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

FORM 10-Q

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

For the Quarterly Period Ended December 31, 2007

OR

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

For the Transition Period From to

Commission File Number: 0-14278

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

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

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

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

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

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

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

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

Class	Outstanding at January 21, 2008
Common Stock, $0.00000625 par value per share	9,306,979,746 shares

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2007

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

INCOME STATEMENTS

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Revenue	**$16,367**	$12,542	**$30,129**	$23,353
Operating expenses:				
Cost of revenue	**3,543**	3,620	**6,218**	5,316
Research and development	**1,885**	1,637	**3,722**	3,423
Sales and marketing	**3,392**	2,999	**6,006**	5,190
General and administrative	**1,066**	814	**1,784**	1,478
Total operating expenses	**9,886**	9,070	**17,730**	15,407
Operating income	**6,481**	3,472	**12,399**	7,946
Investment income and other	**339**	333	**637**	900
Income before income taxes	**6,820**	3,805	**13,036**	8,846
Provision for income taxes	**2,113**	1,179	**4,040**	2,742
Net income	**$ 4,707**	$ 2,626	**$ 8,996**	$ 6,104
Earnings per share:				
Basic	**$ 0.50**	$ 0.27	**$ 0.96**	$ 0.62
Diluted	**$ 0.50**	$ 0.26	**$ 0.95**	$ 0.61
Weighted average shares outstanding:				
Basic	**9,361**	9,806	**9,370**	9,867
Diluted	**9,503**	9,942	**9,519**	9,996
Cash dividends declared per common share	**$ 0.11**	$ 0.10	**$ 0.22**	$ 0.20

See accompanying notes.

MICROSOFT CORPORATION

BALANCE SHEETS
(In millions)

	December 31, 2007 (Unaudited)	June 30, 2007(1)
Assets		
Current assets:		
Cash and cash equivalents	**$ 7,460**	$ 6,111
Short-term investments (including securities pledged as collateral of $1,984 and $2,356)	**13,616**	17,300
Total cash, cash equivalents, and short-term investments	**21,076**	23,411
Accounts receivable, net of allowance for doubtful accounts of $149 and $117	**11,621**	11,338
Inventories, net	**755**	1,127
Deferred income taxes	**1,483**	1,899
Other	**2,840**	2,393
Total current assets	**37,775**	40,168
Property and equipment, net	**4,965**	4,350
Equity and other investments	**9,413**	10,117
Goodwill	**10,309**	4,760
Intangible assets, net	**1,717**	878
Deferred income taxes	**1,200**	1,389
Other long-term assets	**1,960**	1,509
Total assets	**$ 67,339**	$ 63,171
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	**$ 3,612**	$ 3,247
Accrued compensation	**1,977**	2,325
Income taxes	**863**	1,040
Short-term unearned revenue	**10,221**	10,779
Securities lending payable	**2,166**	2,741
Other	**3,219**	3,622
Total current liabilities	**22,058**	23,754
Long-term unearned revenue	**1,957**	1,867
Other long-term liabilities	**8,893**	6,453
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 9,329 and 9,380	**62,528**	60,557
Retained deficit, including accumulated other comprehensive income of $1,628 and $1,654	**(28,097)**	(29,460)
Total stockholders' equity	**34,431**	31,097
Total liabilities and stockholders' equity	**$ 67,339**	$ 63,171

(1) Derived from audited financial statements.

See accompanying notes.

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MICROSOFT CORPORATION

CASH FLOWS STATEMENTS

(In millions)(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Operations				
Net income	**$ 4,707**	$ 2,626	**$ 8,996**	$ 6,104
Depreciation, amortization, and other noncash items	**481**	365	**916**	614
Stock-based compensation expense	**360**	437	**693**	893
Net recognized gains on investments	**(134)**	(29)	**(321)**	(235)
Excess tax benefits from stock-based payment arrangements	**(33)**	(8)	**(102)**	(48)
Deferred income taxes	**323**	(517)	**680**	(351)
Unearned revenue	**5,995**	6,029	**9,816**	9,246
Recognition of unearned revenue	**(5,368)**	(4,265)	**(10,333)**	(8,315)
Accounts receivable	**(2,586)**	(2,945)	**220**	(444)
Other current assets	**445**	723	**210**	(357)
Other long-term assets	**(55)**	(264)	**(66)**	(399)
Other current liabilities	**325**	(354)	**(864)**	(1,196)
Other long-term liabilities	**107**	244	**600**	591
Net cash from operations	**4,567**	2,042	**10,445**	6,103
Financing				
Common stock issued	**2,335**	4,449	**2,981**	4,834
Common stock repurchased	**(4,057)**	(5,797)	**(6,987)**	(13,480)
Common stock cash dividends	**(1,034)**	(980)	**(1,972)**	(1,877)
Excess tax benefits from stock-based payment arrangements	**33**	8	**102**	48
Other	**—**	(3)	**—**	(23)
Net cash used in financing	**(2,723)**	(2,323)	**(5,876)**	(10,498)
Investing				
Additions to property and equipment	**(695)**	(572)	**(1,205)**	(983)
Acquisition of companies, net of cash acquired	**(433)**	(125)	**(5,829)**	(461)
Purchases of investments	**(6,317)**	(9,102)	**(12,314)**	(21,957)
Maturities of investments	**470**	1,325	**800**	2,159
Sales of investments	**6,696**	7,448	**15,816**	26,149
Securities lending payable	**(770)**	(932)	**(574)**	(404)
Net cash from/(used in) investing	**(1,049)**	(1,958)	**(3,306)**	4,503
Effect of exchange rates on cash and cash equivalents	**28**	22	**86**	37
Net change in cash and cash equivalents	**823**	(2,217)	**1,349**	145
Cash and cash equivalents, beginning of period	**6,637**	9,076	**6,111**	6,714
Cash and cash equivalents, end of period	**$ 7,460**	$ 6,859	**$ 7,460**	$ 6,859

See accompanying notes.

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MICROSOFT CORPORATION

STOCKHOLDERS' EQUITY STATEMENTS
(In millions)(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Common stock and paid-in capital				
Balance, beginning of period	**$ 60,699**	$ 57,657	**$ 60,557**	$ 59,005
Common stock issued	**2,380**	4,436	**3,035**	4,834
Common stock repurchased	**(805)**	(1,232)	**(1,621)**	(3,106)
Stock-based compensation expense	**360**	437	**693**	893
Stock option income tax deficiencies	**(106)**	(147)	**(193)**	(481)
Other, net	**—**	1	**57**	7
Balance, end of period	**62,528**	61,152	**62,528**	61,152
Retained deficit				
Balance, beginning of period	**(28,564)**	(21,556)	**(29,460)**	(18,901)
Cumulative effect of a change in accounting principle – adoption of FIN 48 (1)	**—**	—	**(395)**	—
Cumulative effect of a change in accounting principle – adoption of EITF 06-2 (1)	**—**	—	**(17)**	—
Net income	**4,707**	2,626	**8,996**	6,104
Other comprehensive income:				
Net gains/(losses) on derivative instruments	**137**	(1)	**49**	(28)
Net unrealized investments gains/(losses)	**(78)**	184	**(164)**	337
Translation adjustments and other	**39**	35	**89**	44
Comprehensive income	**4,805**	2,844	**8,970**	6,457
Common stock cash dividends	**(1,031)**	(974)	**(2,060)**	(1,949)
Common stock repurchased	**(3,307)**	(4,832)	**(5,135)**	(10,125)
Balance, end of period	**(28,097)**	(24,518)	**(28,097)**	(24,518)
Total stockholders' equity	**$ 34,431**	$ 36,634	**$ 34,431**	$ 36,634

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

See accompanying notes.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS
(Unaudited)

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

Basis of Presentation

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

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

Basis of Consolidation

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

Recent Accounting Pronouncements

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

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

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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

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

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

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for us beginning July 1, 2008. In December 2007, the FASB released a proposed FASB Staff Position (FSP FAS 157-b – *Effective Date of FASB Statement No. 157*) which, if adopted as proposed, would delay the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We are currently assessing the potential impact that adoption of this statement would have on our financial statements.

Note 2 – Inventories

Components of inventories were as follows:

(In millions)	December 31, 2007	June 30, 2007
Raw materials	**$ 241**	$ 435
Work in process	**77**	148
Finished goods	**437**	544
Inventories	**$ 755**	$ 1,127

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Note 3 – Earnings Per Share

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

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

(In millions, except earnings per share)	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006	Six Months Ended December 31, 2007	Six Months Ended December 31, 2006
Net income available for common shareholders (A)	**$ 4,707**	$ 2,626	**$8,996**	$6,104
Weighted average outstanding shares of common stock (B)	**9,361**	9,806	**9,370**	9,867
Dilutive effect of employee stock options and awards	**142**	136	**149**	129
Common stock and common stock equivalents (C)	**9,503**	9,942	**9,519**	9,996
Earnings per share:				
Basic (A/B)	**$ 0.50**	$ 0.27	**$ 0.96**	$ 0.62
Diluted (A/C)	**$ 0.50**	$ 0.26	**$ 0.95**	$ 0.61

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

(In millions)	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006	Six Months Ended December 31, 2007	Six Months Ended December 31, 2006
Shares excluded from calculation of diluted EPS	**71**	240	**77**	266
Shared performance stock awards excluded from calculation of diluted EPS	**—**	10	**—**	10

Note 4 – Unearned Revenue

The components of unearned revenue were as follows:

(In millions)	December 31, 2007	June 30, 2007
Volume licensing programs	**$ 9,145**	$ 9,334
Undelivered elements	**1,650**	1,839
Other	**1,383**	1,473
Unearned revenue	**$ 12,178**	$ 12,646

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Unearned revenue by segment was as follows:

(In millions)	December 31, 2007	June 30, 2007
Client	**$ 2,620**	$ 2,875
Server and Tools	**3,746**	3,652
Microsoft Business Division	**5,359**	5,771
Other	**453**	348
Unearned revenue	**$ 12,178**	$ 12,646

Note 5 – Stockholders' Equity

Share Repurchases

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately $16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. As of December 31, 2007, approximately $8.7 billion remained of the $36.2 billion approved repurchase amount. All repurchases were made using cash resources. The repurchase program may be suspended or discontinued at any time without notice.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
(In millions)	2007	2006	2007	2006
Shares of common stock repurchased	**120**	205	**200**	491
Value of common stock repurchased	**$ 4,081**	$ 6,037	**$6,429**	$12,989

Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
(Fiscal year 2008)				
September 12, 2007	$ 0.11	November 15, 2007	$ 1,034	December 13, 2007
December 19, 2007	$ 0.11	February 21, 2008	$ 1,026(1)	March 13, 2008
(Fiscal year 2007)				
September 13, 2006	$ 0.10	November 16, 2006	$ 979	December 14, 2006
December 20, 2006	$ 0.10	February 15, 2007	$ 977	March 8, 2007

(1) This dividend was included in other current liabilities on our balance sheet as of December 31, 2007.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Note 6 – Investment Income and Other

Components of investment income and other were as follows:

(In millions)	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006	Six Months Ended December 31, 2007	Six Months Ended December 31, 2006
Dividends and interest	**$ 206**	$ 316	**$ 445**	$ 685
Net recognized gains on investments	**87**	103	**238**	466
Net gains/(losses) on derivatives	**48**	(75)	**84**	(231)
Other	**(2)**	(11)	**(130)**	(20)
Investment income and other	**$ 339**	$ 333	**$ 637**	$ 900

Note 7 – Product Warranties

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

The changes in our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities on our balance sheets, were as follows:

(In millions)	Amount
Balance at July 1, 2007	$ 850
Accruals for warranties issued	82
Adjustments to pre-existing warranties	11
Settlements of warranty claims	(86)
Balance at September 30, 2007	$ 857
Accruals for warranties issued	**188**
Adjustments to pre-existing warranties	**5**
Settlements of warranty claims	**(189)**
Balance at December 31, 2007	**$ 861**

Note 8 – Contingencies

Government competition law matters. In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were “not reasonable.” Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should be imposed as from that date. The maximum amount of the potential fine for violation of the March 2004 decision as of October 22, 2007 was €1.5 billion. On January 14, 2008, the European Commission announced that it was

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

opening two new competition law investigations. These investigations appear to relate primarily to interoperability with respect to our Microsoft Office family of products and the inclusion of various capabilities in our Windows operating system software, including Web browsing software. These investigations were precipitated by complaints filed with the Commission by a trade association of Microsoft's competitors and a firm that offers Web browsing software.

We are subject to a Consent Decree and Final Judgment that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Consent Decree imposed various constraints on our Windows operating system businesses. Portions of the Consent Decree are scheduled to expire on January 31, 2008 and we voluntarily agreed to extend expiration of other elements of the Consent Decree to November 2009. In October 2007, some states filed a motion with the U.S. District Court for the District of Columbia seeking to have most of the provisions of the Final Judgment in the action to which they are party extended for five years. This motion is pending. The U.S. Department of Justice and other states advised the Court that they will not seek any extension of the Final Judgments to which they are party.

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

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

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

The settlements in all states have received final court approval. Cases in Arizona, Mississippi and Canada have not been settled. We estimate the total cost to resolve all of these cases will range between $1.7 billion and $1.9 billion. The actual cost depends on factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims. At December 31, 2007, we have recorded a liability related to these claims of approximately $1.0 billion, which reflects our estimated exposure of $1.7 billion less payments made to date of approximately $665 million, mostly for administrative expenses, vouchers, and legal fees.

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

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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

- In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents. Alcatel-Lucent has asserted claims under these patents against computer manufacturers that sell computers with our operating system and application software pre-installed. In February 2007, the jury returned a verdict in Alcatel-Lucent's favor in the first of a series of patent trials, and awarded $1.5 billion in damages. In September 2007, on our motions for judgment as a matter of law, the trial court overturned the jury verdict and entered orders dismissing plaintiff's claims on multiple grounds. Alcatel-Lucent has appealed. The trial court previously dismissed Alcatel-Lucent's claims with respect to a second group of patents and two patents in a third grouping. Trial on a consolidated group of all remaining patents is scheduled to begin in February 2008.
- In March 2006, Alcatel-Lucent filed a lawsuit against us in U.S. District Court in California, claiming the Xbox 360 violates one of its patents. In response, we asserted counterclaims that Alcatel-Lucent infringes 10 Microsoft patents by its sales of various products. The case has been set for trial in April 2008.
- In November 2006, Alcatel-Lucent filed two patent infringement cases against us in U.S. District Court in Texas, asserting Mediaroom and various networking functionalities violate seven of its patents. In April 2007, we asserted infringement counterclaims based on four of our patents relating to functionality similar to that accused by Alcatel-Lucent. The trial on all of the patents is set for January 2009.
- In February 2007, we filed a complaint against Alcatel-Lucent with the International Trade Commission claiming Alcatel-Lucent is infringing four Microsoft patents related to our unified communications technology and seeking to prevent the import of certain Alcatel-Lucent unified communications products into the U.S. Trial of this matter began in October 2007.
- In April 2007, the Multimedia Patent Trust filed a complaint against Microsoft, Dell, and Gateway in San Diego, California accusing the parties of infringing three video-related patents that originally belonged to Alcatel-Lucent. Alcatel-Lucent created the Multimedia Patent Trust prior to the companies' merger and transferred the patents at issue to the trust.

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

In *Z4 Technologies, Inc. v. Microsoft*, filed in U.S. District Court in Texas in September 2004, the plaintiff alleged that Microsoft product activation functionality used in certain products (including versions of Windows and Office) infringe its patents. In April 2006, the jury rendered a $115 million verdict against us, and the trial court enhanced damages by $25 million due to a finding of willful infringement. The court declined to award a permanent injunction. We have been selling additional units of allegedly infringing products and thus incurring potential additional liability. The court of appeals affirmed the trial court's judgment, but we are seeking a rehearing by the court of appeals.

In *Veritas Operating Corporation v. Microsoft*, filed in U.S. District Court in Washington in May 2006, a subsidiary of Symantec filed an action asserting trade secret misappropriation, breach of contract, and patent infringement relating to certain storage technologies. The case is scheduled for trial in May 2008.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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

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

As of December 31, 2007, we had accrued aggregate liabilities of approximately $840 million in other current liabilities and approximately $660 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could be up to $4.1 billion in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial position and on the results of operations for the period in which the effects become reasonably estimable.

Note 9 – Segment Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. This standard requires segmentation based on our internal organization and reporting of revenue and operating income based upon internal accounting methods. Our financial reporting systems present various data for management to operate the business, including internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segments are designed to allocate resources internally and provide a framework to determine management responsibility. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our Chief Executive Officer. Our five segments are Client; Server and Tools; Online Services Business; Microsoft Business Division; and Entertainment and Devices Division. We have recast certain prior period amounts to conform to the way we internally manage and monitor performance at the segment level in fiscal year 2008.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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

(In millions)	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006	Six Months Ended December 31, 2007	Six Months Ended December 31, 2006
Revenue				
Client	**$ 4,238**	$ 2,669	**$ 8,283**	$ 5,975
Server and Tools	**3,284**	2,847	**6,186**	5,343
Online Services Business	**863**	625	**1,534**	1,161
Microsoft Business Division	**4,814**	3,512	**8,921**	6,944
Entertainment and Devices Division	**3,060**	2,968	**4,988**	3,978
Unallocated and other	**108**	(79)	**217**	(48)
Consolidated	**$16,367**	$12,542	**$30,129**	$23,353
Operating income/(loss)				
Client	**$ 3,243**	$ 1,929	**$ 6,488**	$ 4,599
Server and Tools	**1,132**	986	**2,016**	1,787
Online Services Business	**(248)**	(116)	**(510)**	(232)
Microsoft Business Division	**3,140**	2,146	**5,801**	4,387
Entertainment and Devices Division	**334**	(306)	**470**	(430)
Reconciling amounts	**(1,120)**	(1,167)	**(1,866)**	(2,165)
Consolidated	**$ 6,481**	$ 3,472	**$12,399**	$ 7,946

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

Reconciling amounts include adjustments to conform with U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, and accelerated amortization for depreciation, stock awards, and performance-based stock awards. In addition, certain revenue and expenses are excluded from segments or included in corporate-level activity, including certain legal settlements and accruals for legal contingencies.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Significant reconciling items were as follows:

(In millions)	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006	Six Months Ended December 31, 2007	Six Months Ended December 31, 2006
Summary of reconciling amounts:				
Corporate-level activity (1)	**$(1,346)**	$(1,079)	**$(2,353)**	$(2,022)
Stock-based compensation expense	**129**	(4)	**315**	(61)
Revenue reconciling amounts	**88**	(85)	**183**	(87)
Other	**9**	1	**(11)**	5
Total	**$(1,120)**	$(1,167)	**$(1,866)**	$(2,165)

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

Note 10 – Acquisitions

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

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

(In millions)	aQuantive as of August 10, 2007
Cash and cash equivalents	$ 342
Accounts receivable, net	273
Other current assets	6
Property, plant and equipment	50
Intangible assets	939
Goodwill	5,261
Deferred income taxes	109
Other long-term assets	6
Total assets acquired	$ 6,986
Accrued compensation	37
Other current liabilities	683
Deferred income taxes	338
Other long-term liabilities	71
Total liabilities assumed	$ 1,129
Net assets acquired	$ 5,857

As a result of this acquisition, we recorded $5.3 billion of goodwill in our Online Services Business segment. Of the $939 million of acquired intangible assets, $24 million was assigned to in-process research and

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS—(Continued)
(Unaudited)

development assets and was expensed during the first quarter. The remaining acquired intangible assets include $476 million of customer relationships with a weighted average life of six years, $327 million of technology-based intangible assets with a weighted average life of four years, and $112 million of other intangible assets with a weighted average life of five years.

In addition to aQuantive, we acquired nine other entities during the six months ended December 31, 2007 for total consideration of $394 million which was paid primarily in cash. All of the entities were consolidated within Microsoft starting on their respective acquisition dates. Pro forma results of operations have not been presented because the effects of all of these acquisitions, individually and in aggregate, were not material to our consolidated results of operations.

Note 11 – Goodwill

(In millions)	Balance as of July 1, 2007	Acquisitions /purchase accounting adjustments	Balance as of September 30, 2007	Acquisitions /purchase accounting adjustments	Balance as of December 31, 2007
Client	$ 77	$ —	$ 77	**$ —**	**$ 77**
Server and Tools	580	70	650	**5**	**655**
Online Services Business	552	5,330	5,882	**41**	**5,923**
Microsoft Business Division	3,132	—	3,132	**93**	**3,225**
Entertainment and Devices Division	419	(9)	410	**19**	**429**
Total	$ 4,760	$ 5,391	$ 10,151	**$ 158**	**$ 10,309**

During the six months ended December 31, 2007, we recorded $5.5 billion of goodwill resulting from the ten acquisitions described in Note 10 – Acquisitions. None of the amount recorded as goodwill is expected to be deductible for tax purposes. The purchase price allocation for all of the acquisitions is preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities become available. Any change in the fair value of the net assets of the acquired company will change the amount of the purchase price allocable to goodwill.

Note 12 – Intangible Assets

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

	December 31, 2007			June 30, 2007		
(In millions)	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
Contract-based	**$ 996**	**$ (760)**	**$ 236**	$ 988	$ (727)	$ 261
Technology-based	**1,324**	**(517)**	**807**	916	(407)	509
Marketing-related	**161**	**(49)**	**112**	57	(39)	18
Customer-related	**635**	**(73)**	**562**	122	(32)	90
Total	**$ 3,116**	**$ (1,399)**	**$ 1,717**	$ 2,083	$ (1,205)	$ 878

Acquired intangibles are generally amortized on a straight-line basis over their weighted average lives. Intangible assets amortization expense was $112 million for the three months and $214 million for the six months ended December 31, 2007 as compared to $52 million for the three months and $90 million for the six months ended December 31, 2006. The estimated future amortization expense related to intangible assets as of December 31, 2007 is expected to be $244 million for the remainder of fiscal year 2008, $456 million for fiscal year 2009, $400 million for fiscal year 2010, $309 million for fiscal year 2011, and $308 million for fiscal year 2012 and thereafter.

Note 13 – Income Taxes

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

Adopting FIN 48 had the following impact on our financial statements: increased current assets by $228 million, long-term assets by $1.1 billion, long-term liabilities by $2.1 billion, and our retained deficit by $395 million; and decreased our income taxes payable by $394 million. As of July 1, 2007, we had $7.1 billion of unrecognized tax benefits of which $5.3 billion, if recognized, would affect our effective tax rate. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. As of July 1, 2007 we had accrued interest related to uncertain tax positions of $863 million, net of federal income tax benefit, on our balance sheet. Other long-term liabilities related to tax contingencies were $7.7 billion as of December 31, 2007 and $5.1 billion as of June 30, 2007.

We are currently under audit by the Internal Revenue Service for tax years 2000 through 2006. It is reasonably possible that the total amount of unrecognized tax benefits may be reduced within the next 12 months as a result of ongoing discussions we are having with the Internal Revenue Service in connection with the audit of the years 2000 through 2003. In these discussions, we expect to settle certain issues resulting in a reduction of unrecognized tax benefits of approximately $1.1 billion; however, we are unable to determine an estimated range for the resolution of other issues at this time.

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

Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases and are stated at enacted tax rates expected to be in effect when taxes are actually paid or recovered. We have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $9.5 billion as of December 31, 2007 and $6.1 billion as of June 30, 2007, primarily resulting from earnings for certain non-U.S. subsidiaries which are permanently reinvested outside the United States. The amount of unrecognized deferred tax liabilities associated with these temporary differences was $2.8 billion as of December 31, 2007 and $1.8 billion as of June 30, 2007.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the "Corporation") as of December 31, 2007, and the related consolidated statements of income, stockholders' equity, and cash flows for the three-month and six-month periods ended December 31, 2007 and 2006. These interim financial statements are the responsibility of the Corporation's management.

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

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

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

DELOITTE & TOUCHE LLP

/S/ DELOITTE & TOUCHE LLP

Seattle, Washington
January 24, 2008

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

Special Note About Forward-Looking Statements

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

OVERVIEW

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

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

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

All growth and percentage comparisons refer to the three or six months ended December 31, 2007, as compared with the three or six months ended December 31, 2006, unless otherwise noted.

Summary

(In millions, except per share amounts and percentages)	Three months ended December 31, 2007	2006	Percentage Change	Six months ended December 31, 2007	2006	Percentage Change
Revenue	**$16,367**	$12,542	30%	**$30,129**	$23,353	29%
Operating income	**$ 6,481**	$ 3,472	87%	**$12,399**	$ 7,946	56%
Diluted earnings per share	**$ 0.50**	$ 0.26	92%	**$ 0.95**	$ 0.61	56%

For the three and six months ended December 31, 2007, revenue growth was impacted by the deferral of revenue during the first half of fiscal year 2007 from the Express Upgrade to Windows Vista and Microsoft Office Technology Guarantee programs and pre-shipments of Windows Vista and the 2007 Microsoft Office system. Revenue growth for the three months ended December 31, 2007 was driven primarily by licensing of Windows Vista and the 2007 Microsoft Office system, which were made available to consumers in January 2007, and increased revenue associated with Windows Server and SQL Server. Revenue growth for the six months ended December 31, 2007 was driven primarily by licensing of Windows Vista and the 2007 Microsoft Office system, increased Xbox console and game sales, and increased revenue associated with Windows Server and SQL Server. Revenue from licensing of Windows Vista and the 2007 Microsoft Office system reflects growth in our OEM channel and growth from volume licensing. Foreign currency exchange rates accounted for a $410 million or three percentage point increase in revenue during the three months and a $615 million or three percentage point increase during the six months ended December 31, 2007.

Operating income growth for the three months ended December 31, 2007 was driven primarily by the increased revenue, partially offset by increased headcount-related expenses, increased sales and marketing expenses, and increased costs for legal settlements and legal contingencies. During the quarter, we incurred $237 million in legal charges as compared with $111 million in legal charges during the three months ended December 31, 2006. Operating income growth for the six months ended December 31, 2007 was driven primarily by the increased revenue, partially offset by increased cost of revenue, increased headcount-related expenses, and increased sales and marketing expenses. Total headcount-related expenses increased 13% during the three months and 10% during the six months ended December 31, 2007, driven by a 12% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

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

SEGMENT PRODUCT REVENUE/OPERATING INCOME/(LOSS)

Revenue and operating income/(loss) amounts in this section are presented on a basis consistent with U.S. GAAP and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 9 – Segment Information is presented on a basis consistent with our current internal management reporting, in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. Prior period amounts have been recast to conform to the way we internally manage and monitor performance at the segment level in fiscal year 2008.

Client

(In millions, except percentages)	Three months ended December 31, 2007	2006	Percentage Change	Six months ended December 31, 2007	2006	Percentage Change
Revenue	**$ 4,335**	$ 2,586	68%	**$8,473**	$5,893	44%
Operating income	**$ 3,358**	$ 1,838	83%	**$6,727**	$4,485	50%

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

Client revenue increased during the three and six months ended December 31, 2007, primarily reflecting licensing of Windows Vista. During the second quarter of fiscal year 2007, we deferred approximately $1.1 billion of revenue and during the first half of fiscal year 2007, we deferred approximately $1.2 billion of revenue pending the January 2007 release of Windows Vista to consumers. During the three months ended December 31, 2007, OEM revenue increased $1.7 billion or 80% driven by 18% growth in OEM license units. During the six months ended December 31, 2007, OEM revenue increased $2.4 billion or 48%, driven by 19% growth in OEM license units. Revenue from commercial and retail licensing of Windows operating systems increased $92 million or 18% during the three months and $218 million or 21% during the six months ended December 31, 2007, primarily due to strong sales from Enterprise Agreements and anti-piracy efforts in Russia, China, and other emerging markets. The OEM premium mix increased eight percentage points to 75% compared with the second quarter of last year and 12 percentage points to 75% compared to the first half of last year, driven by increased consumer premium mix. Based on our estimates, total worldwide PC shipments from all sources grew 14% to 16% from the second quarter of the previous year and 13% to 15% from the first half of the previous year driven by demand in both emerging and mature markets.

Client operating income increased during the three and six months ended December 31, 2007, reflecting the increased revenue, partially offset by increased cost of revenue and increased sales and marketing expenses. Cost of revenue increased $89 million or 54% during the three months and $193 million or 70% during the six months ended December 31, 2007, driven by Windows Vista product costs. Sales and marketing expenses increased $78 million or 22% during the three months and $157 million or 27% during the six months ended December 31, 2007, primarily reflecting increased headcount-related expenses associated with our corporate sales force. Headcount-related expenses increased 38% during the three months and 4% during the six months ended December 31, 2007.

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

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Server and Tools

(In millions, except percentages)	Three months ended December 31, 2007	2006	Percentage Change	Six months ended December 31, 2007	2006	Percentage Change
Revenue	**$ 3,278**	$ 2,843	15%	**$6,178**	$5,339	16%
Operating income	**$ 1,172**	$ 981	19%	**$2,132**	$1,751	22%

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

Server and Tools revenue increased during the three and six months ended December 31, 2007, reflecting growth in both product and services revenue. Server and server application revenue (including CAL revenue) and developer tools, training, and certificate revenue increased $289 million or 12% during the three months and $551 million or 13% during the six months ended December 31, 2007, primarily driven by growth in new and recurring volume licensing of Windows Server and SQL Server products and reflects broad adoption of the Windows Platform and applications. Consulting, Premier and Professional product support services revenue increased $146 million or 28% during the three months and $288 million or 30% during the six months ended December 31, 2007, primarily due to higher demand for consulting and support services in corporate enterprises. Foreign currency exchange rates accounted for a $111 million or four percentage point increase in revenue for the three months and $177 million or four percentage point increase in revenue for the six months ended December 31, 2007.

Server and Tools operating income increased for the three and six months ended December 31, 2007, primarily reflecting the increased revenue, partially offset by increased sales and marketing expenses and cost of revenue for services. Sales and marketing expenses increased $102 million or 12% during the three months and $235 million or 15% during the six months ended December 31, 2007, primarily reflecting increased headcount-related expenses associated with our corporate sales force. Cost of revenue increased $93 million or 18% during the three months and $169 million or 16% during the six months ended December 31, 2007, reflecting the growth in services provided. Headcount-related expenses increased 9% during the three months and 6% during the six months ended December 31, 2007, driven by an 11% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

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

Online Services Business

(In millions, except percentages)	Three months ended December 31, 2007	2006	Percentage Change	Six months ended December 31, 2007	2006	Percentage Change
Revenue	**$ 863**	$ 625	38%	**$ 1,534**	1,161	32%
Operating loss	**$ (245)**	$ (118)	(108)%	**$ (510)**	(236)	(116)%

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

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

OSB revenue increased during the three and six months ended December 31, 2007 driven primarily by increased online advertising revenue and the inclusion of aQuantive revenue, partially offset by decreased access revenue. Online advertising revenue increased $170 million or 38% to $623 million during the three months and $286 million or 35% to $1.1 billion during the six months ended December 31, 2007. This increase reflects growth in our existing online advertising business and includes aQuantive online advertising revenue of $52 million during the three months and $81 million during the six months ended December 31, 2007. Agency revenue, which is solely derived from aQuantive, was $102 million during the three months and $153 million during the six months ended December 31, 2007. Access revenue was $67 million for the three months and $137 million for the six months ended December 31, 2007, reflecting decreases of 26% and 29%, respectively. As of December 31, 2007, we had approximately 427 million Windows Live IDs compared with 352 million as of the same period last year.

OSB operating loss increased during the three and six months ended December 31, 2007 driven primarily by increased cost of revenue and increased sales and marketing expenses, partially offset by the increased revenue. OSB operating loss for the quarter ended December 31, 2007 included $46 million of amortization of intangible assets acquired from aQuantive, and OSB operating loss for the six months ended December 31, 2007 includes $76 million of intangible assets amortization and a $24 million in-process research and development write-off. Cost of revenue increased $218 million or 82% during the three months and $369 million or 73% during the six months ended December 31, 2007 primarily driven by increased data center costs, online content expenses, and aQuantive-related expenses. Sales and marketing expenses increased $92 million or 43% during the three months and $161 million or 43% during the six months ended December 31, 2007, primarily due to increased marketing costs and amortization of customer-related intangible assets. Headcount-related expenses increased 23% during the three months and 15% during the six months ended December 31, 2007, driven by a 22% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount.

For the remainder of fiscal year 2008, we expect continued growth in online advertising revenue as the portals, channels, and communications services continue to expand globally and the overall Internet advertising market continues to expand. Online advertising revenue is expected to benefit from our acquisition of aQuantive while revenue from narrowband Internet Access is expected to continue to decline. For the remainder of fiscal year 2008, we expect operating expenses to increase as we continue to invest in our long-term strategy. We believe these investments will lay the groundwork for future growth.

Microsoft Business Division

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
Revenue	**$ 4,811**	$ 3,513	37%	**$8,922**	$6,941	29%
Operating income	**$ 3,185**	$ 2,152	48%	**$5,879**	$4,391	34%

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

MBD revenue increased during the three and six months ended December 31, 2007, primarily reflecting licensing of the 2007 Microsoft Office system and the fiscal year 2007 second quarter revenue deferral of approximately $500 million as a result of the Microsoft Office Technology Guarantee program. Business revenue increased $706 million or 23% during the three months and $1.4 billion or 24% during the six months ended December 31, 2007, primarily as a result of growth in volume licensing agreement revenue and strong transactional license sales to businesses. The increase in business revenue also included a 26% increase in Microsoft Dynamics customer billings during the three months and a 24% increase during the six months ended December 31, 2007. Consumer revenue increased $592 million or 153% during the three months and $620 million or 53% during the six months ended December 31, 2007, primarily reflecting the technology guarantee deferral of approximately $500 million discussed above. Foreign currency exchange rates accounted for a $170 million or five percentage point increase in revenue during the three months and a $263 million or four percentage point increase in revenue during the six months ended December 31, 2007.

MBD operating income increased for the three and six months ended December 31, 2007, reflecting the increased revenue, partially offset by increased sales and marketing expenses, cost of revenue, and research and development expenses. Sales and marketing expenses increased $159 million or 19% during the three months and $312 million or 20% during the six months ended December 31, 2007, primarily reflecting increased headcount-related expenses associated with our corporate sales force. Cost of revenue increased $47 million or 26% during the three months and $97 million or 28% during the six months ended December 31, 2007, primarily driven by an increase in online costs reflecting the April 2007 acquisition of Tellme Networks. Research and development expenses increased $52 million or 17% during the three months and $74 million or 12% during the six months ended December 31, 2007, primarily reflecting increased headcount-related expenses. Headcount-related expenses increased 9% during the three months and 4% during the six months ended December 31, 2007, driven by a 6% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

For the remainder of fiscal year 2008, we expect revenue to continue to increase over the prior year due to the strong performance of the 2007 Microsoft Office system. We continue to develop plans to grow revenue in new areas such as unified communications and through our existing portfolio of Microsoft Dynamics products.

Entertainment and Devices Division

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
Revenue	**$ 3,060**	$ 2,969	3%	**$ 4,989**	$ 3,980	25%
Operating income/(loss)	**$ 357**	$ (302)	*	**$ 524**	$ (423)	*

* *Not meaningful*

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

EDD revenue increased during the three and six months ended December 31, 2007, primarily due to increased Xbox 360 platform sales. During the three months ended December 31, 2007, Xbox platform and PC game revenue increased $115 million or 5% primarily as a result of increased Xbox 360 video game sales, Xbox Live revenue, and Xbox 360 accessory sales, partially offset by decreased Xbox 360 console sales. Xbox platform and PC game revenue increased $1.0 billion or 35% during the six months ended December 31, 2007, as a result of increased Xbox 360 console sales, video game sales led by Halo 3, Xbox Live revenues, and Xbox 360 accessory sales. We shipped 4.3 million and 6.1 million Xbox 360 consoles in the second quarter and first half of fiscal year 2008, respectively, as compared to 4.4 million and 5.4 million Xbox 360 consoles in the second quarter and first half of fiscal year 2007, respectively.

EDD operating income increased during the three months ended December 31, 2007, primarily due to the increased revenue, decreased cost of revenue, and decreased sales and marketing expenses. Cost of revenue decreased $523 million or 22% during the three months ended December 31, 2007, primarily driven by decreased Xbox 360 manufacturing costs. Sales and marketing expenses decreased $81 million or 16%, reflecting a decline in Xbox 360 platform marketing expenses. EDD operating income increased during the six months ended December 31, 2007, primarily due to the increased revenue. Headcount-related expenses increased 17% and 14% during the three and six months ended December 31, 2007, respectively, reflecting a 4% increase in headcount and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

For the remainder of fiscal year 2008, we expect revenue to increase due to increased sales of Xbox 360 consoles and related games, accessories, and services. Revenue from existing mobility and embedded devices is expected to increase due to unit volume increases of Windows Mobile software driven by increased market demand for phone-enabled devices and Windows Embedded operating systems.

Corporate-Level Activity

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
Corporate-level results	**$(1,346)**	$(1,079)	(25)%	**$(2,353)**	$(2,022)	(16)%

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

Corporate-level expenses increased for the three months ended December 31, 2007, primarily reflecting increased costs for legal settlements and legal contingencies, increased headcount-related expenses, and increased consulting and professional fees. Corporate-level expenses increased for the six months ended December 31, 2007, primarily reflecting increased headcount-related expenses, increased consulting and professional fees, and increased costs for legal settlements and legal contingencies, partially offset by decreased costs for corporate advertising. We incurred $237 million of legal charges during the three months and $277 million during the six months ended December 31, 2007, compared with $111 million of legal charges during the three months and $198 million during the six months ended December 31, 2006. Headcount-related expenses increased 10% during the three months and 12% during the six months ended December 31, 2007, driven by a 6% increase in headcount over the past twelve months, an increase in salaries and benefits for existing headcount, and an increase in stock-based compensation.

OPERATING EXPENSES

Cost of Revenue

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
Cost of revenue	**$ 3,543**	$ 3,620	(2)%	**$6,218**	$5,316	17%
As a percent of revenue	**22%**	29%	(7)ppt	**21%**	23%	(2)ppt

Cost of revenue includes manufacturing and distribution costs for products sold and programs licensed, operating costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, warranty costs, inventory write-downs, and costs associated with the delivery of consulting services. Cost of revenue decreased during the three months ended December 31, 2007, reflecting decreased Xbox manufacturing costs, offset by increased OSB data center costs and online costs, increased costs associated with the growth in consulting services, and increased Windows Vista product costs. Cost of revenue increased during the six months ended December 31, 2007, primarily driven by increased OSB data center costs and online costs, increased Windows Vista product costs, and increased costs associated with the growth in consulting services.

Research and Development

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
Research and development	**$ 1,885**	$ 1,637	15%	**$3,722**	$3,423	9%
As a percent of revenue	**12%**	13%	(1)ppt	**12%**	15%	(3)ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. The increase in research and development expenses for the three and six months ended December 31, 2007 was primarily driven by an increase in headcount-related expenses of 14% during the three months and 7% during the six months ended December 31, 2007, reflecting a 7% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount, partially offset by decreased stock-based compensation expense.

Sales and Marketing

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
Sales and marketing	**$ 3,392**	$ 2,999	13%	**$6,006**	$5,190	16%
As a percent of revenue	**21%**	24%	(3)ppt	**20%**	22%	(2)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses increased during the three and six months ended December 31, 2007, primarily as a result of increased headcount-related expenses. Headcount-related expenses increased 14% during the three months and 13% during the six months ended December 31, 2007, reflecting both an increase in salaries and benefits for existing headcount and a 7% increase in headcount over the past twelve months, partially offset by decreased stock-based compensation expense.

General and Administrative

(In millions, except percentages)	Three months ended December 31, 2007	Three months ended December 31, 2006	Percentage Change	Six months ended December 31, 2007	Six months ended December 31, 2006	Percentage Change
General and administrative	**$ 1,066**	$ 814	31%	**$1,784**	$1,478	21%
As a percent of revenue	**7%**	6%	1ppt	**6%**	6%	— ppt

General and administrative costs include payroll, employee benefits, stock-based compensation expense and other headcount-related expenses associated with finance, legal, facilities, certain human resources, other administrative headcount, and legal and other administrative fees. General and administrative costs increased for the three and six months ended December 31, 2007, primarily reflecting increased costs for legal settlements and legal contingencies and increased consulting and professional fees. We incurred $237 million of legal charges during the three months and $277 million during the six months ended December 31, 2007, compared with $111 million of legal charges during the three months and $198 million during the six months ended December 31, 2006. Headcount-related expenses increased 7% during the three months and 5% during the six months ended December 31, 2007, reflecting a 12% increase in headcount over the past twelve months, an increase in salaries and benefits for existing headcount, and an increase in stock-based compensation expense.

INVESTMENT INCOME, INCOME TAXES, AND OTHER

Investment Income and Other

The components of investment income and other were as follows:

(In millions)	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006	Change	Six Months Ended December 31, 2007	Six Months Ended December 31, 2006	Change
Dividends and interest	**$ 206**	$ 316	$ (110)	**$ 445**	$ 685	$ (240)
Net recognized gains on investments	**87**	103	(16)	**238**	466	(228)
Net gains/(losses) on derivatives	**48**	(75)	123	**84**	(231)	315
Other	**(2)**	(11)	9	**(130)**	(20)	(110)
Investment income and other	**$ 339**	$ 333	$ 6	**$ 637**	$ 900	$ (263)

During the three and six months ended December 31, 2007, dividends and interest income decreased, reflecting a reduction in the average balance of interest-bearing investments coupled with lower interest rates on our fixed-income investments. Net recognized gains on investments include other-than-temporary impairments of $54 million in the three months ended December 31, 2007 and $69 million in the six months ended December 31, 2007. During the six months ended December 31, 2007, net recognized gains on investments decreased primarily due to lower gains on sales of fixed-income and equity investments coupled with higher other-than-temporary impairments.

During the three and six months ended December 31, 2007, net derivative gains increased primarily due to net gains on equity, interest rate and commodity derivatives during the current fiscal year compared with net losses in the prior year. We use derivative instruments to manage exposures to interest rates, equity prices, and foreign currency markets and to facilitate portfolio diversification. Gains and losses arising from derivatives not designated as accounting hedges are in large part economically offset by unrealized losses and gains, respectively, in the underlying securities, which are recorded as a component of other comprehensive income. Commodity derivatives are held for the purpose of portfolio diversification. Net losses related to foreign currency contracts relate primarily to changes in time value of options used to hedge anticipated foreign currency revenues. Additionally, net gains and losses on foreign currency contracts include the changes in the fair value of derivatives used as economic hedges. These gains and losses are partially offset economically by unrealized losses and gains, respectively, in the underlying assets, which are included in other comprehensive income. Other of $130 million for the six months ended December 31, 2007 includes the correction of several immaterial items from prior periods.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Collateral and/or security interest is determined based upon the underlying security and the creditworthiness of the borrower. Cash collateral is recorded as an asset with a corresponding liability. We anticipate that the magnitude of securities lent under this program will remain relatively consistent during the fiscal year.

Income Taxes

Our effective tax rate was 31% for the three and six months ended December 31, 2007 and 2006.

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

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

FINANCIAL CONDITION

Cash and cash equivalents and short-term investments totaled $21.1 billion as of December 31, 2007, compared with $23.4 billion as of June 30, 2007. Equity and other investments were $9.4 billion as of December 31, 2007, compared with $10.1 billion as of June 30, 2007. Our investments consist primarily of fixed-income securities, diversified among industries and individual issuers. Our investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S.-dollar-denominated securities, but also includes foreign-denominated securities in order to diversify financial risk. We invest primarily in short-term securities to facilitate rapid deployment for immediate cash needs. As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was $28.1 billion at December 31, 2007. Our retained deficit is not expected to affect our future ability to operate or pay dividends given our continuing profitability and strong cash and financial position.

Unearned Revenue

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

The following table outlines the expected recognition of unearned revenue as of December 31, 2007:

(In millions)	Recognition of Unearned Revenue
Three months ended:	
March 31, 2008	**$ 4,346**
June 30, 2008	**3,083**
September 30, 2008	**1,787**
December 31, 2008	**1,005**
Thereafter	**1,957**
Unearned revenue	**$ 12,178**

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

Cash Flows

Cash flow from operations for the six months ended December 31, 2007 increased $4.3 billion compared with the same period in fiscal year 2007 to $10.4 billion due to increased cash collections from customers reflecting our continued revenue growth along with $1.0 billion from deferred taxes reflecting the tax impact of changes in unearned revenue. Cash used for financing was $5.9 billion in the first half of fiscal year 2008, a decrease of $4.6 billion compared with the same period in fiscal year 2007. The decrease reflects $7.0 billion of common stock repurchases in the six months ended December 31, 2007, compared with $13.5 billion in the first six months of the prior fiscal year, which included the impact of our tender offer on August 17, 2006. This impact was partially offset by a $1.9 billion decrease in proceeds from issuance of common stock reflecting the JPMorgan exercise of approximately 113 million call options for $3.3 billion in December 2006, which was included in the $4.8 billion of common stock issued during the six months ended December 31, 2006, as compared with $3.0 billion in the current year. Cash used for investing was $3.3 billion in the first half of fiscal year 2008 as compared with cash provided from investing of $4.5 billion in the first half of fiscal 2007, a change of $7.8 billion. This change reflects a $5.4 billion increase in cash paid for acquisition of companies, reflecting the purchase of aQuantive in the first quarter of fiscal year 2008, along with a $2.0 billion decrease in cash from combined investment purchases, sales, and maturities.

In January 2008, we announced an offer to purchase all the outstanding shares of Fast Search & Transfer ASA for approximately $1.2 billion in cash. We expect to complete this transaction in the fourth quarter of fiscal year 2008.

We have no material long-term debt. Stockholders' equity at December 31, 2007 was $34.4 billion. We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of requirements for capital resources.

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately $16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. As of December 31, 2007, approximately $8.7 billion remained of the $36.2 billion approved repurchase amount.

Our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
(Fiscal year 2008)				
September 12, 2007	$ 0.11	November 15, 2007	$1,034	December 13, 2007
December 19, 2007	$ 0.11	February 21, 2008	$1,026	March 13, 2008
(Fiscal year 2007)				
September 13, 2006	$ 0.10	November 16, 2006	$ 979	December 14, 2006
December 20, 2006	$ 0.10	February 15, 2007	$ 977	March 8, 2007

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

Off-Balance Sheet Arrangements

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

RECENT ACCOUNTING PRONOUNCEMENTS

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

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

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

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

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

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for us beginning July 1, 2008. In December 2007, the FASB released a proposed FASB Staff Position (FSP FAS 157-b – *Effective Date of FASB Statement No. 157*) which, if adopted as proposed, would delay the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We currently are assessing the potential impact that adoption of SFAS No. 157 would have on our financial statements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

VaR is calculated by computing the exposures of each holding's market value to a range of over 1,000 equity, fixed-income, foreign exchange, and commodity risk factors. The exposures are then used to compute the parameters of a distribution of potential changes in the total market value of all holdings, taking into account the weighted historical volatilities of the different rates and prices and the weighted historical correlations among the different rates and prices. The VaR is then calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, credit risk, and legal risk.

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

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

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

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

(In millions) Risk Categories	December 31, 2007	June 30, 2007	Three months ended December 31, 2007 Average	High	Low
Interest rates	**$ 31**	$ 34	**$ 32**	**$ 37**	**$ 28**
Currency rates	**72**	55	**80**	**96**	**64**
Equity prices	**58**	60	**55**	**60**	**49**
Commodity prices	**6**	7	**6**	**7**	**6**

Total one-day VaR for the combined risk categories was $102 million at December 31, 2007 and $95 million at June 30, 2007. The total VaR is 39% less at December 31, 2007, and 39% less at June 30, 2007, than the sum of the separate risk categories in the above table due to the diversification benefit of the overall portfolio.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

The European Commission has initiated proceedings against us under European competition law. In 2004, the Commission ordered us to create new versions of Windows that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. The design of these special versions of Windows and the terms on which we make our protocol technology available are closely regulated by the Commission. The Commission's impact on product design may limit our ability to innovate in Windows in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of protocol licenses may enable competitors to develop software products that better mimic the functionality of our own products which could result in decreased sales of our products.

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

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

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

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

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

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

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

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

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

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

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

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

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

Acquisitions and joint ventures may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don’t realize a satisfactory return on our investment, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management’s attention from our other businesses. These events could harm our operating results or financial condition.

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

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

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

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

(c) STOCK REPURCHASES

Period	(a) Total number of shares purchased	(b) Average price paid per share	(c) Total number of shares purchased as part of publicly announced plans or programs	(d) Maximum number of shares (or approximate dollar value of shares) that may yet be purchased under the plans or programs (in millions)
October 1, 2007 – October 31, 2007	8,378,300	$ 29.74	8,378,300	$ 12,540
November 1, 2007 – November 30, 2007	95,837,252	34.24	95,837,252	$ 9,258
December 1, 2007 – December 31, 2007	15,399,210	35.72	15,399,210	$ 8,708
	119,614,762		119,614,762	

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program that expires on June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately $16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. The repurchase program may be suspended or discontinued at any time without prior notice. During the second quarter of fiscal year 2008, we repurchased 120 million shares for $4.1 billion under the plans described in this paragraph. The transactions occurred in open market purchases and pursuant to a trading plan under Rule 10b5-1.

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

The Annual Meeting of Shareholders was held on November 13, 2007.

The following proposals were adopted by the margins indicated:

1. To elect a Board of Directors to hold office until the next annual meeting of shareholders and until their successors are elected and qualified.

	Number of Shares		
	For	Against	Abstain
William H. Gates III	8,012,136,106	109,572,915	16,105,883
Steven A. Ballmer	8,005,405,328	114,646,475	17,763,101
James I. Cash Jr.	8,001,438,411	111,866,387	24,510,106
Dina Dublon	8,025,642,932	90,639,073	21,532,899
Raymond V. Gilmartin	8,022,477,056	93,385,362	21,952,486
Reed Hastings	8,028,115,383	87,954,132	21,745,389
David F. Marquardt	7,989,340,239	123,300,324	25,174,341
Charles H. Noski	8,027,301,315	88,711,118	21,802,471
Helmut Panke	8,027,175,356	92,595,546	18,044,002
Jon A. Shirley	7,999,566,637	115,434,684	22,813,583

2. To ratify selection of Deloitte & Touche LLP as the Company's independent auditor for fiscal year 2007.

For	8,053,422,269
Against	20,624,109
Abstain	63,768,526

The following proposals were not adopted by the margins indicated:

3. Shareholder proposal to adopt Policies on Internet Censorship.

For	225,816,110
Against	5,501,735,247
Abstain	860,249,522
Broker non-vote	2,813,950,775

4. Shareholder proposal to establish Board of Directors Committee on Human Rights.

For	234,479,263
Against	5,545,629,079
Abstain	807,692,536
Broker non-vote	2,813,950,776

Item 6. Exhibits

10.18	Form of Shared Performance Stock Award Agreement under the Microsoft Corporation 2001 Stock Plan for the fiscal year 2008 performance period
15	Letter re: unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Items 3 and 5 are not applicable and have been omitted.

SIGNATURE

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

Date: January 24, 2008	Microsoft Corporation
	By: /s/ FRANK H. BROD
	Frank H. Brod **Corporate Vice President, Finance and Administration;** **Chief Accounting Officer** **(Principal Authorized Officer)**

SHARED PERFORMANCE STOCK AWARD AGREEMENT UNDER THE MICROSOFT CORPORATION 2001 STOCK PLAN

(Executive Officer Agreement)

Award Number <<GrantIdentifier>>

1. Award of Target Shared Performance Stock Awards. Microsoft Corporation (the "Company"), in the exercise of its sole discretion pursuant to the Microsoft Corporation 2001 Stock Plan (the "Plan"), does on <<GrantDate>> (the "Award Date") hereby award to <<FullName>> (the "Awardee") <<shares granted quantity>> target Shared Performance Stock Awards (target "SPSAs") upon the terms and subject to the conditions of this Award Agreement.

Target SPSAs are used solely to calculate the number of actual SPSAs awarded to Awardee in accordance with this Award Agreement, and do not create any separate rights or entitlements. **ACTUAL SPSAs ARE CALCULATED FOLLOWING THE END OF THE COMPANY'S FISCAL YEAR 2008 AS SET FORTH IN APPENDIX A , AND BASED ON ANY ADJUSTMENTS IN TARGET SPSAs DUE TO EMPLOYMENT CHANGES AS DESCRIBED THE SPSA ADMINISTRATIVE POLICIES (EXECUTIVE OFFICERS) REFERENCED IN SECTION 3(b) BELOW.**

SPSAs represent the Company's unfunded and unsecured promise to issue Common Shares at a future date, subject to the terms of this Award Agreement and the Plan. Awardee has no rights under the SPSAs other than the rights of a general unsecured creditor of the Company.

Capitalized terms used but not defined in this Award Agreement shall have the meanings assigned to them in the Plan.

2. Calculation of SPSAs. Following the end of FY08, Awardee's actual SPSAs will be calculated by multiplying the target SPSAs by the SPI Percentage, rounded up to the nearest whole number. In calculating the number of actual SPSAs, target SPSAs will be determined after taking into account any adjustments due to employment changes, as described in the SPSA Administrative Policies (Executive Officers) referenced in Section 3(b) below. The SPI Percentage is calculated as set forth in Appendix A.

3. Vesting Schedule and Conversion of SPSAs; Adjustments upon Employment Changes.

(a) Subject to the terms of this Award Agreement and the Plan and provided that Awardee remains continuously employed throughout the vesting periods set out below:

(1) 25% of the SPSAs shall vest and be converted into an equivalent number of Common Shares that will be distributed to Awardee on or about August 31, 2008 (the "initial vest date");

(2) 25% of the SPSAs shall vest and be converted into an equivalent number of Common Shares that will be distributed to Awardee one year from the initial vest date;

(3) 25% of the SPSAs shall vest and be converted into an equivalent number of Common Shares that will be distributed to Awardee two years from the initial vest date; and

(4) 25% of the SPSAs shall vest and be converted into an equivalent number of Common Shares that will be distributed to Awardee three years from the initial vest date.

Fractional SPSAs shall be converted into Common Shares as set out in Section 10(c) of this Award Agreement. Vesting will not occur before the first NASDAQ Stock Market regular trading day that is on or after the applicable vest and conversion date above.

(b) AWARDEE’S RIGHTS IN THE SPSAs SHALL BE SUBJECT TO INCREASE, DECREASE, LOSS OR MAY BE OTHERWISE AFFECTED WITH REGARD TO AWARD ELIGIBILITY, SIZE, VESTING AND TERMINATION, BYCHANGES IN LEVEL, LEAVES OF ABSENCE, PART-TIME EMPLOYMENT, DISABILITY AND OTHER CHANGES IN AWARDEE’S EMPLOYMENT AS PROVIDED IN THE COMPANY’S CURRENT SPSA ADMINISTRATIVE POLICIES (EXECUTIVE OFFICERS), WHICH MAY VARY FROM THE POLICIES ON STOCK OPTIONS AND STOCK AWARDS. ACCOMPANYING THIS AWARD AGREEMENT IS A CURRENT COPY OF THE COMPANY’S SPSA ADMINISTRATIVE POLICIES (EXECUTIVE OFFICERS). THESE POLICIES SHALL BE APPROVED BY THE COMPENSATION COMMITTEE OF THE BOARD (THE “COMMITTEE”) AND MAY CHANGE FROM TIME TO TIME, WITHOUT NOTICE, IN THE COMPANY’S SOLE DISCRETION. AWARDEE’S RIGHTS WILL BE GOVERNED BY THE POLICIES IN EFFECT AT THE TIME OF ANY EVENT OR CHANGE COVERED BY THE POLICIES. FOR A COPY OF THE MOST CURRENT SPSA ADMINISTRATIVE POLICIES (EXECUTIVE OFFICERS) AT ANY POINT IN TIME, E-MAIL “BENEFITS” OR GO TO HRWEB, UNDER STOCK.

4. Termination at Conversion of SPSAs. Unless terminated earlier under Section 5, 6, 7 or 8 below, an Awardee’s rights under this Award Agreement with respect to the SPSAs issued under this Award Agreement shall terminate at the time such SPSAs are converted into Common Shares.

5. Termination of Awardee’s Status as a Participant. Except as otherwise specified in Sections 6, 7 and 8 below, in the event of termination of Awardee’s Continuous Status as a Participant (as such term is defined in Section 2(j) of the Plan), Awardee’s rights under this Award Agreement in any unvested SPSAs shall terminate. For the avoidance of doubt, an Awardee’s Continuous Status as a Participant terminates at the time Awardee’s actual employer ceases to be the Company or a “Subsidiary” of the Company, as that term is defined in Section 2(y) of the Plan.

6. Disability of Awardee. Notwithstanding the provisions of Section 5 above, in the event of termination of Awardee’s Continuous Status as a Participant as a result of total and permanent disability (as such term is defined in Section 12(c) of the Plan), then:

(1) If the termination of Awardee’s Continuous Status as a Participant occurs during FY08, Awardee shall vest in the number of SPSAs calculated by multiplying the target SPSAs by 0.25, rounded up to the nearest whole number; and

(2) If the termination of Awardee's Continuous Status as a Participant occurs after FY08, then the next vesting date for the SPSAs set forth in Section 3(a) above shall accelerate so that Awardee vests in any SPSAs that would normally vest within twelve (12) months of the earlier of (i) such date of termination, or (ii) if Awardee's disability originally required him or her to take a short-term disability leave which was later converted into long-term disability, the date of commencement of the short-term disability leave.

Awardee's rights in any unvested SPSAs that remain unvested after the application of this Section 6 shall terminate at the time Awardee ceases to be in Continuous Status as a Participant. An employee who fails to provide the Company with a medical determination of "total and permanent disability" that is acceptable to the Company and that establishes total and permanent disability to the Company's satisfaction shall not be eligible for the vesting of SPSAs pursuant to this Section 6.

7. <u>Death of Awardee</u>. Notwithstanding the provisions of Section 5 above, in the event of the death of Awardee while in Continuous Status as a Participant, then:

(1) If the death occurs during FY08, then Awardee shall vest in a number of SPSAs calculated by multiplying the target SPSAs by 0.25, rounded up to the nearest whole number; and

(2) If the death occurs after FY08, then the next vesting date for the SPSAs set forth in Section 3(a) above shall accelerate so that Awardee vests in any SPSAs that would normally vest within twelve (12) months of the date of death.

Awardee's rights in any unvested SPSAs that remain unvested after the application of this Section 7 shall terminate at the time of Awardee's death.

8. <u>Retirement of Awardee</u>. Notwithstanding the provisions of Section 5 above, in the event of Awardee's Retirement, Awardee shall be treated as continuously employed through the vesting periods in Section 3(a) above. For this purpose, "Retirement" means termination of employment with the Company or its direct and indirect subsidiaries after the earlier of (a) age 65, or (b) attaining age 55 and 15 years of Continuous Service.

This Section 8 will only apply to a Retirement if (a) the Retirement is more than one year after the Award Date, (b) Awardee executes a release in conjunction with the Retirement in the form provided by the Company, and (c) Awardee's employment does not terminate due to misconduct (as determined in the sole discretion of the Committee), including but not limited to misconduct in violation of Company policy and misconduct that adversely affects the Company's interests or reputation.

For purposes of this Section 8, "Continuous Service" means that Awardee has continuously remained an employee of the Company or its direct and indirect subsidiaries, measured from Awardee's "most recent hire date" as reflected in Company records. For an Awardee who became an employee of the Company following the acquisition of his or her employer by the Company or its direct or indirect subsidiaries, service with the acquired employer shall count toward Continuous Service, and Continuous Service shall be measured from Awardee's acquired company hire date as reflected in the Company's records.

9. Value of Unvested SPSAs. In consideration of the award of these SPSAs, Awardee agrees that upon and following termination of Awardee's Continuous Status as a Participant for any reason (whether or not in breach of applicable laws), and regardless of whether Awardee is terminated with or without cause, notice, or pre-termination procedure or whether Awardee asserts or prevails on a claim that Awardee's employment was terminable only for cause or only with notice or pre-termination procedure, any unvested SPSAs under this Award Agreement shall be deemed to have a value of zero dollars ($0.00).

10. Conversion of SPSAs to Common Shares; Responsibility for Taxes.

(a) Provided Awardee has satisfied the requirements of Section 10(b) below, on the vesting of any SPSAs such vested SPSAs shall be converted into an equivalent number of Common Shares that will be distributed to Awardee within 10 days after the date of the vesting event, or in the event of Awardee's death, to Awardee's legal representative within 10 days after such representative provides proof of death to, and in the manner prescribed by, the Company. The distribution to Awardee, or in the case of Awardee's death, to Awardee's legal representative, of Common Shares in respect of the vested SPSAs shall be evidenced by a stock certificate, appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company, or other appropriate means as determined by the Company. In the event ownership or issuance of Common Shares is not feasible due to applicable exchange controls, securities regulations, tax laws or other provisions of applicable law, as determined by the Company in its sole discretion, Awardee, or in the event of Awardee's death, Awardee's legal representative, shall receive cash proceeds in an amount equal to the value of the Common Shares otherwise distributable to Awardee, as determined by the Company in its sole discretion, net of amounts withheld in satisfaction of the requirements of Section 10(b) below.

(b) Regardless of any action the Company or Awardee's actual employer takes with respect to any or all income tax (including federal, state and local taxes), social insurance, payroll tax, payment on account or other tax-related withholding items ("Tax-Related Items") that arise in connection with the SPSAs, Awardee acknowledges and agrees that the ultimate liability for any Tax-Related Items determined by the Company in its discretion to be legally due by Awardee, is and remains Awardee's responsibility. Awardee acknowledges and agrees that the Company and/or Awardee's actual employer (i) make no representations or undertakings regarding the treatment of any Tax-Related Items in connection with any aspect of the SPSAs, including the grant of the SPSAs, the vesting of SPSAs, the conversion of the SPSAs into Common Shares or the receipt of an equivalent cash payment, the subsequent sale of any Common Shares acquired and the receipt of any dividends; and (ii) do not commit to and are under no obligation to structure the terms of the grant or any aspect of the SPSAs to reduce or eliminate Awardee's liability for any Tax-Related Items.

Prior to the relevant taxable or tax-withholding event, as applicable, Awardee shall pay, or make adequate arrangements satisfactory to the Company or to Awardee's actual employer (in their sole discretion) to satisfy all obligations for Tax-Related Items. In this regard, Awardee authorizes the Company or Awardee's actual employer to withhold all applicable Tax-Related Items from Awardee's wages or other cash compensation payable to Awardee by the Company or Awardee's actual employer. Alternatively, or in addition, the Company or Awardee's actual employer may, in their sole discretion, and without notice to or authorization by Awardee, (i) sell or arrange for the sale of Common Shares to be issued upon the vesting of SPSAs to satisfy the withholding obligation, and/or (ii) withhold in Common Shares, provided that the Company and Awardee's actual employer shall withhold only the amount of shares necessary to satisfy the minimum withholding amount or such other amount determined by the Company as not resulting in negative accounting consequences for the Company. Awardee will be deemed to have been issued the full number of Common Shares subject to the SPSAs, notwithstanding that a number of whole vested Common Shares are held back solely for the purpose of paying the Tax-Related Items due as a result of any aspect of Awardee's SPSAs. Awardee shall pay to the Company or to Awardee's actual employer any amount of Tax-Related Items that the Company or Awardee's actual employer may be required to withhold as a result of Awardee's receipt of SPSAs, the vesting of SPSAs, or the conversion of vested SPSAs to Common Shares that cannot be satisfied by the means described in this paragraph. Except where applicable legal or regulatory provisions prohibit, the standard process for the payment of an Awardee's Tax-Related Items shall be for the Company or Awardee's actual employer to withhold in Common Shares only to the amount of shares necessary to satisfy the minimum withholding amount or such other amount determined by the Company as not resulting in negative accounting consequences for the Company. The Company may refuse to deliver Common Shares to Awardee if Awardee fails to comply with Awardee's obligation in connection with the Tax-Related Items as described in this Section 10.

(c) In lieu of issuing fractional Common Shares, on the vesting of a fraction of a SPSA, the Company shall round the shares to the nearest whole share and any such share that represents a fraction of a SPSA will be included in a subsequent vest date.

(d) Until the distribution to Awardee of the Common Shares in respect of the vested SPSAs is evidenced by a stock certificate, appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company, or other appropriate means, Awardee shall have no right to vote or receive dividends or any other rights as a shareholder with respect to such Common Shares, notwithstanding the vesting of SPSAs. No adjustment will be made for a dividend or other right for which the record date is prior to the date Awardee is recorded as the owner of the Common Shares, except as provided in Section 14 of the Plan.

(e) By accepting the Award of SPSAs evidenced by this Award Agreement, Awardee agrees not to sell any of the Common Shares received on account of vested SPSAs at a time when applicable laws or Company policies prohibit a sale. This restriction shall apply so long as Awardee is an Employee, Consultant or outside director of the Company or a Subsidiary of the Company.

11. Non-Transferability of SPSAs. Awardee's right in the SPSAs awarded under this Award Agreement and any interest therein 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. SPSAs shall not be subject to execution, attachment or other process.

12. Acknowledgment of Nature of Plan and SPSAs. In accepting the Award, Awardee acknowledges that:

(a) the Plan is established voluntarily by the Company, it is discretionary in nature and may be modified, amended, suspended or terminated by the Company at any time, as provided in the Plan;

(b) the Award of SPSAs is voluntary and occasional and does not create any contractual or other right to receive future awards of SPSAs or other awards, or benefits in lieu of SPSAs even if SPSAs have been awarded repeatedly in the past;

(c) all decisions with respect to SPSAs or other future awards, if any, will be at the sole discretion of the Company;

(d) Awardee's participation in the Plan is voluntary;

(e) the future value of the underlying Common Shares is unknown and cannot be predicted with certainty;

(f) if Awardee receives Common Shares, the value of such Common Shares acquired on vesting of SPSAs may increase or decrease in value;

(g) notwithstanding any terms or conditions of the Plan to the contrary and consistent with Section 5 above, in the event of termination of Awardee's Continuous Status as a Participant under circumstances where Section 8 does not apply (whether or not in breach of applicable laws) Awardee's right to receive SPSAs and vest under the Plan, if any, will terminate effective as of the date that Awardee is no longer actively employed and will not be extended by any notice period mandated under applicable law. Awardee's right to receive Common Shares pursuant to the SPSAs after termination of Continuous Status as a Participant employment, if any, will be calculated as of the date of termination of Awardee's active employment and will not be extended by any notice period mandated under applicable law. The Committee shall have the exclusive discretion to determine when Awardee is no longer actively employed for purposes of the award of SPSAs;

(h) Awardee acknowledges and agrees that, regardless of whether Awardee is terminated with or without cause, notice or pre-termination procedure or whether Awardee asserts or prevails on a claim that Awardee's employment was terminable only for cause or only with notice or pre-termination procedure, Awardee has no right to, and will not bring any legal claim or action for, (a) any damages for any portion of the SPSAs that have been vested and converted into Common Shares, or (b) termination of any unvested SPSAs under this Award Agreement; and

(i) Awardee promises never to pursue any claim relating to the Plan or this Award Agreement before (1) notifying the Company in writing of Awardee's claim within thirty (30) days after Awardee first knows or should have known the facts on which the claim is based, (2) if requested by the Company to do so within thirty (30) days after so notifying the Company, participating in good faith in any nonbinding dispute resolution procedure the Company prescribes, and (3) keeping Awardee's claim completely confidential, except to the minimum extent needed to pursue the claim, until all the requirements of this subsection have been satisfied. The dispute resolution procedure the Company prescribes shall be paid for by the Company and must be reasonably capable of being completed within ninety (90) days after Awardee is requested to use it. Awardee agrees that his or her right to any awards, stock or amounts under this Award Agreement are conditioned on Awardee's strictly complying with the requirements of this subsection.

13. Data Privacy Notice and Consent. Awardee hereby explicitly and unambiguously consents to the collection, use and transfer, in electronic or other form, of Awardee's personal data as described in this Award Agreement by and among, as applicable, Awardee's actual employer, the Company, its Subsidiaries and its affiliates for the exclusive purpose of implementing, administering and managing Awardee's participation in the Plan.

Awardee understands that the Company and Awardee's actual employer may hold certain personal information about Awardee, including, but not limited to, Awardee's name, home address and telephone number, date of birth, social insurance number or other identification number, salary, nationality, job title, any shares of stock or directorships held in the Company, details of all SPSAs or any other entitlement to Common Shares awarded, canceled, vested, unvested or outstanding in Awardee's favor, for the purpose of implementing, administering and managing the Plan ("Data"). Awardee understands that Data may be transferred to any third parties assisting in the implementation, administration and management of the Plan, that these recipients may be located in Awardee's country, or elsewhere, and that the recipient's country may have different data privacy laws and protections than Awardee's country. Awardee understands that Awardee may, to the extent required by local law, request a list with the names and addresses of any potential recipients of the Data by contacting Awardee's local human resources representative. Awardee authorizes the recipients to receive, possess, use, retain and transfer the Data, in electronic or other form, for the sole purpose of implementing, administering and managing Awardee's participation in the Plan, including any requisite transfer of such Data as may be required to a broker, escrow agent or other third party with whom Awardee may elect to deposit any Common Shares received upon vesting of the SPSAs. Awardee understands that Data will be held only as long as is necessary to implement, administer and manage Awardee's participation in the Plan. Awardee understands that Awardee may to the extent required by local law, at any time, view Data, request additional information about the storage and processing of Data, require any necessary amendments to Data or refuse or withdraw the consents herein, in any case without cost, by contacting in writing Awardee's local human resources representative. Awardee understands that refusal or withdrawal of consent may affect Awardee's ability to participate in the Plan. For more information on the consequences of Awardee's refusal to consent or withdrawal of consent, Awardee understands that Awardee may contact Awardee's local human resources representative.

14. No Employment Right; Effect of Relocation Outside U.S.A. Awardee acknowledges that neither the fact of this Award of SPSAs nor any provision of this Award Agreement or the Plan or the policies adopted pursuant to the Plan shall confer upon Awardee any right with respect to employment or continuation of current employment with the Company or with Awardee's actual employer, or to employment that is not terminable at will. Awardee further acknowledges and agrees that neither the Plan nor this Award of SPSAs makes Awardee's employment with the Company or Awardee's actual employer for any minimum or fixed period, and that such employment is subject to the mutual consent of Awardee and the Company or Awardee's actual employer, and may be terminated by either Awardee or the Company or Awardee's actual employer at any time, for any reason or no reason, with or without cause or notice or any kind of pre- or post-termination warning, discipline or procedure. In the event Awardee's employment with the Company is relocated outside the United States, this Stock Award Agreement shall be amended to include such provisions regarding employment rights with respect to the SPSAs as the Company, in its sole discretion, has determined to be appropriate for inclusion in SPSA Award Agreements for the location to which Awardee relocates.

15. Administration. The authority to manage and control the operation and administration of this Award Agreement shall be vested in the Committee (as such term is defined in Section 2(f) of the Plan). The Committee shall have all powers and discretion with respect to this Award Agreement as it has with respect to the Plan. Any interpretation of the Award Agreement by the Committee and any decision made by the Committee with respect to the Award Agreement shall be final and binding on all parties.

16. Plan Governs. Notwithstanding anything in this Award Agreement to the contrary, the terms of this Award Agreement shall be subject to the terms of the Plan, and this Award Agreement is subject to all interpretations, amendments, rules and regulations promulgated by the Committee from time to time pursuant to the Plan.

17. Notices. Any written notices provided for in this Award Agreement that are sent by mail shall be deemed received three business days after mailing, but not later than the date of actual receipt. Notices shall be directed, if to Awardee, at Awardee's address indicated by the Company's records and, if to the Company, at the Company's principal executive office.

18. Electronic Delivery. The Company may, in its sole discretion, decide to deliver any documents related to SPSAs awarded under the Plan or future SPSAs that may be awarded under the Plan by electronic means or request Awardee's consent to participate in the Plan by electronic means. Awardee hereby consents to receive such documents by electronic delivery and agrees to participate in the Plan through an on-line or electronic system established and maintained by the Company or another third party designated by the Company.

19. Acknowledgment. By Awardee's acceptance as evidenced below, Awardee acknowledges that Awardee has received and has read, understood and accepted all the terms, conditions and restrictions of this Award Agreement, the Plan, and the current SPSA Administrative Policies (Executive Officers) referenced in Section 3(b) of this Award Agreement. Awardee understands and agrees that this Award Agreement is subject to all the terms, conditions, and restrictions stated in this Award Agreement and in the other documents referenced in the preceding sentence, as the latter may be amended from time to time in the Company's sole discretion.

20. Board Approval. These SPSAs have been awarded pursuant to the Plan and accordingly this Award of SPSAs is subject to approval by the Committee. If this Award of SPSAs has not already been approved, the Company agrees to submit this Award for approval as soon as practical. If such approval is not obtained, this award is null and void.

21. Governing Law. This Award Agreement shall be governed by the laws of the State of Washington, U.S.A., without regard to Washington laws that might cause other law to govern under applicable principles of conflicts of law. For purposes of litigating any dispute that arises under this Award of SPSAs or this Award Agreement, the parties hereby submit to and consent to the jurisdiction of the State of Washington, and agree that such litigation shall be conducted in the courts of King County, Washington, or the federal courts for the United States for the Western District of Washington, and no other courts, where this Award of SPSAs is made and/or to be performed.

22. Severability. If one or more of the provisions of this Award Agreement shall be held invalid, illegal or unenforceable in any respect, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby and the invalid, illegal or unenforceable provisions shall be deemed null and void; however, to the extent permissible by law, any provisions which could be deemed null and void shall first be construed, interpreted or revised retroactively to permit this Award Agreement to be construed so as to foster the intent of this Award Agreement and the Plan.

23. Internal Revenue Code section 409A. This Award Agreement shall be interpreted, operated, and administered in a manner so as not to subject Awardee to the assessment of additional taxes or interest under Code section 409A, and this Award Agreement shall be amended as the Company, in its sole discretion, determines is necessary and appropriate to avoid the application of any such taxes or interest.

24. Complete Award Agreement and Amendment. This Award Agreement (which includes Appendix A and the SPSA Administrative Policies (Executive Officers) referenced in Section 3(b), each as modified from time to time), the Notice of Receipt of Stock Awards (if any), and the Plan constitute the entire agreement between Awardee and the Company regarding this award of SPSAs. Any prior agreements, commitments or negotiations concerning these SPSAs are superseded. This Award Agreement may be amended only by written agreement of Awardee and the Company, except that (i) Appendix A and the SPSA Administrative Policies (Executive Officers) referenced in Section 3(b) may be modified by the Company as described in this Award Agreement (including Appendix A) or the SPSA Administrative Policies (Executive Officers), and (ii) no written agreement is necessary for an amendment that in the reasonable judgment of the Compensation Committee confers a benefit on the Awardee. Awardee agrees not to rely on any oral information regarding this Award of SPSAs or any written materials not identified in this Section 24.

EXECUTED as of the Award Date first above written.

MICROSOFT CORPORATION
Lisa Brummel,

/s/ Lisa Brummel
Senior Vice President, Human Resources

AWARDEE'S ACCEPTANCE:
I have read and fully understood this Award Agreement and, as referenced in Section 19 above, I accept and agree to be bound by all of the terms, conditions and restrictions contained in this Award Agreement and the other documents referenced in it. I intend to express my acceptance of the Award and this Award Agreement by typing my name in the Awardee acceptance window provided in “step 2” of the award acceptance checklist, and I further intend the typing of my name to have the same force and effect in all respects as a handwritten signature.

Exhibit 15

January 24, 2008

Microsoft Corporation
One Microsoft Way
Redmond, Washington

We have reviewed, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the unaudited interim financial information of Microsoft Corporation and subsidiaries for the periods ended December 31, 2007 and 2006, as indicated in our report dated January 24, 2008; because we did not perform an audit, we expressed no opinion on that information.

We are aware that our report referred to above, which was included in your Quarterly Report on Form 10-Q for the quarter ended December 31, 2007, is incorporated by your reference in Registration Statements Nos. 333-120511, 333-109185, 333-06298, 333-16665, 333-118764, 333-91755, 333-52852, 333-102240, 33-36498, 33-45617 and 333-132100 of Microsoft Corporation on Forms S-8 and Registration Statement Nos. 333-43449, 333-110107, and 333-108843 of Microsoft Corporation on Forms S-3.

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

DELOITTE & TOUCHE LLP

/s/ DELOITTE & TOUCHE LLP
Seattle, Washington

Exhibit 31.1

CERTIFICATIONS

I, Steven A. Ballmer, certify that:

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

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

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

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

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

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

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

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

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

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

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

January 24, 2008

/s/ Steven A. Ballmer

Steven A. Ballmer
Chief Executive Officer

Exhibit 31.2

CERTIFICATIONS

I, Christopher P. Liddell, certify that:

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

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

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

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

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

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

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

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

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

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

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

January 24, 2008

/s/ Christopher P. Liddell

Christopher P. Liddell
Chief Financial Officer

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

In connection with the Quarterly Report of Microsoft Corporation, a Washington corporation (the “Company”), on Form 10-Q for the quarter ended December 31, 2007, as filed with the Securities and Exchange Commission (the “Report”), Steven A. Ballmer, Chief Executive Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

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

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

/s/ Steven A. Ballmer

Steven A. Ballmer
Chief Executive Officer
January 24, 2008

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

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

In connection with the Quarterly Report of Microsoft Corporation, a Washington corporation (the "Company"), on Form 10-Q for the quarter ended December 31, 2007, as filed with the Securities and Exchange Commission (the "Report"), Christopher P. Liddell, Chief Financial Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

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

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

/s/ Christopher P. Liddell

Christopher P. Liddell
Chief Financial Officer
January 24, 2008

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