.).

“**Claim**” or “**Claims**” includes, without limitation, any threatened, pending, or completed action, suit, or proceeding, whether civil, derivative, criminal, administrative, investigative, or otherwise, initiated by a person other than the Beneficiary (including any Claims by or in the right of Grantor), unless the Claim was initiated by the Beneficiary in good faith to establish or enforce a right to indemnification under the Articles, this Trust or applicable statute.

“**Covered Act**” means any act or omission (including, without limitation, any alleged breach of duty, neglect, error, misstatement, misleading statement, or otherwise, or appearing as or preparing to be a witness) by a Beneficiary, and any Claim against such Beneficiary, by reason of the fact that that Beneficiary is or was a director of Grantor, or of any subsidiary or division, or is or was serving at the request of Grantor as a director, officer, partner, trustee, employee, or agent of another corporation, partnership, joint venture, trust, employee benefit plan, or other enterprise.

“**Corporate Securities**” means USD denominated senior debt obligations that are obligations (whether direct or by virtue of guarantees) of corporations organized in the United States whose long-term, unsecured, unsubordinated debt securities are rated at least “A” (or its equivalent successor rating) in the case of Standard & Poor’s Ratings Group or “A2” (or its equivalent successor rating) in the case of Moody’s Investors Service, Inc.

“**Eligible Securities**” means Cash, Treasury Securities, Government Securities and Municipal Securities, Corporate Securities, Money Market Funds and Other Eligible Securities. All Eligible Securities must be in a form suitable for delivery and retransfer, and must be capable of being priced by recognized third-party dealers.

“**Excluded Claim**” means any payment for Losses or Expenses in connection with any Claim the payment of which is Ultimately Determined to be prohibited by the Act, public policy, or other applicable law (including binding regulations and orders or, and undertakings or other commitments with, any governmental entity or agency) as the same exists or may hereafter be amended (but, in the case of any such amendment, only to the extent that such amendment permits Grantor to provide broader indemnification rights than said law permitted Grantor to provide prior to such amendment).

“**Expenses**” means any reasonable expenses incurred by Beneficiary as a result of a Claim or Claims made against him or her for Covered Acts including, without limitation, counsel fees and costs of investigative, judicial, or administrative proceedings and any appeals.

“**Fines**” shall include any fine, penalty or, with respect to an employee benefit plan, any excise tax, or penalty assessed with respect thereto.

“**Government Securities**” means bonds, notes, debentures, obligations or other evidence of indebtedness issued and/or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation or the Government National Mortgage Association, including mortgage participation certificates, mortgage pass-through certificates and other mortgage-backed securities, but excluding collateralized mortgage obligations and mortgage-related securities representing payments of interest only or principal only and REMIC securities and CMBS (commercial mortgage backed securities).

“**Loss**” means any amount which Beneficiary is legally obligated to pay as a result of any Claim or Claims made against him or her for Covered Acts including, without limitation, Fines, damages, judgments, costs of defense of any Claims and sums paid in settlement of any Claim or Claims, specifically including fees of plaintiff’s counsel.

“**Money Market Funds**” means money market funds rated “AAAm” or AAAm-G by Standard & Poors Rating Service, including funds for which the Trustee or its affiliates provide investment advisory or other management services.

“**Municipal Securities**” means senior and unsubordinated debt obligations that are obligations (whether direct or by virtue of guarantees) of U.S. state or municipal issuers whose long-term, unsecured, unsubordinated, debt securities are rated at least “A” (or its equivalent successor rating) in the case of Standard & Poor’s Ratings Group or “A2” (or its equivalent successor rating) in the case of Moody’s Investors Service, Inc., excluding “A” or “A2” rated debt securities of housing and hospital issuers and municipal funds and partnerships where the rating is not based upon the rating of a third-party credit enhancer of such securities.

“**Other Eligible Securities**” means securities other than Cash, Corporate Securities, Treasury Securities, Government Securities, Money Market Funds and Municipal Securities mutually agreed upon in writing by Beneficiaries’ Representative and Grantor.

“**Treasury Securities**” means securities issued or guaranteed by the United States Government, including United States Treasury obligations and any other obligations the timely payment of principal and interest of which is guaranteed by the United States Government.

“**Ultimate Determination**” means a final order from which there is no further right of appeal in any action in which a Beneficiary seeks indemnification. Such an order shall constitute the Ultimate Determination of the Beneficiary’s right to indemnification from Grantor. “Ultimately Determined” shall have a correlative meaning.

ARTICLE 2
PRIOR COVERED ACTS AND CLAIMS

2.1 Indemnification for Covered Acts. The Beneficiaries (as defined below) under this Trust shall be indemnified for any Losses, Expenses or Fines that result from a Claim based on a Covered Act asserted while this Trust is in effect without regard to whether the Covered Act occurred on, before or after the establishment of this Trust.

2.2 Nonexclusive Remedy. The rights of Beneficiaries to indemnification from this Trust are limited to the assets of the Trust, but this does not limit the Beneficiaries' rights, if any, to indemnification (without duplication) from other Grantor arrangements or obligations, including but not limited to applicable insurance coverage.

ARTICLE 3
THE BENEFICIARIES AND THE
BENEFICIARIES' REPRESENTATIVE

3.1 The Beneficiaries. All present and future members of Grantor's Board of Directors shall be "**Beneficiaries**" of the Trust, *provided*, *however*, that if there is a "Change in Control" of Grantor no directors elected or appointed after or in connection with such Change in Control shall be entitled to be Beneficiaries who were not Beneficiaries prior to such Change in Control. For purposes of this Agreement, the term "**Change of Control**" shall mean (a) a tender offer or exchange offer where the purpose of such offer is to take over and control Grantor and such offer is accepted by owners of securities of Grantor representing 50% or more of the combined voting power of Grantor's then outstanding voting securities, (b) Grantor is merged or consolidated with another corporation and as a result of such merger or consolidation less than 50% of the outstanding voting securities of the surviving or resulting corporation shall then be owned in the aggregate by the former shareholders of Grantor, (c) Grantor transfers substantially all of its assets to another corporation which is not a wholly-owned subsidiary of Grantor, or (d) during any period of twelve (12) consecutive months, individuals who at the beginning of such twelve (12) month period were directors of Grantor cease for any reason to constitute at least a majority of Grantor's Board of Directors. The Beneficiaries' Representative shall promptly notify the Trustee of a Change in Control. Any Beneficiary shall remain a Beneficiary despite his or her resignation, removal, or other failure to continue to be a member of Grantor's Board of Directors during the term of this Agreement. A person whose conduct gives rise to a right of indemnification both as a member of the Board of Directors and as an officer, shall be a Beneficiary hereunder as to all such conduct without being required to separate his or her activities between the role of director and the role of officer.

3.2 New Beneficiaries. If prior to a Change in Control an individual is duly elected to the Grantor's Board of Directors, Grantor agrees to notify the Trustee promptly of such election or appointment; *provided*, *however*, Grantor's failure to so notify the Trustee shall not affect in any way an individual director's rights as a beneficiary under this Trust. The Trustee shall have the right to rely on the accuracy and completeness of any statement provided to it by the Grantor's Secretary, Assistant Secretary or Chief Executive Officer as to the Beneficiary status of any individual.

3.3 Beneficiaries' Representative. Except as expressly provided elsewhere in this Agreement, all communications or demands made by and among the Trustee and the Beneficiaries are to be made through the individual then designated as the Beneficiaries' Representative. The Beneficiaries' Representative shall have the exclusive right to convey Demands (as defined below) from time to time on the Trustee to direct payment to one or more of the Beneficiaries.

3.4 Identity of Beneficiaries' Representative. The Beneficiaries' Representative shall be a Beneficiary who is a present or past nonemployee director of Grantor, designated in writing to the Trustee and Grantor from time to time by a majority of the then living nonemployee directors who are Beneficiaries under this Agreement. For this purpose a director who has not been employed by Grantor during the current year and the preceding three (3) years shall be regarded as a nonemployee director. The Trustee and Grantor shall be entitled to rely on the original appointment of that individual as the Beneficiaries' Representative unless notified in writing of a change in the Beneficiaries' Representative by a writing signed by the former Beneficiary Representative. A Beneficiary shall be deemed to have consented to such change in Beneficiaries Representative if such Beneficiary is provided with notice of such change in accordance with Section 8.6 of this Agreement and does not provide written notice of objection to such change within ten (10) days. The Trustee shall be entitled to rely on such subsequent appointment as of the date such writing is received by the Trustee. The Trustee shall be entitled to rely on the accuracy and completeness of a written list delivered to the Trustee by Grantor, and certified by the Secretary of Grantor to be accurate and to have been prepared in good faith, identifying the individuals who constitute the then living past and present nonemployee directors who are Beneficiaries under this Agreement. In the absence of an effective appointment of a Beneficiaries' Representative, the Trustee or any Beneficiary may, after ten (10) days' written notice to all Beneficiaries and the Grantor, petition a court of competent jurisdiction at the expense of the Trust for appointment of a Beneficiaries' Representative who need not be a Beneficiary (if none are willing or able to serve), but shall in no event be an officer or director elected or appointed after a Change in Control who was not a Beneficiary prior to such Change in Control. The designation or appointment of a successor Beneficiaries' Representative shall become effective only upon the execution of a counterpart of this Agreement whereby such successor Beneficiaries' Representative shall assume and become bound by all the duties and responsibilities of a Beneficiaries' Representative under this Agreement.

3.5 Right of Beneficiaries to Receive Payments. The rights of the Beneficiaries to make a Demand and receive distributions from the Trustee shall not be affected or diminished in any way by the existence of any dispute between one or more Beneficiaries and Grantor, and the Trustee in making distributions from the Trust Fund (as defined below) shall be entitled to rely upon the simple Demand of a Beneficiary, as conveyed by the Beneficiaries' Representative pursuant to Section 4.7. Such distributions shall be made notwithstanding any notice or demand by or on behalf of Grantor that the distributions should not be made, whether based on Grantor's claim that any Beneficiary is not entitled to some or all of the amount of such distributions or otherwise. The Trustee shall have no responsibility or liability to Grantor for making any payment despite having received any such notice or demand by or on behalf of Grantor. The Trustee shall have no responsibility to inquire into the accuracy or truthfulness of any such notice or demand, whether from the Grantor or the Beneficiaries' Representative.

ARTICLE 4
THE TRUST FUND

4.1 Trust Fund; Grantor Trust. The Trustee shall hold all property received by it as custodian in Trust hereunder as one fund which, together with the income and gains therefrom and additions thereto, shall constitute the "**Trust Fund**." The Trust is intended to be a grantor trust within the meaning of Section 761 of the Internal Revenue Code of 1986, as amended, and shall be construed accordingly. The Trust Fund shall not be paid to the Grantor or any trustee in bankruptcy of the Grantor, shall be held separate and apart from other funds of the Grantor, and shall be used exclusively for the purposes set forth herein.

4.2 Minimum Balance. Grantor shall deliver to the Trustee the amount stated in **Exhibit A** of this Trust Agreement (the "**Minimum Balance**"), to be held in trust, for the stated uses and purposes in accordance with the terms of this Agreement. Nothing contained herein shall preclude Grantor from making additional transfers of funds from time to time to the Trustee, whether required under the terms of this Agreement or not, to be held in trust as part of the Trust Fund. If Grantor makes additional transfers of funds to the Trust Fund, such additional transfers shall be deemed an increase of the Minimum Balance and **Exhibit A** shall be automatically amended without further action by the parties hereto. The Grantor and the Beneficiaries' Representative shall periodically, but no less than every third anniversary of this Agreement, review the adequacy of the Minimum Balance.

4.3 Maintenance of Minimum Balance. The Trustee agrees to provide monthly reports to Grantor and the Beneficiaries' Representative showing the current fair market value of the Trust Fund. If any such report shows that the current fair market value of the Trust Fund is less than the Minimum Balance, then within ten (10) days after such report, Grantor agrees to deliver cash funds to the Trustee equal to the difference between the fair market value of the Trust Fund and the Minimum Balance so that the Trust balance is at least equal to the Minimum Balance. Notwithstanding the foregoing, Grantor shall have no obligation to make payments to the Trustee in excess of $100,000,000 (including the initial transfer of funds) under or with respect to this Agreement.

4.4 Additional Contributions. Subject to the aggregate limitation of $100,000,000 set forth in Section 4.3, Grantor agrees to make additional contributions ("**Additional Contributions**") to the Trust Fund within ten (10) days after receipt of a written request from the Beneficiaries' Representative certifying in good faith that Claims have or are reasonably expected to be asserted against Beneficiaries and that estimated Losses and Expenses for all pending, threatened or anticipated Claims against all Beneficiaries are reasonably expected to exceed the then Trust Fund balance. A copy of such written certification shall be provided to the Trustee at the same time and in the same manner as it is provided to Grantor. Such written certification shall be accompanied by an opinion of independent counsel to the effect that, based on the information made known to such counsel, (a) the Claims are not Excluded Claims and (b) the amount requested is reasonable. Independent counsel shall be selected by the Beneficiaries' Representative and shall have no present or past professional relationship to the Beneficiaries who are the subject of the Claims.

4.5 Excess Balance. If at any time the fair market value of the Trust Fund shall exceed the Minimum Balance, plus any additional contributions which continue to be required pursuant to Section 4.4, Grantor shall be entitled to withdraw an amount equal to the excess over the said sum upon thirty (30) days' advance written notice to the Beneficiaries' Representative.

4.6 Direction of Investment. Notwithstanding anything contained in this Agreement to the contrary, Grantor retains the right to direct the investment of the Trust Fund and Trustee shall have no duty to review or recommend investments; *provided*, *however*, that the Grantor shall only direct the Trustee to invest the Trust Fund in Eligible Securities in accordance with Grantor's current cash-management policies. If the Grantor instructs the Trustee to invest in securities other than in Cash, Government Securities, Municipal Securities, Money Market Funds or Treasury Securities, such instruction shall be accompanied by the written consent of the Beneficiaries' Representative as to the investment(s) in such Other Eligible Securities. Unless otherwise instructed by Grantor in writing, the Trustee shall initially invest the Trust Fund in the investments set forth on **Exhibit B**. If for any reason one or more investments on **Exhibit B** shall not be available, and Grantor shall fail to direct the Trustee pursuant to written instructions as to how to invest the Trust Fund (including the consent of Beneficiaries' Representative if the proposed investment is in other than Eligible Securities), the Trustee shall invest the Trust Fund in Money Market Funds. In the event the Trustee is required to make a distribution pursuant to Section 4.7 at a time when the Trust Fund has insufficient cash to cover such distribution, the Trustee shall seek the advice of the Grantor with regard to which Trust investments to liquidate in order to cover the required distribution; if the Grantor does not respond to the Trustee's inquiry within forty-eight (48) hours the Trustee shall use its discretion in choosing which investments to liquidate.

4.7 Distributions From Trust Fund.

4.7.1 **Duties of Beneficiary**. The Beneficiary shall certify in each demand regarding a Claim for a Covered Act (a "**Demand**") delivered to the Beneficiaries' Representative that (i) he or she is entitled to payment of at least the amount demanded, (ii) that no part of the Demand is precluded by RCW 23B.08.560 (a)-(c) or other provision in the Act or applicable successor statute, (iii) that the Beneficiary will repay to the Trust any amounts paid or applied to or for the use of such Beneficiary in the event of a Ultimate Determination that such payments are precluded by RCW 23B.08.560 (a)-(c), or in the event the Beneficiary receives payment for the same Claim from another source, (iv) that a request to the Grantor for indemnification has remained unsatisfied for 20 days and that no part of the amount then being demanded from the Trust Fund has been previously received from the Grantor, and (v) that he or she has complied with any applicable requirements of Grantor's Articles and policy with respect to indemnification, if any, with respect to the Demand.

4.7.2 **Duties of Beneficiaries' Representative**. The Beneficiaries' Representative shall convey a Beneficiary's Demand to the Trustee. Along with the conveyance of such Demand to the Trustee, the Beneficiaries' Representative shall submit, in a writing signed by the Beneficiaries' Representative, a statement (i) that such Demand is being made pursuant to the Articles, as such may be amended and restated from time to time, provided that any such amendment shall be given effect under this Agreement only to the extent that such amendment provides broader indemnification rights than existed prior to such amendment, (ii) that the Demand is for satisfaction of indemnification obligations, (iii) that the Demand is being made by a Beneficiary, (iv) the amounts being demanded by such Beneficiary, and (v) that he or she is not aware of any facts or conditions that would make indemnification pursuant to this Agreement inappropriate, *provided*, *however*, that the Beneficiaries' Representative has no duty to independently investigate the validity of a Demand.

4.7.3 **Duties of Trustee**. The Trustee shall deliver a copy of each Demand to Grantor as promptly as reasonably possible. As soon as practicable after any such Demand is conveyed by the Beneficiaries' Representative, subject to the provisions of Section 3.5, the Trustee shall distribute funds to the Beneficiary specified in such Demand in the amount and manner set forth therein. If the Trustee does not have sufficient funds to satisfy all pending Demands of Beneficiaries in full, the Trustee shall make all reasonable efforts to make pro rata payments, less any amounts due the Trustee, to the Beneficiaries as specified by the Beneficiaries' Representative. Upon the replenishment of the Trust Fund, if that occurs in accordance with Section 4.3, the Trustee shall continue to make pro rata distributions, less any amounts due the Trustee, until such Demand is satisfied or to satisfy subsequent Demands.

4.8 Taxes. The Grantor agrees to pay any and all taxes on the Trust Fund or the income thereof or which the Beneficiaries or the Trustee would otherwise be required to pay with respect to the interest of any person or person therein, and to provide the Trustee with proof of payment. This does not include any taxes payable upon an indemnification payment distribution from the Trust if the same would be taxable to the recipient beneficiary under applicable law.

4.9 Duties and Responsibilities of Beneficiaries' Representative. The Beneficiaries' Representative (and any successor Beneficiaries' Representative) shall have the following affirmative duties and responsibilities:

4.9.1 To demand deposits from the Grantor so as to maintain the Minimum Balance of the Trust in accordance with Section 3.3 and any Additional Contributions required by section 3.4;

4.9.2 To demand payment by the Trustee to a Beneficiary who has made a Demand and who, in the good faith judgment of the Beneficiaries' Representative, has satisfied the conditions for indemnification as set forth in this Agreement and the Articles, *provided*, *however*, that the Beneficiaries' Representative has no duty to independently investigate the validity of a Demand; and

4.9.3 To generally cause the Grantor and Trustee to discharge their respective responsibilities under this Agreement and the responsibilities of the Grantor under the Articles, including the bringing of legal actions and proceedings to enforce such agreement.

4.10 Investment Powers of the Trustee. Subject to the Grantor's rights pursuant to Section 4.6 to direct investment of the Trust Fund, the Trustee shall have those powers provided under Washington law with respect to any property at any time held by it and constituting part of the Trust Fund.

4.11 Administrative Powers of Trustee. Subject to the Grantor's right pursuant to Section 4.6 to direct investment of the Trust Fund in Eligible Securities, the Trustee shall have the power, to do any of the following:

4.11.1 To cause any investment to be registered and held in the name of one or more of its nominees, or one or more nominees of any system for the central handling of securities, without increase or decrease of liability;

4.11.2 To collect and receive any and all money and other property due to the Trust Fund and to give full discharge therefor;

4.11.3 To make investments and investment decisions in its discretion when the Grantor does not respond to a Trustee inquiry for directions within two (2) business days after the request; and

4.11.4 To hold uninvested, without liability for interest thereon, such monies received by the Trustee as the Trustee considers necessary to meet anticipated and imminent disbursements.

4.12 Adverse Determination. In the event the trust arrangement created hereby is deemed to be invalid or ineffective by a court of competent jurisdiction, whether in connection with the bankruptcy of one of the parties hereto or otherwise (an "**Adverse Determination**"), then the parties agree that the nature of their relationship shall be Grantor as debtor, Trustee as securities intermediary and Beneficiaries' Representative as secured party for the benefit of the Beneficiaries. To that end, and to secure the obligation of Grantor to indemnify Beneficiaries, Grantor hereby grants the Beneficiaries' Representative for the benefit of the Beneficiaries a continuing security interest in, and pledges all right title and interest in and to, the following (for purposes of this Section 4.12, the "**Collateral**"):

4.12.1 The Trust account and the Trust Fund, and any certificates or instruments representing or evidencing the Trust Fund, and all cash, investment property, interest, dividends, rights and other property at any time and from time to time received, receivable or otherwise issued, distributed or distributable in respect of or in exchange for any or all of the Trust Fund;

4.12.2 All other investment property and other property hereafter issued, delivered or deliverable to Trustee in substitution for or in addition to any of the foregoing, all certificates and instruments representing or evidencing such other property and all cash, investment property, interest, dividends, rights and other property at any time and from time to time received, receivable or otherwise issued, distributed or distributable after the date hereof in respect of or in exchange for any or all thereof; and

4.12.3 All proceeds of all of the foregoing.

Grantor and, at the direction of Beneficiaries' Representative, Trustee shall execute such other documents and instruments as Beneficiaries' Representative may reasonably require from time to time to perfect and protect its first priority security interest in the Collateral. In the event of an Adverse Determination, Beneficiaries' Representative shall have and shall be deemed to have had all the rights and remedies of a secured party under Article 9 of the Uniform Commercial Code ("**UCC**") and may exercise any of the rights and remedies available to it under the UCC as in effect from time to time in the State of Washington or otherwise available to it, including, without limitation, sale, assignment or other disposal of the Collateral in exchange for cash or credit. Grantor agrees that a Demand is also a notice of disposition under Section 9-611 of the UCC and that five Business Days is reasonable notice if notice of a disposition is required under Section 9-611. Furthermore, Grantor agrees that any Beneficiary may be the purchaser of the Collateral consisting of Cash, Corporate Securities, Government Securities or Municipal Securities at a private sale without notice because the Collateral is of a type sold on a recognized market or the subject of widely distributed standard price quotations. Beneficiaries' Representative shall provide Trustee with an Adverse Determination Notice as soon as practicable, although failure to provide such notice shall not affect the rights or obligations of the parties hereunder, except that Beneficiary shall not take any action with respect to Trustee as securities intermediary until such notice is provided. Except for the amounts due to Trustee pursuant to Section 7.3, Trustee waives any right of set-off, banker's lien or other lien or claim it may have to the Collateral.

Grantor covenants and agrees that it shall not pledge, assign, hypothecate or transfer its interest in the Trust account or the Trust Fund. Grantor further covenants and agrees that it shall not so direct Trustee, and Trustee agrees that it will not acknowledge or agree to any such pledge, assignment, hypothecation or transfer.

ARTICLE 5
RESIGNATION, REMOVAL, OR DEATH OF TRUSTEE

5.1 Resignation of Trustee. The Trustee may resign at any time by filing its written resignation with Grantor and Beneficiaries' Representative. Such resignation shall take effect sixty (60) days from the date of such filing or upon appointment of a successor pursuant to Section 5.3, whichever shall first occur.

5.2 Removal of Trustee. Grantor and the Beneficiaries' Representative may remove the Trustee at any time by delivering to the Trustee a written notice of its removal and the appointment of a successor pursuant to Section 5.3.

5.3 Appointment of Successor Trustee.

5.3.1 Removal of the Trustee and the appointment of a successor Trustee shall take effect sixty (60) days following delivery to the Trustee of (i) an instrument in writing removing the Trustee and appointing such successor, executed by Grantor and accompanied by an instrument in writing signed by the Beneficiaries' Representative certifying that a majority of the then living Beneficiaries agree to such removal and appointment, and (ii) an acceptance in writing, executed by such successor, both acknowledged in the same form as this Agreement. The Trustee may agree to an earlier effective date. In the event of the death or dissolution of the Trustee, the successor trustee shall be appointed by the Grantor with the approval of the Beneficiaries' Representative, which approval shall not be unreasonably withheld, and a writing to such effect and an acceptance in writing, as referred to above, shall be delivered to the Trustee. In order to qualify to serve as Trustee, any successor trustee must, at a minimum: (i) be authorized under state or federal law to exercise corporate trust powers, (ii) have a combined capital and surplus of at least $100 million, and (iii) be subject to supervision or examination by federal or state authority.

5.3.2 All of the provisions set forth herein with respect to the Trustee shall relate to each successor with the same force and effect as if such successor had been originally named as Trustee under this Trust.

5.3.3 If a successor is not appointed within sixty (60) days after the Trustee gives notice of its resignation pursuant to Section 4.1, or within sixty (60) days after the Trustee's death or dissolution, the Trustee or the Beneficiaries' Representative may apply to any court of competent jurisdiction at the expense of the Trust for appointment of a successor.

5.4 Transfer of Fund to Successor. Upon appointment of a successor trustee as set forth above, the Trustee shall transfer and deliver the Trust Fund to such successor with authority to retain only reasonable reserves pending settlement of its final account as provided in Section 7.4.

ARTICLE 6
DURATION, TERMINATION, AND AMENDMENT OF TRUST

6.1 Term.

6.1.1 The term of this Trust shall be for a period of ten (10) years until June 30, 2013, unless extended or terminated according to the terms of this Trust. This Trust may be terminated by consent of a majority of the Grantor's Board of Directors and a majority of the then living Beneficiaries; *provided*, *however*, no such termination shall be effective (i) following a Change of Control, or (ii) so as to reduce indemnification otherwise available to a Beneficiary of this Trust for any Demand then existing and still pending or with respect to any later asserted Demand arising out of a Covered Act occurring before the effective date of such termination. Expiration or termination of this Trust shall operate prospectively only, so that all provisions of this Agreement shall remain in full force and effect as to any Demand asserted prior to the effective date of expiration or termination relating to a Covered Act that occurs prior to the effective date of expiration or termination. The Grantor and the Beneficiaries' Representative shall notify the Trustee of termination of the Trust by, with respect to the Grantor, an instrument in writing executed by the Grantor together with a certified copy of the resolution of the Grantor's Board of Directors authorizing such termination and, with respect to the Beneficiaries' Representative, written evidence of the consent of a majority of the then living Beneficiaries. Termination by consent of the Grantor and majority of the then living Beneficiaries shall be effective on the later to occur of (i) the Grantor's board resolution and (ii) receipt by Beneficiaries' Representative of written consents from at least a majority of the then living Beneficiaries.

6.1.2 The Grantor and the Beneficiaries' Representative (jointly or separately) as applicable shall provide the Trustee and the Beneficiaries and their successors in interest with written notice of expiration thirty (30) days prior to the expiration date.

6.1.3 In the event of a proposed termination prior to the expiration of the term of this Trust, Beneficiaries may assert a Demand if, in such Beneficiaries' good faith judgment, there is a reasonable likelihood that following such proposed termination, a Claim will be asserted arising out of a Covered Act that occurred before the effective date of such termination. If so made, such Demand(s) shall be treated as a then existing and still pending Demand hereunder.

6.2 Distribution Upon Termination. When this Trust expires or is terminated in accordance with Section 6.1, the Trustee shall distribute the Trust Fund to Grantor less any full and adequate provision or reserves for any distributions to be made pursuant to any outstanding demands under Section 4.7 and 6.1.2 and any deductions authorized or required by Section 7.3.

6.3 Amendment of Trust Instrument.

6.3.1 Except in the event of a change of control, this Trust may be amended by consent of a majority of the Grantor's Board of Directors, a majority of the then living Beneficiaries and the Trustee, *provided*, *however*, no such amendment shall be effective (i) following a Change of Control, or (ii) so as to reduce indemnification otherwise available to a Beneficiary of this Trust for any Claim then existing and still pending or with respect to any later asserted Claim arising out of a Covered Act occurring before the effective date of such amendment and *provided further,* that approval of the Trustee shall only be required if the proposed amendment affects in any way the Trustee's rights or duties under this Agreement. If the Trust is amended without the consent of the Trustee as provided above, the Grantor shall deliver notice of amendment to the Trustee or its successor in interest thirty (30) days prior to the proposed effective date of the amendment by an instrument in writing executed by the Grantor and the Beneficiaries' Representative, together with a certified copy of the resolution of the Grantor's Board of Directors authorizing such amendment. The Grantor shall send a copy of such notice to each individual Beneficiary or his or her successors in interest.

6.3.2 In the event of a proposed amendment of this Trust, Beneficiaries may assert a Demand if, in such Beneficiaries' good faith judgment, there is a reasonable likelihood that following such proposed amendment, a Claim will be asserted arising out of a Covered Act that occurred before the effective date of such amendment and which will be affected by such amendment. If so made, such Demand(s) shall be treated as a then existing and still pending Demand hereunder.

ARTICLE 7
RIGHTS AND OBLIGATIONS OF THE TRUSTEE

7.1 Duties of Trustee. The duties and liabilities of the Trustee shall at all times be limited to those expressly stated in this Agreement. The Trustee shall discharge its duties hereunder with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. The Trustee shall not be liable for any loss sustained by the Trust Fund by reason of the purchase, retention, sale, or exchange or any investment made in good faith and in accordance with the Grantor's written directions and the provisions of this Agreement.

7.2 Indemnification of Trustee. The Trustee shall not be liable for any action taken or omitted by it in good faith and believed by it to be authorized hereby or within the rights or powers conferred upon it hereunder, or taken or omitted by it in accordance with advice of counsel (which counsel may be of the Trustee's own choosing and which may be house counsel of the Trustee), and shall not be liable for any mistake of fact or error of judgment or for any acts or omissions of any kind unless caused by willful misconduct or gross negligence. Grantor agrees to indemnify the Trustee and hold it harmless against any and all liabilities, losses, claims, expenses (including reasonable attorneys' fees), and damages incurred by it hereunder, except for liabilities, losses, claims, expenses, and damages incurred by the Trustee resulting from its own willful misconduct or gross negligence.

7.3 Expenses and Compensation. The Trustee shall pay from the Trust Fund, to the extent not paid by Grantor, the Trustee's reasonable expenses of administration of the Trust, including reasonable compensation of counsel (including house counsel) and any agents engaged by the Trustee to assist it in such administration. The Grantor shall pay the Trustee reasonable compensation for its services as Trustee hereunder and the Trustee shall have a lien on the Trust Fund for such compensation and expenses until paid.

7.4 Accounts of Trustees. The Trustee shall keep full accounts of all of its receipts and disbursements. Its financial statements, books, and records with respect to the Trust Fund shall be open to inspection by the Grantor or the Beneficiaries' Representative or their representatives at all reasonable times during business hours of the Trustee and may be audited not more frequently than once in each fiscal year by an independent certified public accountant engaged by the Beneficiaries' Representative. Within ninety (90) days after the close of each fiscal year, or any termination of the duties of the Trustee, the Trustee shall prepare, sign, and submit in duplicate to Grantor an account of its acts and transactions as Trustee hereunder.

ARTICLE 8
MISCELLANEOUS

8.1 Governing Law. The validity, interpretation, performance, and enforcement of this Agreement and the Trust created hereby shall be governed by the laws of the state of Washington. The parties irrevocably submit to the jurisdiction and venue of any Washington State or United States Federal Court sitting in Seattle, Washington. Any proceeding with respect to this Trust shall be in King County Superior Court unless otherwise consented to by Grantor.

8.2 Successors. This Agreement and the Trust created hereby shall be binding upon and shall inure to the benefit of the spouses, heirs, personal and legal representatives, estates, successors, and assigns of the parties hereto and of the Beneficiaries.

8.3 Third Party Beneficiaries. The Beneficiaries are specifically acknowledged as third party beneficiaries of this Agreement and shall have the right to bring actions to enforce this Agreement where the Beneficiaries' Representative fails to bring such an action or fails to prosecute an action in good faith.

8.4 Enforcement Expenses. Grantor shall be responsible for all costs and expenses, including reasonable attorneys' fees and costs, incurred in any action brought to enforce or interpret this Agreement, whether brought by the Beneficiaries' Representative, a Beneficiary, the Trustee, or otherwise, unless the court determines that such Claim for enforcement was not brought in good faith or was frivolous.

8.5 Titles and Headings Not to Control. The titles to articles and headings of sections in this Agreement are for convenience of reference only and in case of any conflict the text of this Agreement, rather than any title or heading, shall control.

8.6 Notices, Consents and Other Communications. All notices, consents, or other communications required or contemplated by this Agreement shall be in writing and shall be deemed to have been given when delivered either by (a) personal delivery, (b) prepaid overnight courier, (c) postage prepaid return receipt requested certified mail or (d) facsimile pursuant to and subject to the terms of section 8.8. The other nit is the lack of a space in the clean version in section 4.6 between" in" and" Money Market Funds:

If to a Beneficiary: The last address given to the Trustee by each respective Beneficiary

If to Beneficiaries' Representative: The last address given to the Trustee by the Beneficiaries' Representative

If to Microsoft:
Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399
Attention: Deputy General Counsel,
Finance and Operations
Telephone No.: (425) 882-8080
Facsimile No.: (425) 869-1327

With a copy to:
Preston Gates & Ellis LLP
925 Fourth Avenue, Suite 2900
Seattle, WA 98104-1158
Attention: Kent Carlson
Telephone No.: (206) 623-7580
Facsimile No.: (206) 623-7022

If to Trustee:
BNY Western Trust Company
Two Union Square, Suite 1720
601 Union Street
Seattle, WA 98101-2321
Attention: Corporate Trust Services
Telephone No.: (206) 667-8904
Facsimile No.: (206) 667-8905

Notice by personal delivery shall be effective upon the date delivery is made and notice by certified mail or overnight courier shall be effective on the date it is recorded as delivered by the U.S. Postal Service or the overnight courier, respectively.

8.7 Force Majeure. From the effective date of this Agreement, the Trustee, or any successor in interest, shall not be considered in breach of or in default in its obligations with respect to any obligations created hereunder in the event of an unavoidable delay in the performance of such obligations due to unforeseeable causes beyond its control and without its fault or negligence, including, but not limited to, acts of God, or of the public enemy, acts of a government, acts of the other party, fires, floods, epidemics, quarantine restrictions, strikes, freight embargoes, earthquakes, explosion, mob violence, riot, inability to procure or general sabotage or rationing of labor, equipment, facilities, sources of energy, material or supplies in the open market, malicious mischief, condemnation, and unusually severe weather or delays of suppliers or subcontractors due to such causes or any similar event and/or occurrences beyond the control of the Trustee.

8.8 Facsimile Instruction. The Trustee agrees to accept and act upon facsimile transmission of written instructions and/or directions pursuant to this Agreement, *provided, however,* that: (a) the Grantor and/or Beneficiaries' Representative as applicable, subsequent to such facsimile transmission of written instructions, shall provide the originally executed instructions and/or directions to the Trustee in a timely manner, (b) such originally executed instructions and/or directions shall be signed by a person as may be designated and authorized to sign for the Grantor and/or Beneficiaries' Representative and, (c) the Grantor and/or Beneficiaries' Representative shall provide to the Trustee an incumbency certificate listing such designated persons which such incumbency certificate shall be amended whenever a person is to be added or deleted from the listing.

[*remainder of page intentionally left blank*]

IN WITNESS WHEREOF, the parties hereto have executed this agreement as of the day and year first above written.

Attest:

By: /s/ C. KENT CARLSON

C. Kent Carlson

BNY WESTERN TRUST COMPANY
("Trustee")

By: /s/ PERRY TOBE

Perry Tobe
Assistant Vice President

Attest:

By: /s/ JOHN A. SEETHOFF

John A. Seethoff
Assistant Secretary

MICROSOFT CORPORATION
("Grantor")

By: /s/ STEVEN A. BALLMER

Steven A. Ballmer
Chief Executive Officer

Attest:

By: /s/ JOHN A. SEETHOFF

John A. Seethoff

ADDITIONAL PARTY
("Beneficiaries' Representative")

By: /s/ WILLIAM G. REED, JR.

William G. Reed, Jr.

SUBSIDIARIES OF THE COMPANY

The following is a list of subsidiaries of the Company as of June 30, 2003, omitting some subsidiaries which, considered in the aggregate, would not constitute a significant subsidiary.

NAME	WHERE INCORPORATED
Microsoft Asia, Ltd.	Nevada, USA
Microsoft Business Solutions ApS	Denmark
Microsoft Capital Group, L.P.	Nevada, USA
Microsoft E-Holdings, Inc.	Nevada, USA
Microsoft Finance Company Limited	Ireland
Microsoft Ireland Capital Limited	Ireland
Microsoft Ireland Operations Limited	Ireland
Microsoft Licensing, Inc.	Nevada, USA
Microsoft Manufacturing B.V.	Netherlands
Microsoft T-Holdings, Inc.	Nevada, USA
MSLI, GP	Nevada, USA
Round Island, LLC	Nevada, USA
Round Island One Limited	Ireland

INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statement Numbers 33-51583 and 333-06298 (Microsoft Corporation 1991 Stock Option Plan), 333-16665 (Microsoft Corporation 1997 Employee Stock Purchase Plan), 333-75243 (Microsoft Corporation Savings Plus 401(k) Plan), 333-91755 (Microsoft Corporation 1999 Stock Option Plan for Non-Employee Directors), 333-52852 (Microsoft Corporation 2001 Stock Plan), 333-102240 (Microsoft Corp 2003 Employee Stock Purchase Plan) of Microsoft Corporation on Forms S-8 and 333-43449 of Microsoft Corporation on Form S-3 of our report dated July 17, 2003 (September 3, 2003, as to certain information in Note 20) (which report expresses an unqualified opinion and includes an explanatory paragraph relating to the adoption of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*) appearing in this Annual Report on Form 10-K of Microsoft Corporation for the year ended June 30, 2003.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP
Seattle, Washington
September 3, 2003

Exhibit 31.1

CERTIFICATIONS

I, Steven A. Ballmer, certify that:

1. I have reviewed this annual report on Form 10-K 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)) 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) 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

c) 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.

Date: September 4, 2003

/s/ Steven A. Ballmer

Steven A. Ballmer
Chief Executive Officer

Exhibit 31.2

CERTIFICATIONS

I, John G. Connors, certify that:

1. I have reviewed this annual report on Form 10-K 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)) 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) 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

c) 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.

Date: September 4, 2003

/s/ John G. Connors

John G. Connors
Chief Financial Officer

Exhibit 32

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

In connection with the Annual Report of Microsoft Corporation, a Washington corporation (the "Company"), on Form 10-K for the year ending June 30, 2003, as filed with the Securities and Exchange Commission (the "Report"), Steven A. Ballmer, Chief Executive Officer of the Company and John G. Connors, Chief Financial Officer of the Company, respectively, do each 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

September 4, 2003

/s/ JOHN G. CONNORS

John G. Connors
Chief Financial Officer

September 4, 2003

[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.]