MICROSOFT CORP
Form 10-Q
January 25, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended December 31, 2006

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 x 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 x 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 x

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 22, 2007**
Common Stock, $0.00000625 par value per share	9,792,314,405 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2006

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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,	
	2006	2005	2006	2005
Revenue	$ 12,542	$ 11,837	$ 23,353	$ 21,578
Operating expenses:				
Cost of revenue	3,620	2,239	5,316	3,492
Research and development	1,637	1,591	3,423	3,106
Sales and marketing	2,999	2,689	5,190	4,634
General and administrative	814	661	1,478	1,643
Total operating expenses	9,070	7,180	15,407	12,875
Operating income	3,472	4,657	7,946	8,703
Investment income and other	333	480	900	986
Income before income taxes	3,805	5,137	8,846	9,689
Provision for income taxes	1,179	1,484	2,742	2,895
Net income	$ 2,626	$ 3,653	$ 6,104	$ 6,794
Earnings per share:				
Basic	$ 0.27	$ 0.35	$ 0.62	$ 0.64
Diluted	$ 0.26	$ 0.34	$ 0.61	$ 0.63
Weighted average shares outstanding:				
Basic	9,806	10,560	9,867	10,628
Diluted	9,942	10,638	9,996	10,708
Cash dividends declared per common share	$ 0.10	$ 0.09	$ 0.20	$ 0.17

See accompanying notes.

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MICROSOFT CORPORATION

BALANCE SHEETS

(In millions)

	December 31, 2006 (Unaudited)	June 30, 2006(1)
Assets		
Current assets:		
Cash and equivalents	$ 6,859	$ 6,714
Short-term investments (including securities pledged as collateral of $2,473 and $3,065)	22,014	27,447
Total cash, equivalents, and short-term investments	28,873	34,161
Accounts receivable, net of allowance for doubtful accounts of $136 and $142	9,895	9,316
Inventories, net	1,725	1,478
Deferred income taxes	2,607	1,940
Other	2,080	2,115
Total current assets	45,180	49,010
Property and equipment, net	3,686	3,044
Equity and other investments	9,631	9,232
Goodwill	4,189	3,866
Intangible assets, net	745	539
Deferred income taxes	1,656	2,611
Other long-term assets	1,284	1,295
Total assets	$ 66,371	$ 69,597
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 2,944	$ 2,909
Accrued compensation	1,559	1,938
Income taxes	1,337	1,557
Short-term unearned revenue	10,023	9,138
Securities lending payable	2,713	3,117
Other	3,639	3,783
Total current liabilities	22,215	22,442
Long-term unearned revenue	1,838	1,764
Other long-term liabilities	5,684	5,287
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding 9,777 and 10,062	61,152	59,005
Retained deficit, including accumulated other comprehensive income of $1,582 and $1,229	(24,518)	(18,901)
Total stockholders equity	36,634	40,104
Total liabilities and stockholders equity	$ 66,371	$ 69,597

(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,	
	2006	**2005**	**2006**	**2005**
Operations				
Net income	$ 2,626	$ 3,653	$ 6,104	$ 6,794
Depreciation, amortization, and other noncash items	365	231	614	465
Stock-based compensation expense	437	514	893	978
Net recognized gains on investments	(29)	(75)	(235)	(205)
Excess tax benefits from stock-based payment arrangements	(8)	(13)	(48)	(44)
Deferred income taxes	(517)	170	(351)	42
Unearned revenue	6,029	3,670	9,246	6,702
Recognition of unearned revenue	(4,265)	(3,622)	(8,315)	(7,041)
Accounts receivable	(2,945)	(2,012)	(444)	(604)
Other current assets	723	(354)	(357)	(694)
Other long-term assets	(264)	(10)	(399)	(8)
Other current liabilities	(354)	(89)	(1,196)	(298)
Other long-term liabilities	244	168	591	473
Net cash from operations	2,042	2,231	6,103	6,560
Financing				
Common stock issued	4,449	466	4,834	1,467
Common stock repurchased	(5,797)	(7,435)	(13,480)	(10,551)
Common stock cash dividends	(980)	(846)	(1,877)	(1,703)
Excess tax benefits from stock-based payment arrangements	8	13	48	44
Other	(3)	0	(23)	0
Net cash used for financing	(2,323)	(7,802)	(10,498)	(10,743)
Investing				
Additions to property and equipment	(572)	(318)	(983)	(531)
Acquisition of companies, net of cash acquired	(125)	(63)	(461)	(250)
Purchases of investments	(9,102)	(16,151)	(21,957)	(35,561)
Maturities of investments	1,325	743	2,159	1,692
Sales of investments	7,448	22,481	26,149	38,081
Securities lending payable	(932)	0	(404)	0
Net cash from (used for) investing	(1,958)	6,692	4,503	3,431
Net change in cash and equivalents	(2,239)	1,121	108	(752)
Effect of exchange rates on cash and equivalents	22	(12)	37	(16)
Cash and equivalents, beginning of period	9,076	2,974	6,714	4,851
Cash and equivalents, end of period	$ 6,859	$ 4,083	$ 6,859	$ 4,083

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,	
	2006	**2005**	**2006**	**2005**
Common stock and paid-in capital				
Balance, beginning of period	$ 57,657	$ 60,862	$ 59,005	$ 60,413
Common stock issued	4,436	462	4,834	1,289
Common stock repurchased	(1,232)	(1,629)	(3,106)	(2,360)
Stock-based compensation expense	437	514	893	978
Stock option income tax deficiencies	(147)	(69)	(481)	(181)
Other, net	1	0	7	1
Balance, end of period	61,152	60,140	61,152	60,140
Retained deficit				
Balance, beginning of period	(21,556)	(12,535)	(18,901)	(12,298)
Net income	2,626	3,653	6,104	6,794
Other comprehensive income:				
Net gains/(losses) on derivative instruments	(1)	94	(28)	136
Net unrealized investments gains/(losses)	184	(156)	337	(333)
Translation adjustments and other	35	(13)	44	(19)
Comprehensive income	2,844	3,578	6,457	6,578
Common stock cash dividends	(974)	(928)	(1,949)	(1,780)
Common stock repurchased	(4,832)	(6,047)	(10,125)	(8,432)
Balance, end of period	(24,518)	(15,932)	(24,518)	(15,932)
Total stockholders equity	$ 36,634	$ 44,208	$ 36,634	$ 44,208

See accompanying notes.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

Note 1 Basis of Presentation and Consolidation

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 life cycles, 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; 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 Management s Discussion and Analysis and the financial statements and notes thereto included in the Microsoft Corporation 2006 Form 10-K.

As discussed in Note 8, effective July 1, 2006, we reorganized our business into five operating segments, organized under one of three operating divisions. Accordingly, we have restated prior period segment information to conform to the current period presentation.

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 are accounted for under the cost method.

Note 2 Inventories, net

Components of inventories were as follows:

(In millions)	December 31, 2006	June 30, 2006
Finished goods	**$ 1,431**	$ 1,013
Raw materials and work in process	**294**	465
Inventories, net	**$ 1,725**	$ 1,478

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.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

(In millions, except earnings per share)	**Three Months Ended December 31, 2006**	**2005**	**Six Months Ended December 31, 2006**	**2005**
Net income available for common shareholders (A)	**$ 2,626**	$ 3,653	**$ 6,104**	$ 6,794
Weighted average outstanding shares of common stock (B)	**9,806**	10,560	**9,867**	10,628
Dilutive effect of employee stock options and awards	**136**	78	**129**	80
Common stock and common stock equivalents (C)	**9,942**	10,638	**9,996**	10,708
Earnings per share:				
Basic (A/B)	**$ 0.27**	$ 0.35	**$ 0.62**	$ 0.64
Diluted (A/C)	**$ 0.26**	$ 0.34	**$ 0.61**	$ 0.63

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, 2006**	**2005**	**Six Months Ended December 31, 2006**	**2005**
Shares excluded from calculation of diluted EPS	**240**	674	**266**	672
Shared performance stock awards excluded from calculation of diluted EPS	**10**	26	**10**	26

Note 4 Unearned Revenue

Components of unearned revenue were as follows:

(In millions)	**December 31, 2006**	**June 30, 2006**
Volume licensing programs	**$ 6,917**	$ 7,661
Undelivered elements	**3,757**	2,066
Other	**1,187**	1,175
Unearned revenue	**$ 11,861**	$ 10,902

Unearned revenue by segment was as follows:

(In millions)	December 31, 2006	June 30, 2006
Client	**$ 3,953**	$ 2,851
Server and Tools	**2,702**	2,910
Microsoft Business Division	**4,863**	4,783
Other	**343**	358
Unearned revenue	**$ 11,861**	$ 10,902

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

The increase in Client and Microsoft Business Division unearned revenue was primarily attributable to undelivered elements associated with the Express Upgrade to Windows Vista and Microsoft Office Technology Guarantee programs and shipments currently in the channel that will be recognized upon consumer launch of Windows Vista and the 2007 Microsoft Office system. The technology guarantee programs provide consumers who purchase current products with free or discounted rights to Windows Vista and the 2007 Microsoft Office system when those products become available to consumers. The unearned revenue balance reflects an increase from June 30, 2006 primarily due to revenue deferrals from the above programs totaling $45 million and $1.6 billion in the first and second quarters of fiscal year 2007, respectively.

Note 5 Stockholders Equity

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20 billion tender offer, which was completed on August 17, 2006; and authorization for up to an additional $20 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 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, 2006, approximately $29.3 billion remained of the $36.2 billion approved repurchase amount. All repurchases were made using cash. The repurchase program may be suspended or discontinued at any time without notice. In any period, cash used in financing activities related to common stock repurchased may differ from the comparable change in stockholders equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

We repurchased common stock in fiscal year 2006 pursuant to the repurchase program approved by our Board of Directors on July 20, 2004 to buy back up to $30 billion of Microsoft common stock. On July 20, 2006, we announced the completion of that repurchase program. The repurchases were made using our cash resources.

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)	**2006**	**2005**	**2006**	**2005**
Shares of common stock repurchased	**205.4**	283.1	**490.5**	397.2
Value of common stock repurchased	**$ 6,037**	$ 7,666	**$ 12,989**	$ 10,695

In December 2006, JP Morgan Chase Bank (JPMorgan) exercised approximately 113 million call options for $3.3 billion at an average price per share of $28.80. The call options were among 345 million options acquired by JPMorgan in fiscal year 2004 through our employee stock option transfer program. The other approximately 232 million options expired unexercised and, as of December 31, 2006, no options transferred in the program remained outstanding.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

During the six months ended December 31, 2006, and 2005, our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
(Fiscal year 2007)				
September 13, 2006	$ 0.10	November 16, 2006	$ 980	December 14, 2006
December 20, 2006	$ 0.10	February 15, 2007	$ 978(1)	March 8, 2007
(Fiscal year 2006)				
September 23, 2005	$ 0.08	November 17, 2005	$ 846	December 8, 2005
December 14, 2005	$ 0.09	February 17, 2006	$ 926	March 9, 2006

(1) This dividend was included in other current liabilities on our balance sheet as of December 31, 2006.

Note 6 Investment Income and Other

Components of investment income and other were as follows:

(In millions)	Three Months Ended December 31, 2006	2005	Six Months Ended December 31, 2006	2005
Dividends and interest	**$ 316**	$ 382	**$ 685**	$ 758
Net recognized gains on investments	**103**	212	**466**	238
Net losses on derivatives	**(75)**	(185)	**(231)**	(99)
Other, net	**(11)**	71	**(20)**	89
Investment income and other	**$ 333**	$ 480	**$ 900**	$ 986

Note 7 Contingencies

Government competition law matters. In March 2004, the European Commission issued a decision in its competition law investigation of us. The Commission concluded that we infringed European competition law by refusing to provide our competitors with licenses to certain protocol technology in the Windows server operating systems and by including streaming media playback functionality in Windows desktop operating systems. The Commission ordered us to make the relevant licenses to our technology available to our competitors and to develop and make available a version of the Windows desktop operating system that does not include specified software relating to media playback. The decision also imposed a fine of 497 million ($605 million). We appealed the decision to the Court of First Instance, on the basis that we did not infringe European competition law. In July 2006 the European Commission announced its determination that we had not complied with the technical documentation requirements of the 2004 Decision, and levied a fine of 281 million ($351 million). We have appealed this fine to the Court of First Instance. Both fines have been paid, pending appeals.

In December 2005, the Korean Fair Trade Commission (KFTC) announced a ruling in its investigation of us, holding that we abused a market dominant position and engaged in unfair trade practices under the Korean Fair Trade Act by incorporating instant messaging and media player functionality into the Windows PC operating system, and streaming media technologies into the Windows server operating system. The KFTC also imposed a fine of approximately $34 million. The KFTC s ruling and corrective order issued in February 2006 held that our integration of

Windows Media Player and Windows Messenger in Windows PC operating systems and

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

integration of Windows Media Services in Windows server operating systems constituted an abuse of monopoly power and unlawful tying in violation of the Korean Fair Trade Act. Under the order, which became effective in August 2006, we are required to develop and distribute in Korea versions of Windows XP and its successors that do not include Windows Media Player or Windows Messenger functionality. In addition, we also may distribute a second modified version of Windows that contains the removed functionality, provided the second version includes promotional links in the user interface that will enable consumers to link to and download a select group of competing media players and instant messengers. We have appealed the KFTC s decision to the Seoul High Court. In May 2006, the KFTC denied our motion for reconsideration of its ruling, but also dropped the element of its ruling that prohibited us from including Windows Media Player or Windows Messenger, or any feature with similar functionality, in any product other than the Windows client operating system for which we have a 50% or greater market share. On August 23, 2006, we announced the release to manufacture of the mandated versions of Windows XP Home Edition and Windows XP Professional Edition.

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 and federal courts on behalf of variously defined classes of direct and indirect purchasers of our PC operating system and certain software applications products. We were successful in obtaining 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 in a number of other cases. Under the settlements, class members will be able to obtain vouchers that entitle the class members to be reimbursed up to the face value of their vouchers for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that may be issued varies by state. A percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state) will be made available to certain schools. The total value of vouchers ultimately issued will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued in these settlements is approximately $2.5 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools who are issued and redeem vouchers. The settlements in most states have received final court approval. Settlements in Arkansas and Wisconsin have received preliminary court approval. The cases in Mississippi have not been settled. In Iowa, a jury trial on the plaintiffs claims began in November 2006. We estimate the total cost to resolve all of these cases will range between $1.5 billion and $1.8 billion, with the actual cost dependent upon many unknown factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims process. In accordance with SFAS No. 5, *Accounting for Contingencies*, and FIN No. 14, *Reasonable Estimation of the Amount of a Loss,* at December 31, 2006, we have recorded a liability related to these claims of approximately $1.1 billion, which reflects our estimated exposure of $1.5 billion less payments made to date of approximately $400 million, primarily for administrative expenses and legal fees.

Other antitrust litigation and claims. In November 2004, Novell, Inc. filed a complaint in the U.S. District Court for 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

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

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. An appeal of that ruling is now pending and the case is effectively stayed during the appeal.

Patent and intellectual property claims. We are a defendant in more than 35 patent infringement cases that we are defending vigorously. In the case of *Eolas Technologies, Inc. and University of California v. Microsoft*, filed in the U.S. District Court for the Northern District of Illinois in February 1999, the plaintiffs alleged infringement by the browser functionality of Windows. In January 2004, the trial court entered final judgment of $565 million, and entered an injunction against distribution of any new infringing products, but stayed execution of the judgment and the injunction pending our appeal. We appealed and in March 2005 the U.S. Court of Appeals for the Federal Circuit reversed the decision and vacated the judgment, based on certain evidentiary rulings of the trial court. The appellate court also reversed the trial court s decision that the inventors had not engaged in inequitable conduct. We believe the total cost to resolve this case will not be material to our financial position, results of operations, or our cash flows. The actual costs will be dependent upon many unknown factors such as the events of a retrial of the plaintiff s claims. In *Microsoft v. Lucent*, filed in the U.S. District Court in San Diego in April 2003, we are seeking a declaratory judgment that we do not infringe any valid patent among a number of patents Lucent has been asserting against computer manufacturers that sell computers with our software pre-installed. The first in a series of back-to-back trials on the various patent groupings is currently set to begin in January 2007. In March 2006, Lucent filed a new lawsuit against us in U.S. District Court in San Diego, claiming the Xbox 360 violates one of the patents that earlier had been dismissed from the older lawsuit. In response to Lucent s new complaint, we asserted patent infringement counterclaims accusing Lucent of infringing 10 Microsoft patents by its sales of various products. No trial date has been set in the new lawsuit. In *Z4 Technologies, Inc. v. Microsoft,* the plaintiff alleged that Microsoft Windows and Office product activation functionality violates its patent rights. In April 2006, the jury rendered a $115 million verdict against us. In August 2006, the trial court increased damages by $25 million pursuant to the jury s finding of willful infringement and awarded Z4 $2 million in attorneys fees. We have appealed the verdict. In *Veritas Operating Corporation v. Microsoft*, filed in the U.S. District Court for the Western District of Washington in May 2006, a subsidiary of Symantec filed an action asserting claims of trade secret misappropriation, breach of contract, and patent infringement relating to certain storage technologies. Adverse outcomes in some or all of the matters described in this paragraph may result in significant monetary damages or injunctive relief against us that would adversely affect distribution of our operating system or application products. The risks associated with an adverse decision may result in material settlements.

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, 2006, we had accrued aggregate liabilities totaling approximately $800 million in other current liabilities and approximately $700 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 which we estimate could be up to $1.0 billion in aggregate beyond recorded amounts. Were an unfavorable final outcome to occur, there exists the possibility of a material adverse impact on the Company s financial position, results of operations, and cash flows for the period in which the effect becomes reasonably estimable.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 8 Segment Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, 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 run the business, including internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. Effective July 1, 2006, we reorganized our business into five operating segments, organized under one of three operating divisions Platforms and Services Division, Microsoft Business Division, and Entertainment and Devices Division.

The five operating segments are described below. The first three of these comprise the Platforms and Services Division.

Client includes the former Client segment. Client generates nearly all of its revenue from the licensing of the Windows line of operating systems, including Windows Vista, Windows XP Professional and Home, Media Center Edition, Tablet PC Edition, and other standard Windows operating systems.

Server and Tools includes the former Server and Tools segment, excluding Exchange Server, Exchange client access licenses and a portion of Core client access licenses which are now a part of the Microsoft Business Division. Server and Tools generates revenues from the following products: Windows Server operating system, Microsoft SQL Server, Visual Studio, Forefront security family of products, and Biz Talk Server among others. In addition, Server and Tools provides the following services: Microsoft Consulting Services; Premier; and professional support services.

Online Services Business (OSB) includes the former MSN segment and Windows Live. OSB derives its revenue principally through the delivery of advertising and paid search. OSB also generates services revenue through providing the following online offerings: MSN Internet Access; MSN Premium Web Services (consisting of MSN Internet Software Subscriptions, MSN Hotmail Plus, MSN Bill Pay, and MSN Radio Plus); and MSN Mobile Services.

Microsoft Business Division (MBD) includes the former Information Worker and Microsoft Business Solutions segments, and the Exchange Server business and certain client access licenses formerly included in the Server and Tools segment. MBD derives its revenues principally through the Microsoft Office system which includes: Microsoft Office, Microsoft Project; Microsoft Visio; Microsoft Access; SharePoint Portal Server client access licenses; OneNote; Office Communication Server; Microsoft Office Small Business Accounting; and revenues generated by Microsoft LiveMeeting. Product revenues are also derived through licensing the Dynamics suite of software including: Microsoft Dynamics AX; Microsoft Dynamics CRM; Microsoft Dynamics GP; Microsoft Dynamics NAV; Microsoft Dynamics SL; and Microsoft Dynamics Retail Management System.

Entertainment and Devices Division (EDD) includes the former Home and Entertainment and Mobile and Embedded Devices segments. EDD generates product revenues through both hardware and software sales and licensing. The Xbox 360 console generates the majority of hardware revenue with the remainder driven by consumer peripherals and accessories, including the Zune digital music and entertainment device. Software revenues are generated by Xbox games; games for Windows; Mac Office; MSTV Platforms; Windows Mobile software platform and Windows Embedded device operating system. Online services revenues are generated by certain product support and Xbox Live.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

(In millions)	Three Months Ended December 31, 2006	2005	Six Months Ended December 31, 2006	2005
Revenue				
Client	**$ 2,531**	$ 3,464	**$ 5,831**	$ 6,586
Server and Tools	**2,847**	2,450	**5,350**	4,574
OSB	**624**	596	**1,163**	1,161
MBD	**3,502**	3,718	**6,936**	6,970
EDD	**3,002**	1,703	**4,021**	2,299
Unallocated and other	**36**	(94)	**52**	(12)
Consolidated	**$ 12,542**	$ 11,837	**$ 23,353**	$ 21,578
Operating income/(loss)				
Client	**$ 1,770**	$ 2,706	**$ 4,454**	$ 5,281
Server and Tools	**1,029**	839	**1,882**	1,497
OSB	**(153)**	125	**(287)**	212
MBD	**2,132**	2,500	**4,391**	4,747
EDD	**(277)**	(275)	**(425)**	(456)
Reconciling amounts	**(1,029)**	(1,238)	**(2,069)**	(2,578)
Consolidated	**$ 3,472**	$ 4,657	**$ 7,946**	$ 8,703

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. Intersegment cost commissions are estimated by management and used to compensate or charge each segment for such shared costs and to incent shared efforts.

Reconciling amounts include adjustments to conform significant internal accounting policies with U.S. GAAP and corporate-level activity not specifically attributed to a segment. Certain revenue and expenses, including legal settlements and legal contingencies, are excluded from segments or included in corporate-level activity. Significant reconciling items to arrive at operating income were as follows:

(In millions)	Three Months Ended December 31, 2006	2005	Six Months Ended December 31, 2006	2005
Summary of reconciling amounts:				
Corporate-level activity	**$ (1,165)**	$ (988)	**$ (2,196)**	$ (2,286)
Stock-based compensation expense	**(2)**	(135)	**(59)**	(264)
Revenue reconciling amounts	**28**	(94)	**29**	(12)
Other	**110**	(21)	**157**	(16)
Total	**$ (1,029)**	$ (1,238)	**$ (2,069)**	$ (2,578)

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 9 Goodwill

During the six months ended December 31, 2006, we recorded goodwill resulting from the following acquisitions:

Server and Tools: Softricity, Inc. ($191 million); Whale Communications Ltd. ($66 million); Winternals Software LP ($31 million); and others ($19 million);

Online Services Business: Gteko Ltd. ($60 million) and other ($10 million); and

Entertainment and Devices Division: Colloquis, Inc. ($24 million).

All of the entities were consolidated with Microsoft since their respective acquisition dates. The purchase price allocations for these acquisitions are preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available. Any change in the fair value of the net assets of the acquired companies will change the amount of the purchase price allocable to goodwill. Pro forma results of operations have not been presented because the effects of these acquisitions, individually and in the aggregate, were not material.

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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 as of December 31, 2006, and the related consolidated statements of income, stockholders equity, and cash flows for the three-month and six-month periods ended December 31, 2006 and 2005. 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, 2006, 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 22, 2006, 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, 2006 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 23, 2007

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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, 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 entitled 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, financial condition, and cash flows 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 and channels around the world and Live Search.

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, Entertainment and Devices has generated over 40% of its yearly segment revenues in our second fiscal quarter. We believe the seasonality of revenue is likely to continue in the future.

Summary

(In millions, except percentages)	Three months ended December 31, 2006	Three months ended December 31, 2005	Percentage Change	Six months ended December 31, 2006	Six months ended December 31, 2005	Percentage Change
Revenue	**$ 12,542**	$ 11,837	6%	**$ 23,353**	$ 21,578	8%
Operating income	**$ 3,472**	$ 4,657	(25)%	**$ 7,946**	$ 8,703	(9)%

For the three and six months ended December 31, 2006, revenue growth was impacted by the $1.6 billion second quarter revenue deferral 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 provide consumers who purchase current products with free or discounted rights to Windows

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Vista and the 2007 Microsoft Office system when those products become available to consumers. Our revenue increase for the three and six months ended December 31, 2006 was driven primarily by sales of the Xbox 360 console which was launched in November 2005, sales of Zune, our digital music and entertainment device which was launched in November 2006, and increased licensing of SQL Server, Windows Server, and Visual Studio.

For the three months and six months ended December 31, 2006, operating income decreased primarily reflecting the revenue deferral, a shift to products with lower margins, and increased headcount-related costs as we continue to invest in our new and upcoming offerings such as the 2007 Microsoft Office system, the Windows Live platform, and Zune. Headcount-related costs, including stock-based compensation expense, increased 10% and 16%, respectively, during the three and six months ended December 31, 2006, reflecting a 15% increase in headcount over the past 12 months, an increase in salaries and benefits for existing headcount, and offsetting impacts of five and two percentage points, respectively, resulting from the capitalization of certain software development costs.

For the remainder of the fiscal year, we expect revenue to grow at a higher rate than fiscal year 2006, mainly reflecting significant product launches in fiscal year 2007. We expect to recognize the $1.6 billion of revenue deferred in the second quarter with the consumer launch of Windows Vista and 2007 Microsoft Office system during the third quarter of fiscal year 2007. We expect our operating income growth rate in fiscal year 2007 will lag behind our revenue growth rate. We expect our level of spending to increase in four key areas in fiscal year 2007: increased product costs associated with Xbox consoles and Zune devices; marketing and field sales spending including product launch costs; quickening the pace of development in growth areas such as business intelligence, security, management and unified communications (including through acquisitions); and increased costs to execute on our online services strategy. While these investments will translate into increased operating expenses, we believe they will help lay the groundwork for future growth and profitability.

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 8   Segment Information of the Notes is presented on a basis consistent with the Company s 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 presented separately. Fiscal year 2006 amounts have been restated for certain internal reorganizations.

Client

(In millions, except percentages)	Three months ended December 31, 2006	Three months ended December 31, 2005	Percentage Change	Six months ended December 31, 2006	Six months ended December 31, 2005	Percentage Change
Revenue	**$ 2,589**	$ 3,430	(25)%	**$ 5,892**	$ 6,591	(11)%
Operating income	**$ 1,880**	$ 2,661	(29)%	**$ 4,544**	$ 5,255	(14)%

Client consists of premium edition operating systems, including Windows XP Professional, Media Center Edition, Tablet PC Edition, and standard Windows operating systems, including Windows XP Home and Windows Vista. Premium offerings are Windows operating systems sold at a premium above Windows XP Home. 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.

Client revenue decreased for the three months ended December 31, 2006, primarily reflecting approximately $1.1 billion of revenue deferred as a result of the Express Upgrade to Windows Vista program and shipments

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currently in the channel that will be recognized upon consumer launch of Windows Vista. This revenue deferral was partially offset by 10% growth in OEM license units from increased PC unit shipments. During the quarter, 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) increased 18 percentage points to 67% over the prior year driven by the continued demand for Windows Media Center Edition. The differences between unit growth rates and revenue growth rates from year to year are affected by changes in the OEM Premium Mix, changes in the geographical mix, and the channel mix of products sold by large, multi-national OEMs versus those sold by local and regional system builders. Client revenue decreased during the six months ended December 31, 2006, reflecting the revenue deferrals, partially offset by 11% growth in OEM license units from increased PC unit shipments. Based on our preliminary estimates, total worldwide PC shipments from all sources grew 8% to 10% from the second quarter of the previous year and approximately 8% to 10% from the first half of the previous year driven by strong consumer demand in both emerging and mature markets.

Client operating income decreased during the three and six months ended December 31, 2006, reflecting the decreased revenue and increased costs of sales, including support costs, which were partially offset by decreased research and development expenses reflecting the capitalization of certain Windows Vista software development costs in the second quarter of fiscal year 2007. Headcount-related costs decreased 25% and 3%, respectively, during the three and six months ended December 31, 2006, reflecting an increase in salaries and benefits for existing headcount, a 5% increase in headcount, and offsetting impacts of 32 and 16 percentage points, respectively, resulting from the capitalization of certain software development costs.

For the remainder of fiscal year 2007, we expect revenue to grow reflecting improvement in the commercial and retail portion of the business due to the launch of Windows Vista. We expect our third quarter revenue to increase significantly as we recognize the $1.1 billion of revenue that was deferred in the second quarter. We expect PC shipments to grow 8% to 10% for fiscal year 2007. We believe that PC unit growth rates will be higher in the consumer segment than in the business segment and higher in emerging markets than in mature markets.

Server and Tools

	Three months ended December 31,		**Percentage**	**Six months ended December 31,**		**Percentage**
(In millions, except percentages)	**2006**	**2005**	**Change**	**2006**	**2005**	**Change**
Revenue	**$ 2,845**	$ 2,438	17%	**$ 5,344**	$ 4,565	17%
Operating income	**$ 1,032**	$ 767	35%	**$ 1,850**	$ 1,367	35%

Server and Tools consists 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. The segment uses multiple channels for licensing including pre-installed OEM versions, licenses through partners, and licenses directly to end customers. The licenses are sold both as one-time licenses and as multi-year volume licenses.

Server and server application revenue, including CAL revenue, and developer tools, training and certification revenue, increased $319 million or 16% during the three months and $643 million or 17% during the six months ended December 31, 2006. This increase was primarily driven by increased revenue associated with SQL Server, Windows Server, and Visual Studio and reflects broad adoption of Windows Server products. SQL Server 2005 and Visual Studio 2005 were launched in the second quarter of fiscal year 2006 and continue to produce revenue growth with SQL Server growing over 30% for the quarter and first half of fiscal year 2007. Overall revenue growth was also driven by Consulting, Premier, and Professional product support services revenue which grew $88 million or 20% during the three months and $136 million or 16% during the six months ended December 31, 2006.

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Server and Tools operating income increased during the three and six months ended December 31, 2006, primarily reflecting the increased revenue, partially offset by increased headcount-related costs and cost of revenue for services. Headcount-related costs increased 11% and 12% in the second quarter and first half of fiscal year 2007, respectively, reflecting both an increase in salaries and benefits for existing headcount and a 14% increase in headcount. Cost of revenue increased $49 million or 10% in the second quarter and $92 million or 10% in the first half of fiscal year 2007, reflecting the growth in consulting services provided.

We expect continued revenue growth from fiscal year 2006 product launches and the expansion of our products in security, management and overall Windows Server growth in fiscal year 2007. We continue to estimate that overall server hardware unit shipments will grow 10% to 12% in fiscal year 2007.

Online Services Business

(In millions, except percentages)	Three months ended December 31, 2006	Three months ended December 31, 2005	Percentage Change	Six months ended December 31, 2006	Six months ended December 31, 2005	Percentage Change
Revenue	**$ 624**	$ 593	5%	**$ 1,163**	$ 1,157	1%
Operating income (loss)	**$ (155)**	$ 58	(367)%	**$ (291)**	$ 137	(312)%

Online Services Business (OSB) includes personal communications services, such as e-mail and instant messaging, and 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, MSN Premium Web Services and One Care. Revenue is derived primarily from advertisers on MSN.com and Live Search, from consumers and partners through subscriptions and transactions generated from online paid services, and from MSN narrowband Internet access subscribers. AdCenter our internally developed advertising platform now serves all paid search traffic on our online properties in the U.S. and in certain international markets. We continue to launch new online initiatives and expect to do so in the future. For example, in the first half of fiscal year 2007, we have launched Live Search and Live.com in 47 international markets, Live Local Search in the U.S. and U.K., beta versions of MSN Soapbox (our expansion of the MSN Video experience), Virtual Earth ™ 3D and other offerings.

OSB revenue increased during the three months ended December 31, 2006, primarily driven by advertising revenue which increased $77 million or 20% to $462 million, due primarily to growth in display advertising for home page, portals, channels, email, and messaging services, partially offset by a $42 million or 31% decrease in access revenue. OSB revenue was flat during the six months ended December 31, 2006, primarily reflecting advertising revenue growth of $94 million or 13% to $836 million, which was offset by a $85 million or 30% decrease in access revenue. The increase in advertising revenue during the six months ended December 31, 2006 reflects increased display revenue partially offset by decreased search revenue as a result of the ongoing transition to adCenter. At December 31, 2006, OSB had 1.8 million access subscribers and 10.7 million total subscribers compared with 2.5 million access subscribers and 9.8 million total subscribers at December 31, 2005. In addition, we estimate that OSB has over 268 million active Hotmail accounts and over 263 million active Messenger accounts.

OSB operating income decreased for the three and six months ended December 31, 2006, primarily reflecting increased headcount-related costs primarily as a result of continued investments in Windows Live, adCenter, and other properties, and increased cost of revenue as a result of the continued build out of our data center infrastructure. Headcount-related costs increased 36% and 39%, respectively, during the three and six months ended December 31, 2006, reflecting both a 36% increase in headcount and an increase in salaries and benefits for existing headcount.

For the remainder of fiscal year 2007, we expect increased growth in display advertising revenue as the portals, channels, and communications services continue to expand globally and the overall Internet advertising

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market continues to expand. Search revenue is expected to benefit from the transition to adCenter in fiscal year 2007 despite market share pressure on search queries, while revenue from narrowband Internet Access is expected to continue to decline.

Microsoft Business Division

(In millions, except percentages)	Three months ended December 31, 2006	2005	Percentage Change	Six months ended December 31, 2006	2005	Percentage Change
Revenue	**$ 3,512**	$ 3,689	(5)%	**$ 6,936**	$ 6,972	(1)%
Operating income	**$ 2,169**	$ 2,445	(11)%	**$ 4,422**	$ 4,689	(6)%

Microsoft Business Division (MBD) consists of programs, servers, services, and solutions designed to increase personal, team, and organization productivity. MBD includes the Microsoft Office system, Microsoft Dynamics, and the Microsoft Partner Program. MBD also includes the Small and Mid-market Solutions & Partners organization, which focuses on helping Microsoft, its customers, and industry partners in the small and mid-market customer segments. Our Office System products represent over 90% of Microsoft Business Division revenues and include Microsoft Office, Microsoft Exchange Server and CALs, Microsoft Project, Microsoft Visio, Microsoft Office Communications Server, Sharepoint Portal Server and CALs, Microsoft LiveMeeting, and One Note. Revenue growth depends on the ability to add value to the core Office product set and expand our product offerings in other information worker and business solution areas such as document lifecycle management, collaboration, business intelligence, customer relationship management, and enterprise resource planning.

MBD revenue decreased during the three and six months ended December 31, 2006, primarily reflecting approximately $500 million of revenue deferred during the second quarter as a result of the Microsoft Office Technology Guarantee program and shipments currently in the channel that will be recognized upon the launch of the 2007 Microsoft Office system. Non-OEM revenue, which includes volume licensing, retail packaged products, and preinstalled versions of Office in Japan, decreased $170 million or 5% during the three months ended December 31, 2006, reflecting $312 million of revenue deferred for the Microsoft Office Technology Guarantee program and 2007 Microsoft Office system shipments currently in the channel. OEM revenue decreased $7 million or 2%, reflecting $188 million of revenue deferred for the Microsoft Office Technology Guarantee program. During the six months ended December 31, 2006, OEM revenue decreased $11 million or 1% while non-OEM revenue, which reflects a 19% increase in Microsoft Dynamics customer billings, remained flat.

MBD operating income decreased during the three months ended December 31, 2006, reflecting the decrease in revenue and an increase in sales and marketing expenses primarily related to the 2007 Microsoft Office system. MBD operating income decreased during the six months ended December 31, 2006, reflecting the decrease in revenue and an increase in costs associated with the 2007 Microsoft Office system. During the three and six months ended December 31, 2006, headcount-related costs increased 5% and 11%, respectively, reflecting an 8% increase in headcount over the past 12 months, an increase in salaries and benefits for existing headcount, and offsetting impacts of five and three percentage points, respectively, resulting from the capitalization of certain software development costs.

For the remainder of fiscal year 2007, we expect revenue growth in both non-OEM and OEM offerings due to the launch of the 2007 Microsoft Office system. We expect our third quarter revenue to increase significantly as we recognize the approximately $500 million of revenue that was deferred in the second quarter. We continue to develop plans to drive revenue growth in new areas such as unified communications and through our existing portfolio of Microsoft Dynamics products.

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Entertainment and Devices Division

(In millions, except percentages)	Three months ended December 31, 2006	2005	Percentage Change	Six months ended December 31, 2006	2005	Percentage Change
Revenue	**$ 2,964**	$ 1,687	76%	**$ 3,994**	$ 2,293	74%
Operating loss	**$ (289)**	$ (286)	(1)%	**$ (383)**	$ (459)	17%

Entertainment and Devices Division (EDD) products include the Microsoft Xbox video game console system, PC games, consumer software and hardware products, the Zune digital music and entertainment device, TV platform products for the interactive television industry, and Mobile and Embedded devices (principally Windows Mobile software platform and Windows Embedded device operating system). The success of video game consoles is determined by console innovation, 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 launched during the quarter. We also believe launching in advance of competing consoles will provide a strategic advantage for the long-term success of Xbox 360.

EDD revenue increased during the three and six months ended December 31, 2006, primarily driven by increased Xbox 360 console sales, sales of Zune after its November 2006 launch, and increased Xbox accessories and video game sales led by the Xbox 360 title Gears of War. Xbox and PC game revenue increased by approximately $1.0 billion or 76% during the three months and $1.3 billion or 82% during the six months ended December 31, 2006, as a result of higher console volumes and related accessories and video game sales. We sold approximately 4.4 million Xbox 360 consoles during the second quarter and approximately 5.4 million Xbox 360 consoles during the first half of fiscal year 2007. Since the Xbox 360 console was launched in November 2005, we have sold approximately 10.4 million units. Revenue from Zune, consumer hardware and software, and TV platforms increased $260 million or 104% during the three months and $323 or 71% during the six months ended December 31, 2006, primarily reflecting the recent release of Zune, new consumer hardware products, and deployments of MSTV products. Mobile and Embedded Devices revenue increased $29 million or 22% during the three months and $71 million or 31% during the six months ended December 31, 2006, driven by sales growth in Windows Mobile software and Windows Embedded operating systems. Increased revenue for Windows Mobile software was primarily driven by increased market demand for phone-enabled PDAs and Smartphones, partially offset by decreased volume shipments for standalone PDAs. The increase in Windows Embedded revenue was due to our operating system being included in new product designs for both new and existing customers.

EDD operating loss in the second quarter of fiscal year 2007 was flat relative to the prior year and decreased during the six months ended December 31, 2006, reflecting increased revenue and lower Xbox 360 console per unit cost of goods sold, offset by development and marketing expenses primarily related to Xbox and the launch of Zune, and increased Xbox 360 console warranty and repair expenses. Xbox 360 console warranty and repair expenses were primarily driven by the extension of the Xbox 360 console product warranty from 90 days to one year in the United States and Canada. Headcount-related costs increased 12% and 15% during the three and six months ended December 31, 2006, reflecting both an increase in salaries and benefits for existing headcount and a 17% increase in headcount.

In fiscal year 2007, we expect revenue to increase due to the increased availability of Xbox 360 during the entire fiscal year and sales of Zune after its November 2006 launch. The availability of a commercial IPTV product is expected to drive growth in MSTV revenue across several geographies. 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. Short product life cycles in product lines such as Windows Mobile software may impact our continuing revenue streams.

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Corporate-Level Results

(In millions, except percentages)	Three months ended December 31, 2006	2005	Percentage Change	Six months ended December 31, 2006	2005	Percentage Change
Corporate-level results	**$ (1,165)**	$ (988)	(18)%	**$ (2,196)**	$ (2,286)	4%

Certain corporate-level results are not allocated to our segments. Those results include expenses related to corporate operations associated with 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 during the three months ended December 31, 2006, primarily reflecting increased headcount-related costs and increased costs for legal settlements and legal contingencies. Corporate-level expenses decreased during the six months ended December 31, 2006, primarily reflecting decreased costs for legal settlements and legal contingencies partially offset by increased headcount-related costs. We incurred $111 million and $198 million in legal charges during the three and six months ended December 31, 2006, respectively, as compared to $66 million and $515 million in legal charges during the three and six months ended December 31, 2005, respectively. Legal costs during the first half of fiscal year 2006 included a $361 million charge related to our settlement with RealNetworks, Inc. Headcount-related costs increased 24% and 27% during the three and six months ended December 31, 2006, respectively, reflecting both an increase in salaries and benefits for existing headcount and a 24% increase in headcount.

Operating Expenses

Cost of Revenue

(In millions, except percentages)	Three months ended December 31, 2006	2005	Percentage Change	Six months ended December 31, 2006	2005	Percentage Change
Cost of revenue	**$ 3,620**	$ 2,239	62%	**$ 5,316**	$ 3,492	52%
As a percent of revenue	**29%**	19%	10ppt	**23%**	16%	7ppt

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, and costs associated with the delivery of consulting services. Cost of revenue increased in the three and six months ended December 31, 2006, primarily driven by an increase in the number of total Xbox consoles sold, costs associated with Zune, and OSB costs to continue building out our data center infrastructure.

Research and Development

(In millions, except percentages)	Three months ended December 31, 2006	2005	Percentage Change	Six months ended December 31, 2006	2005	Percentage Change
Research and development	**$ 1,637**	$ 1,591	3%	**$ 3,423**	$ 3,106	10%
As a percent of revenue	**13%**	13%		**15%**	14%	1ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related costs associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Research and development costs increased during the three and six months ended December 31, 2006, primarily as a result of increased headcount-related costs and development costs associated with new offerings including our Windows

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Live platform, Windows Vista, the 2007 Microsoft Office system, Unified Communications, and Zune. The increases in research and development costs were partially offset by the capitalization of approximately $120 million of certain software development costs primarily associated with Windows Vista and the 2007 Microsoft Office system. Headcount-related costs decreased 1% and increased 7% during the three and six months ended December 31, 2006, respectively, reflecting a 17% increase in headcount, an increase in salaries and benefits for existing headcount, and offsetting impacts of 11 and six percentage points, respectively, resulting from the capitalization of certain software development costs.

Sales and Marketing

(In millions, except percentages)	Three months ended December 31, 2006	Three months ended December 31, 2005	Percentage Change	Six months ended December 31, 2006	Six months ended December 31, 2005	Percentage Change
Sales and marketing	**$ 2,999**	$ 2,689	12%	**$ 5,190**	$ 4,634	12%
As a percent of revenue	**24%**	23%	1ppt	**22%**	21%	1ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related costs 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, 2006, primarily as a result of increased headcount-related costs and other marketing costs related to recent and upcoming product launches. Headcount-related costs increased 23% and 25% during the three and six months ended December 31, 2006, respectively, reflecting both an increase in salaries and benefits for existing headcount and a 15% increase in headcount.

General and Administrative

(In millions, except percentages)	Three months ended December 31, 2006	Three months ended December 31, 2005	Percentage Change	Six months ended December 31, 2006	Six months ended December 31, 2005	Percentage Change
General and administrative	**$ 814**	$ 661	23%	**$ 1,478**	$ 1,643	(10)%
As a percent of revenue	**6%**	6%	ppt	**6%**	8%	(2)ppt

General and administrative costs include payroll, employee benefits, stock-based compensation expense and other headcount-related costs associated with finance, legal, facilities, certain human resources, other administrative headcount, and legal and other administrative fees. General and administrative costs increased during the three months ended December 31, 2006, primarily reflecting increased headcount-related costs and increased costs for legal settlements and legal contingencies. General and administrative costs decreased during the six months ended December 31, 2006, primarily reflecting decreased costs for legal settlements and legal contingencies partially offset by increased headcount-related costs. We incurred $111 million and $198 million in legal charges during the three and six months ended December 31, 2006, respectively, as compared to $66 million and $515 million in legal charges during the three and six months ended December 31, 2005, respectively. Legal costs during the first half of fiscal year 2006 included a $361 million charge related to our settlement with RealNetworks, Inc. Headcount-related costs increased 11% and 17%, respectively, during the three and six months ended December 31, 2006, reflecting both an increase in salaries and benefits for existing headcount and a 15% increase in headcount.

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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, 2006	Three Months Ended December 31, 2005	Change	Six Months Ended December 31, 2006	Six Months Ended December 31, 2005	Change
Dividends and interest	**$ 316**	$ 382	$ (66)	**$ 685**	$ 758	$ (73)
Net recognized gains on investments	**103**	212	(109)	**466**	238	228
Net losses on derivatives	**(75)**	(185)	110	**(231)**	(99)	(132)
Other, net	**(11)**	71	(82)	**(20)**	89	(109)
Investment income and other	**$ 333**	$ 480	$ (147)	**$ 900**	$ 986	$ (86)

For the three months and six months ended December 31, 2006, dividends and interest income declined, reflecting a decline in the average balance of dividend and interest-bearing investments, partly offset by higher interest rates received on our fixed-income investments. Net gains on sales of equity investments, net gains on sales of fixed-income investments, and other-than-temporary impairments on both equity and fixed-income investments comprise our net recognized gains on investments. Net recognized gains for the three months ended December 31, 2006, declined primarily due to fewer gains on the sale of equity investments in the current period as compared to the comparable period in the prior year. Other-than-temporary impairments in the second quarter of fiscal 2007 were not material and were $37 million in the comparable quarter of the prior fiscal year. Net recognized gains for the six months ended December 31, 2006, increased primarily due to gains on sales of fixed-income investments in the current period as compared to losses in the prior period, partly offset by fewer gains on the sale of equity investments in the current period as compared to the prior period. Net gains on investments for the six months ended December 31, 2006 included $15 million in other-than-temporary impairments in the current period as compared to $49 million in the comparable period of the prior fiscal year.

We use derivative instruments to manage exposures to interest rates, equity prices, and foreign currency markets and to facilitate portfolio diversification. Net losses on derivatives were as follows:

(In millions)	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Change	Six Months Ended December 31, 2006	Six Months Ended December 31, 2005	Change
Net losses on equity derivatives	**$ (1)**	$ (9)	$ 8	**$ (38)**	$ 97	$ (135)
Net gains/(losses) on commodity derivatives	**(1)**	(54)	53	**(27)**	50	(77)
Net losses on interest rate derivatives	**(2)**	(28)	26	**(14)**	(49)	35
Net losses on foreign exchange contracts	**(71)**	(94)	23	**(152)**	(197)	45
Net losses on derivatives	**$ (75)**	$ (185)	$ 110	**$ (231)**	$ (99)	$ (132)

During the three months ended December 31, 2006, we experienced fewer net losses on derivatives as compared the comparable period in the prior year primarily reflecting smaller losses on commodity and interest rate derivatives. Additionally, net losses in time value on foreign exchange contracts used to hedge anticipated foreign currency revenues declined in the current period as compared to the prior period. During the six months ended December 31, 2006, net losses on derivatives were higher in the current year primarily due to losses on equity derivatives in the current period as compared to gains in the prior period.

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Gains and losses arising from derivatives not designated as accounting hedges are 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 exchange 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.

During the second quarter of the prior fiscal year, Microsoft and NBC Universal, Inc. entered into amended and restated agreements to restructure their joint venture relationships for MSNBC Cable L.L.C. (CJV) and MSNBC Interactive News, L.L.C. (IJV). Investment income and other for the prior year includes a net gain related to the restructuring of CJV and IJV.

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, 2006. Our effective tax rate for the three months and six months ended December 31, 2005 was 29% and 30%, respectively.

FINANCIAL CONDITION

Cash and equivalents and short-term investments totaled $28.87 billion as of December 31, 2006, compared to $34.16 billion as of June 30, 2006. Equity and other investments were $9.63 billion as of December 31, 2006, compared to $9.23 billion as of June 30, 2006. The investment portfolio consists primarily of fixed-income securities, diversified among industries and individual issuers. Our investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S.-dollar-denominated securities, but also includes foreign-denominated securities in order to diversify financial risk. The portfolio is primarily invested 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 $24.52 billion at December 31, 2006. Our retained deficit is not expected to impact 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, 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, TV platform, Microsoft Business Solutions, advertising, and subscriptions 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.

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Unearned revenue as of December 31, 2006 increased $1.8 billion from September 30, 2006, and $1.0 billion from June 30, 2006, primarily reflecting the $1.6 billion second quarter revenue deferral. The increase from June 30, 2006 was partially offset by the recognition of unearned revenue from multi-year licensing that exceeded deferrals by $0.7 billion.

The following table outlines the expected recognition of unearned revenue as of December 31, 2006:

(In millions)		Recognition of Unearned Revenue
Three months ended:		
March 31, 2007	$	5,177
June 30, 2007		2,496
September 30, 2007		1,495
December 31, 2007		855
Thereafter		1,838
Unearned revenue	$	11,861

See Note 4 Unearned Revenue of the Notes to Financial Statements (Part I, Item 1)

Cash Flows

Cash flow from operations for the six months ended December 31, 2006 decreased $457 million from the first six months of fiscal year 2006 to $6.10 billion, due to increased payments for income taxes contributing to an $898 million increase in cash used for other current liabilities combined with cash used to fund other changes in working capital. These impacts were partially offset by a $1.27 billion increase in cash from deferred revenue due to increased billings in the six months ended December 31, 2006. Cash used for financing was $10.50 billion in the first half of fiscal year 2007, a decrease of $245 million from the corresponding period in fiscal year 2006. Several events occurred during the first half of fiscal year 2007 that affected cash used for financing. JPMorgan exercised approximately 113 million call options for $3.30 billion in December 2006 which was included in the $4.83 billion of common stock issued during the six months ended December 31, 2006, an increase of $3.37 billion from the same period in fiscal year 2006. We also completed our tender offer on August 17, 2006, which was included in the $13.48 billion of common stock repurchases in the six months ended December 31, 2006. Cash from investing was $4.50 billion in the first half of fiscal year 2007, an increase of $1.07 billion from the first half of fiscal year 2006, due to a $2.14 billion increase in net cash from combined investment purchases, sales, and maturities, partially offset by increased additions to property and equipment and a decline in our securities lending program in which we lend certain fixed-income and equity securities to increase investment returns.

We have no material long-term borrowings. Stockholders equity at December 31, 2006, was $36.63 billion. Additions to property and equipment will continue, including new facilities 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. We have issued residual value guarantees in connection with various operating leases. These guarantees provide that if we do not purchase the leased property from the lessor at the end of the lease term, then we are liable to the lessor for an amount equal to the shortage (if any) between the proceeds from the sale of the property and an agreed value. As of December 31, 2006, the maximum amount of the residual value guarantees was approximately $271 million. We believe that proceeds from the sale of properties under operating leases would exceed the payment obligation and therefore no liability currently exists. 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.

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On September 13, 2006, our Board of Directors declared a regular quarterly dividend of $0.10 per share. The dividend was paid on December 14, 2006 to shareholders of record at the close of business on November 16, 2006. On December 20, 2006, our Board of Directors declared a regular quarterly dividend of $0.10 per share. The dividend is payable on March 8, 2007 to shareholders of record at the close of business on February 15, 2007. This dividend of approximately $978 million was included in other current liabilities on our balance sheet. On September 23, 2005, our Board of Directors declared a regular quarterly dividend of $0.08 per share. The dividend was paid on December 8, 2005, to shareholders of record at the close of business on November 17, 2005. On December 14, 2005, our Board of Directors declared a regular quarterly dividend of $0.09 per share. The dividend was paid on March 9, 2006 to shareholders of record at the close of business on February 17, 2006.

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20 billion tender offer, which was completed on August 17, 2006; and authorization for up to an additional $20 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 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, 2006, approximately $29.3 billion remained of the $36.2 billion approved repurchase amount.

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.

Other Matters

During the quarter, we finalized a set of business and technical collaboration agreements with Novell, Inc. that are intended to provide greater interoperability between the two companies products. As part of these arrangements, each company also announced agreements to provide their respective customers with patent coverage for covered products. These agreements will be in place until at least 2012. The parties also provided releases to each other for prior patent infringement.

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.

RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements.* SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect

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transition adjustment. SAB No. 108 is effective for our fiscal year 2007 annual financial statements. We are currently assessing the potential impact that adoption of SAB No. 108 will have on our financial statements.

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. We are currently assessing the potential impact that adoption of SFAS No. 157 will have on our financial statements.

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109,* which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 requires recognition of tax benefits that satisfy a greater than 50% probability threshold. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for us beginning July 1, 2007. We are currently assessing the potential impact that adoption of FIN No. 48 will have on our financial statements.

In June 2006, the FASB ratified the Emerging Issues Task Force (EITF) consensus on EITF Issue No. 06-2, *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43* . EITF Issue No. 06-2 requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. EITF Issue No. 06-2 is effective for us beginning July 1, 2007. The cumulative effect of the application of this consensus on prior period results should be recognized through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. Elective retrospective application is also permitted. We are currently evaluating the financial impact of this guidance and the method of adoption that will be used.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management s application of accounting policies. Critical accounting policies for us include revenue recognition, impairment of investment securities, impairment of goodwill, accounting for research and development costs, accounting for legal contingencies, 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. 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 which is recognized over the product s estimated life cycle. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product s estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and SEC SAB 59, *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 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. During the second quarter of fiscal year 2007, we determined that technological feasibility was reached with Windows Vista and the 2007 Microsoft Office system. Accordingly, we capitalized approximately $120 million of software development costs during the quarter. Previously, such costs were expensed. The amortization of these costs will be included in cost of revenue over the estimated life of the products.

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

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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 tax contingencies are provided for in accordance with the requirements of SFAS No. 5.

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 value of the award and is recognized as expense over the vesting 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.

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 are generally not hedged. However, we use options 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

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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, 2006, and as of June 30, 2006:

(In millions)	June 30,	December 31,	Three months ended December 31, 2006		
Risk Categories	2006	2006	Average	High	Low
Interest rates	$ 66	$ 41	$ 42	$ 47	$ 37
Currency rates	91	43	58	71	43
Equity prices	88	59	56	59	54
Commodity prices	12	7	7	8	6

Total one-day VaR for the combined risk categories was $89 million at December 31, 2006 and $158 million at June 30, 2006. The total VaR is 40% less at December 31, 2006, and 38% less at June 30, 2006, 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, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

Item 1. Legal Proceedings

See Note 7 Contingencies of the Notes to Financial Statements (Part I, Item 1) for information regarding 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. Please refer also to our annual report on Form 10-K for fiscal year 2006 for additional information concerning these and other uncertainties that could negatively impact the Company.

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. We believe the license-based software model has had substantial benefits for users of software, allowing them to rely on our expertise and the expertise of other software developers that have powerful incentives to develop innovative software that is useful, reliable, and compatible with other software and hardware. In recent years, 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. Although we believe our products provide customers with significant advantages in security and productivity, and generally have a lower total cost of ownership than open source software, the popularization of the open source software model continues to pose a significant challenge to our business model, including continuing efforts by proponents of open source software to convince governments worldwide to mandate the use of open source software in their purchase and deployment of software products. 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 consequently decline.

Another development is the software-as-a-service business model, by 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 software-as-a-service strategies. It is uncertain whether these strategies will prove 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 offers benefits to our customers that are a competitive advantage, our competitors that are focused on a narrower product line 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. The Internet as a distribution channel and the non-commercial software model described above have reduced barriers to entry even further. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products. In response to competitive factors, we are developing

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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 protect our intellectual property rights against piracy, infringement of our patents by third parties, or declining legal protection for intellectual property. We defend our intellectual property rights and combat unlicensed copying and use of software and intellectual property rights through a variety of techniques. Preventing unauthorized use or infringement of our rights is difficult. Piracy of our products represents a loss of revenue to us. While this adversely affects U.S. revenue, the impact on revenue from outside the United States is more significant, particularly in countries where laws are less protective of intellectual property rights. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Future legal changes could make this even more challenging. 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 compliance with additional intellectual property obligations impacting the rights of software developers 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. Responding to these claims may require us to enter into royalty and licensing agreements on less favorable terms, require us to stop selling or to redesign affected products, or to pay damages or to satisfy indemnification commitments with our customers including contractual provisions under various license arrangements. If we are required to enter into such agreements or take such actions, our operating margins may decline as a result. 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 certain portions of our source code for various software programs and operating systems 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. The loss of future trade secret protection 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 could also increase the 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 these critical issues. We focus on engineering even more secure products, enhancing security and reliability options and settings when we deliver products, and providing guidance to help our customers make the best use of our products and services to protect against computer viruses and other attacks on their computing environment. In addition, we are working to improve the deployment of software updates to address security vulnerabilities discovered after our products are released. We are also investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed. We advise customers on how to help protect themselves from security threats through the use of our online automated security tools, our published security guidance, and the

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deployment of 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 be held effective under applicable laws and judicial decisions.

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 scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers based on alleged 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 November 2001 and a Final Judgment entered in November 2002. These proceedings imposed regulatory constraints on our Windows operating system businesses, including limits on certain contracting practices, required disclosure of certain software program interfaces, limits on Microsoft s ability to ensure the visibility of certain Windows features in new PCs, and required licensing of certain communications protocols. Although we believe we currently are in full compliance with the Decree and Judgment, if we fail to comply with them in the future additional restrictions could be imposed on us that would adversely affect our business.

In March 2004, the European Commission determined that we must create new versions of Windows that do not include certain multimedia technologies, many of which are required for certain Web sites, software applications and other aspects of Windows to function properly, and we must provide our competitors with specifications for how to implement certain communications protocols supported in Windows. Microsoft has appealed both determinations to European courts. As a result of the Commission decision, we have incurred and will (absent a reversal of this ruling) continue to incur duplicative development costs. The Commission ruling obligates Microsoft to make available specifications for certain Windows communications protocol technologies on licensing terms that are closely regulated by the Commission. The availability of these licenses may enable competitors to develop software products that better mimic the functionality of Microsoft s own products which could result in a reduction in sales of our products. Pending resolution of Microsoft s appeal, there will remain uncertainty about the legal principles that govern product design issues for future releases of Microsoft products in Europe.

In February 2006, the Korean Fair Trade Commission (KFTC) completed an investigation of whether including streaming media technology or instant messenger technology in Windows, or including Windows Media Services as an optional component of Windows Server, violates the Korean Fair Trade Act. The KFTC ruled that we had violated the law and issued a remedial order requiring us to offer two versions of Windows PC operating systems, one with Windows Media Player and instant messenger removed and another with those functionalities but also including opportunities for OEMs to install competing media player and instant messaging programs. If upheld on appeal, these remedies could adversely affect the utility and competitive position of Windows PC operating systems in the Korean market.

We believe our integrated approach to delivery of product innovation benefits consumers and business. Current or future government regulatory efforts and court decisions may hinder or delay our ability to provide these benefits thereby reducing the attractiveness of our products and the revenues that come from them. Moreover, there always remains the risk of new legal action, either by these or other governments or private claimants including with respect to products or features that haven t been scrutinized or been the subject of

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objections in the past. The outcome of such legal actions could adversely affect us in a variety of ways, including:

- We may have to design or develop alternative versions of products for specific geographical markets to remove or limit visibility of certain functionality, resulting in reduced customer benefits, additional costs and delays in the release of product lines or specific product versions, or withdraw products from a market to avoid fines or penalties.
- Mandated alternative versions of our software may cause confusion that harms our reputation, including among consumers and with third-party software and Web site developers who rely on the functionality removed from these alternative versions.
- Competition authorities may authorize competitors to distribute implementations of Microsoft communications protocols in source code form without proper contractual provisions to protect our intellectual property.
- We may have to disclose otherwise confidential and trade secret information concerning the operation of our software that may facilitate the development of competing software.
- If not reversed or limited on appeal, the rulings described above may be cited as a precedent in other proceedings that seek to limit our ability to continue to improve Windows by adding new functionality in response to consumer demand.

Our online offerings are subject to government regulation of the Internet domestically and internationally in areas such as user privacy, 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 cease conducting the 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 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.

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, MSN Search, Windows Server, Zune, and Windows Live. Investments in new technology are inherently speculative. Commercial success depends on many factors including innovativeness, developer support, and effective distribution and marketing. Significant revenue from new product and service investments may not be achieved 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.

Declines in demand for software could occur. If overall market demand for PCs, servers, and other computing devices declines significantly, or consumer or corporate spending for such products declines, our revenue will be adversely affected. In addition, our revenue would be unfavorably impacted if customers reduce their purchases of new software products or upgrades to existing products because new product offerings are not perceived as providing significant new functionality or other value to prospective purchasers. We are making significant investments in Windows Vista and the 2007 Microsoft Office system. If these products are not perceived as offering significant new functionality or value to prospective purchasers, our revenue and operating margins could be adversely affected.

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 the claims pending against us may result in significant monetary damages or injunctive relief against us that could adversely affect our ability to conduct our business. Although management currently believes that 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. There exists the possibility of a material adverse impact on our financial position, results of operations, and cash flows 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 both the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different 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.

We may be at risk of having insufficient supplies of certain Xbox 360 components or console inventory. Some components of the Xbox 360 are obtained from a single supplier and others may be subject to an industry-wide supply shortage. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain replacement supplies on a timely basis, resulting in reduced console and game sales. Components are ordered based on forecasted console demand, so we may experience component shortages for the Xbox 360 or, alternatively, excess console inventory that 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 required to be 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.

Changes in accounting may affect our reported earnings and operating income. Generally accepted accounting principles and accompanying accounting pronouncements, implementation guidelines, and interpretations for many aspects of our business, such as revenue recognition for software, accounting for investments, and treatment of goodwill or amortizable intangible assets, are highly complex and involve subjective judgments. Changes in these rules or their interpretation or changes in our products or business could significantly change our reported earnings and operating income and could add significant volatility to those measures, without a comparable underlying change in cash flow from operations. See Note 1 Basis of

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Presentation and Consolidation of the Notes to Financial Statements (Part I, Item 1) and Management s Discussion and Analysis of Financial Condition and Results of Operations Application of Critical Accounting Policies (Part I, Item 2) of this report.

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.

General economic and geo-political risks may affect our revenue and profitability. Inflation, softness in corporate information technology spending, or other changes in general economic conditions that affect demand for computer hardware or software could adversely affect our revenue or our investment portfolio. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries or generally and could require changes in our operations and security arrangements, thus increasing our operating costs. These conditions may lend additional uncertainty to the timing and budget for technology investment decisions by our customers.

Catastrophic events may disrupt our business. We are a highly automated business and a disruption or failure of our systems in the event of a major earthquake, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales and providing services. 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 severely affect our ability to conduct normal business operations and, as a result, our future operating results could be adversely affected.

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 the investment we make, 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 factors could adversely affect our operating results or financial condition.

We have limited insurance. We maintain third party insurance coverage against various liability risks and risks of property loss. Because of the unavailability or high cost of conventional insurance arrangements, we have entered into captive insurance arrangements for the purpose of protecting against possible catastrophic and other risks not covered by traditional insurance markets. As of December 31, 2006, the face value of captive insurance arrangements was $2.0 billion. Actual value at any particular time will vary due to deductibles, exclusions, other restrictions, and claims. Although we believe these arrangements are an effective way to insure against liability and property damage risks, the potential liabilities associated with the risks discussed in this report or other events could exceed the coverage provided by such arrangements.

Improper disclosure of personal data could result in liability and harm our reputation. We store and process significant amounts of personally identifiable information as we offer a large array of products and services to our customers. 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

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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
- Our ability to implement operating cost structures that align with revenue growth
- The continued availability of third-party distribution channels for MSN service and other online offerings
- Disruption to our operations as a result of weather-related events

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

Items 2(a) and (b) are inapplicable.

(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, 2006 October 31, 2006	6,470,000	$ 28.70	6,470,000	$ 35,112,863,601
November 1, 2006 November 30, 2006	111,180,100	29.29	111,180,100	31,856,664,408
December 1, 2006 December 31, 2006	87,766,471	29.56	87,766,471	29,261,979,966
	205,416,571		205,416,571	

On July 20, 2006, we announced that our Board of Directors authorized a $20 billion ongoing share repurchase program with an expiration of June 30, 2011. On August 18, 2006, we announced that the authorization for the $20 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 2007, we repurchased 205.4 million shares for $6.0 billion under the plan. The transactions occurred in open market purchases and pursuant to a trading plan under Rule 10b5-1.

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

The Annual Meeting of Shareholders was held on November 14, 2006.

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	8,461,064,639	92,775,414	64,567,873
Steven A. Ballmer	8,459,565,558	93,158,224	65,684,145
James I. Cash Jr.	8,488,064,349	59,691,681	70,651,896
Dina Dublon	8,506,597,478	41,578,270	70,232,178
Raymond V. Gilmartin	8,496,469,361	47,166,659	74,771,906
David F. Marquardt	8,452,715,964	94,830,441	70,861,525
Charles H. Noski	8,505,697,393	39,381,601	73,328,935
Helmut Panke	8,506,411,877	38,769,998	73,226,051
Jon A. Shirley	8,446,160,930	101,990,883	70,256,116

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

For	8,460,674,663
Against	94,018,665
Abstain	63,714,601
Broker non-vote	1,225,751,130

The following proposals were not adopted by the margins indicated:

3. Shareholder proposal to restrict selling products and services to foreign governments.

For	123,346,451
Against	5,767,016,863
Abstain	737,686,372
Broker non-vote	3,216,109,373

4. Shareholder proposal about sexual orientation and the Company s equal employment opportunity policy.

For	177,168,386
Against	6,157,684,760
Abstain	293,196,539
Broker non-vote	3,216,109,372

5. Shareholder proposal about hiring a proxy advisor for shareholders.

For	122,072,089
Against	6,087,861,013
Abstain	418,116,582
Broker non-vote	3,216,109,374

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Item 6. Exhibits

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

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

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SIGNATURE

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

Date: January 25, 2007

Microsoft Corporation

By: /s/ FRANK H. BROD

Frank H. Brod

Corporate Vice President, Finance and Administration;

Chief Accounting Officer

(Principal Authorized Officer)