



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

FORM 10-Q

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

For the Quarterly Period Ended December 31, 1995

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 98052-6399
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (206) 882-8080

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

Yes No

The number of shares outstanding of the registrant's common stock as of January 31, 1996 was 594,003,653.

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 1995

INDEX

	Page

PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
a) Income Statements for the Three and Six Months Ended December 31, 1995 and 1994.....	1
b) Balance Sheets as of December 31, 1995 and June 30, 1995.....	2
c) Cash Flows Statements for the Six Months Ended December 31, 1995 and 1994.....	3
d) Notes to Financial Statements.....	4
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.....	5
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings.....	9
Item 6. Exhibits and Reports on Form 8-K.....	9
SIGNATURE.....	10

Part I. Financial Information

ITEM 1. FINANCIAL STATEMENTS

MICROSOFT CORPORATION

INCOME STATEMENTS

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

	Three Months Ended December 31		Six Months Ended December 31	
	1994	1995	1994	1995
Net revenues	\$1,482	\$2,195	\$2,729	\$4,211
Costs and expenses:				
Cost of revenues	222	330	408	652
Research and development	199	313	377	615
Sales and marketing	479	690	874	1,311
General and administrative	62	76	113	139
Total costs and expenses	962	1,409	1,772	2,717
Operating income	520	786	957	1,494
Interest income - net	42	76	78	142
Other income (expense)	(5)	23	(7)	19
Income before income taxes	557	885	1,028	1,655
Provision for income taxes	184	310	339	581
Net income	\$ 373	\$ 575	\$ 689	\$1,074
Earnings per share	\$ 0.60	\$ 0.90	\$ 1.10	\$ 1.68
Weighted average shares outstanding	625	638	624	639

See accompanying notes.

MICROSOFT CORPORATION

BALANCE SHEETS (In millions)

	June 30 1995	Dec. 31 1995 (1)
<hr/>		
ASSETS		
Current assets:		
Cash and short-term investments	\$4,750	\$6,017
Accounts receivable - net	581	771
Inventories	88	108
Other	201	207
<hr/>		
Total current assets	5,620	7,103
Property, plant, and equipment - net	1,192	1,297
Other assets	398	706
<hr/>		
Total assets	\$7,210	\$9,106
<hr/>		
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 563	\$ 651
Accrued compensation	130	148
Income taxes payable	410	680
Unearned revenues	54	495
Other	190	267
<hr/>		
Total current liabilities	1,347	2,241
<hr/>		
Minority interest	125	125
<hr/>		
Put warrants	405	560
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Stockholders' equity:		
Common stock and paid-in capital -- shares authorized 2,000; shares outstanding 588 and 590	2,005	2,285
Retained earnings	3,328	3,895
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Total stockholders' equity	5,333	6,180
<hr/>		
Total liabilities and stockholders' equity	\$7,210	\$9,106
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(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION

CASH FLOWS STATEMENTS (In millions)(Unaudited)

	Six Months Ended December 31	
	1994	1995
CASH FLOWS FROM OPERATIONS		
Net income	\$ 689	\$ 1,074
Depreciation and amortization	133	147
Current liabilities	194	892
Accounts receivable	(134)	(187)
Inventories	(17)	(20)
Other current assets	(30)	(5)
Net cash from operations	835	1,901
CASH FLOWS USED FOR FINANCING		
Common stock issued	140	173
Common stock repurchased	(560)	(472)
Stock option income tax benefits	78	71
Net cash used for financing	(342)	(228)
CASH FLOWS USED FOR INVESTMENTS		
Additions to property, plant, and equipment	(170)	(204)
Other assets	(90)	(203)
Short-term investments	(785)	(906)
Net cash used for investments	(1,045)	(1,313)
Net change in cash and equivalents	(552)	360
Effect of exchange rates on cash and equivalents	(8)	1
Cash and equivalents, beginning of period	1,477	1,962
Cash and equivalents, end of period	917	2,323
Short-term investments, end of period	2,922	3,694
Cash and short-term investments, end of period	\$ 3,839	\$ 6,017

See accompanying notes.

MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

BASIS OF PRESENTATION

In the opinion of management, the accompanying balance sheets and related interim statements of income and cash flows include all adjustments (consisting only of normal recurring items) necessary for their fair presentation. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1995 Annual Report on Form 10-K.

EARNINGS PER SHARE

Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, using the treasury stock method.

MERGER

During January 1996, Microsoft merged with Vermeer Technologies, Inc., a developer of Web authoring software. The transaction will be accounted for as a pooling of interests. Management does not expect the transaction to have a material financial effect on the Company's financial results.

CONTINGENCIES

The Antitrust Division of the U.S. Department of Justice has stated that it is conducting an investigation concerning Microsoft's inclusion of client-access software for The Microsoft Network in Microsoft Windows(R) 95. Although there is no assurance that this matter will be resolved favorably and that Microsoft's future financial statements will not be adversely affected, Microsoft currently believes that resolution of this matter will not have a material adverse effect on its financial condition or results of operations.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

Microsoft develops, manufactures, licenses, sells, and supports a wide range of software products, including operating systems for personal computers (PCs), workstations, and servers; business and consumer programs for productivity, reference, education, and entertainment; and development tools. Microsoft also offers an online service, sells personal computer books and input devices, and is engaged in the research and potential development of advanced technology software products.

REVENUES

Revenues for the second quarter of fiscal 1996 increased 48% over revenues for the second quarter of fiscal 1995. For the first half of the year, revenues increased 54% over the comparable period of the prior year.

Software license volume (as opposed to price) increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone desktop applications to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and corporate license programs, such as Microsoft Select, is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, e.g., Microsoft Office, are less than the sum of the prices for the individual programs included in these products when such programs are licensed separately.

PRODUCT GROUPS

Platforms product group revenues were \$1.13 billion in the second quarter of 1996, compared to \$592 million recorded in the same period of 1995, an increase of 90%. On a year-to-date basis, platforms product group revenues increased to \$2.17 billion from \$1.10 billion. Platforms product group revenues are primarily from licenses of personal computer operating systems and business systems with client-server architectures.

During the first quarter of fiscal 1996, the Company released Microsoft Windows 95, its new personal computer operating system, which experienced strong demand by users of existing PCs. To prevent stock outs in the retail channel, certain distributors and resellers over-ordered Windows 95 product prior to its formal launch on August 24, 1995 and began returning excess inventory in the first two quarters of 1996. The Company provided for management's estimate of additional product that will be returned to Microsoft. The Company's earned retail revenues of Windows 95 were \$260 million in the first quarter and \$180 million in the second quarter. Additionally, unearned revenues as of December 31, 1995 on the accompanying balance sheet include \$200 million attributable to future telephone support and unspecified enhancements to Windows 95 which will be recognized ratably over the product's life cycle as it is earned. The Company also experienced continued revenue growth in Microsoft MS-DOS(R), Microsoft Windows 3.1, Microsoft Windows for Workgroups 3.11, and Windows 95 operating systems licensed through the OEM channel. (Windows 3.1 and Windows for Workgroups 3.11 are hereafter referred to collectively as "Windows 3.x."). Revenues from business systems products (principally the Windows NT(TM) operating system and server applications in the Microsoft's BackOffice(TM) family of products) increased strongly, due to greater corporate demand for Windows NT Workstation and Windows NT Server.

Applications and content product group revenues were \$1.07 billion in the second quarter of 1996, increasing 20% from \$890 million in the second quarter of 1995. For the first two quarters of 1996, applications and content product revenues were \$2.05 billion, compared to \$1.63 billion in the corresponding period of 1995. Applications product group revenues include primarily licenses of desktop productivity, consumer, and developer programs.

Increases in applications and content revenues were led by strong sales of 16-bit and 32-bit versions of Microsoft Office. Microsoft Office Standard includes the Microsoft Word word processor, the Microsoft Excel spreadsheet, and the Microsoft PowerPoint(R) presentation graphics program. The Microsoft Office for Windows 95 (32-bit) version also includes the Microsoft Schedule+ calendar and scheduling program. Microsoft Office Professional includes all of the above plus the Microsoft Access(R) database management program. The accompanying balance sheet also includes \$230 million of unearned revenues as of December 31, 1995 in connection with the sale of 16-bit versions of desktop productivity programs that will not be earned and recognized as revenues until related coupons for Windows 95 version upgrades have been fulfilled.

Revenues from consumer products grew 23% in the second quarter of 1996. New titles and new versions of existing titles both contributed to the growth, in spite of across-the-board price decreases. Developer product revenues also grew, reflecting the introduction of Microsoft Visual Basic version 4.0.

SALES CHANNELS

Microsoft distributes its products primarily through OEM licenses, corporate licenses, and retail packaged products. OEM channel revenues are license fees from original equipment manufacturers. Microsoft has three major geographic sales and marketing organizations: U.S. and Canada, Europe, and elsewhere in the world (Other International). Sales of corporate licenses and packaged products in these channels are primarily to distributors and resellers.

OEM revenues (primarily personal computer operating systems) grew 75% to \$672 million in the second quarter from the \$385 million recorded in the comparable quarter of the prior year. On a year-to-date basis, OEM revenues were \$1.22 billion, compared to \$733 million in 1995. The percentage of OEMs preinstalling Windows 95 on new PCs increased during the second quarter of 1996. Also, MS-DOS and Microsoft Windows 3.x continued to be preinstalled on many PCs sold by OEMs. Higher levels of PC shipments was the principal driver of increased revenues through the OEM channel.

Revenues in the U.S. and Canada were \$632 million in the second quarter of 1996 compared to \$491 million in 1995. Revenues in the first half of 1996 were \$1.38 billion, compared to \$914 million recorded last year. The increase in revenues of 51% for the first two quarters primarily reflects the release of new versions of Windows 95 and 32-bit versions of desktop applications, particularly Microsoft Office for Windows 95.

Revenues in Europe were \$569 million in the second quarter of 1996 compared to \$399 million the prior year. European revenues were \$995 million in the first half of 1996 compared to \$688 million the prior year, an increase of 45%. Revenues in Europe benefited greatly by the release of localized versions of Windows 95 and 32-bit desktop applications.

Other International channel revenues increased 56% to \$322 million in the second quarter of 1996 from \$207 million in the second quarter of 1995, reflecting the release of Kanji versions of Windows 95 and Microsoft Office in Japan. Year-to-date revenues were \$619 million in 1996 compared to \$394 million in 1995. As in Europe, many localized versions of Windows 95 and 32-bit desktop applications were released through the Other International channel in the first half of 1996.

Microsoft's operating results are affected by foreign exchange rates. Had the exchange rates in effect during the second quarter of the prior year been in effect during the second quarter of 1996, translated revenues in Europe would have been \$21 million lower and translated Other International revenues would have been \$4 million higher. Since much of Microsoft's international manufacturing costs and operating expenses are also incurred in local currencies, the relative translation impact of exchange rates on net income is less than on revenues.

COSTS AND EXPENSES, NONOPERATING ITEMS, AND INCOME TAXES

Cost of revenues as a percentage of revenues was 15.0% in the second quarters of both 1996 and 1995. For the first two quarters of 1996, cost of revenues was 15.5% of revenues, compared to 15.0% the prior year. The slight increase is principally attributable to a shift in sales mix due to high shipments of retail upgrade versions of Windows 95 and Microsoft Office for Windows 95. The increase in the cost of revenues percentage was somewhat offset by the increased mix of CD-ROM media, which carry lower costs of goods sold than floppy disks.

Research and development expenses increased 57% to \$313 million, or 14.3% of revenues in the second quarter of 1996 from \$199 million, or 13.4% of revenues in the corresponding quarter of 1995. The increase in research and development expenses in both the second quarter and first half of 1996 resulted primarily from planned hiring of software developers and higher levels of third-party development costs.

Sales and marketing expenses increased 44% to \$690 million from \$479 million in the comparable quarter. As a percentage of revenues, sales and marketing expenses were 31.4% and 32.3% in the respective second quarters of 1996 and 1995. The increase in sales and marketing expenses in both the second quarter and first half of 1996 was impacted by marketing costs of Windows 95 and Microsoft Office for Windows 95 and increased product support costs.

General and administrative expenses were \$76 million (3.5% of revenues) in the second quarter of 1996 and \$62 million (4.2% of revenues) in the second quarter of 1995. The increases in absolute dollars incurred in both the second quarter and first half of 1996 were due to growth in the systems and number of people necessary to support overall increases in the scope of the Company's operations.

Net interest income increased as a result of a larger investment portfolio generated by cash from operations combined with higher interest rates. Other income in the second quarter of 1996 included a net gain of \$30 million from the disposal of long-term assets.

The effective income tax rate was 35% and 33% in the first halves of 1996 and 1995 with the increase due primarily to changes in the U.S. tax law.

NET INCOME

Net income for the second quarter of 1996 was \$575 million. Net income as a percentage of revenues was 26.2% in the second quarter of 1996, compared with 25.2% in the second quarter of 1995. On a year-to-date basis, net income as a percent of revenues was 25.5% compared to 25.2% the prior year. The increase in net income as a percentage of revenues was primarily the result of revenues growing faster than operating expenses other than those for research and development and higher nonoperating income such as interest income and the disposal gain.

FINANCIAL CONDITION

Microsoft's cash and short-term investment portfolio totaled \$6 billion at December 31, 1995. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft has no material long-term debt and has \$70 million of standby multicurrency lines of credit that support foreign currency hedging and international cash management. Stockholders' equity at December 31, 1995 exceeded \$6 billion.

Cash generated from operations has been sufficient historically to fund Microsoft's investment in research and development activities and facilities expansion. As Microsoft grows, investments will continue in research and development in existing and advanced areas of technology. Microsoft's cash will be used to acquire technology and to fund ventures and other strategic opportunities. Additions to property, plant, and equipment are expected to continue, including new facilities and computer systems for research and development, sales and marketing, product support, and administrative staff.

The exercise of stock options by employees provides additional cash. These proceeds have funded Microsoft's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is continuing in 1996.

To enhance its stock repurchase program, Microsoft sold equity put warrants to independent third parties during 1995 and 1996. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices. On December 31, 1995, 10 million warrants were outstanding with strike prices ranging between \$82 and \$91 per share. The warrants expire at various dates between the fourth quarter of 1996 and the fourth quarter of 1997, are exercisable only at maturity, and are settleable in cash at Microsoft's option. The maximum potential repurchase obligation as of December 31, 1995, \$560 million, has been reclassified from stockholders' equity to put warrants.

A subsidiary of Tele-Communications, Inc. (TCI) owns a 20% minority interest in The Microsoft Network, LLC. TCI contributed \$125 million of TCI common stock, and Microsoft contributed the business assets of its online service, The Microsoft Network, which began operation in August 1995.

During December 1995, Microsoft and NBC announced the creation of two joint ventures: a 24-hour cable news and information channel and an interactive online news service distributed on The Microsoft Network. Both of these services will be offered worldwide and integrated with the NBC Television Network. Microsoft has agreed to pay \$220 million over five years for its interest in the cable venture.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next twelve months. Microsoft's cash and short-term investments are also managed to be available for strategic investment opportunities or other potential large-scale cash needs that may arise in pursuit of Microsoft's long-term strategies. Additionally, Microsoft shareholders have authorized the issuance of up to 100 million shares of preferred stock, which may be used by Microsoft for any proper corporate purpose.

Microsoft has not paid cash dividends on its common stock.

Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

See Notes to Financial Statements.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

11. Computation of Earnings Per Share
27. Financial Data Schedule

(B) Reports on Form 8-K

No reports on Form 8-K were filed by Microsoft during the quarter ended December 31, 1995.

ITEMS 2, 3, 4 AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

Signature

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

Microsoft Corporation

Date: February 13, 1996 By: /s/ Michael W. Brown

Michael W. Brown,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting Officer and Duly Authorized Officer)

EXHIBIT 11.

MICROSOFT CORPORATION

Computation of Earnings Per Share

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

	Three Months Ended December 31		Six Months Ended December 31	
	1994	1995	1994	1995

Weighted average number of common shares outstanding	581	590	581	590
Common stock equivalents from outstanding stock options	44	48	43	49

Average common and common stock equivalents outstanding	625	638	624	639

Net income	\$ 373	\$ 575	\$ 689	\$1,074

Earnings per share (1)	\$0.60	\$0.90	\$1.10	\$ 1.68

(1) Fully diluted earnings per share have not been presented because the effects are not material.

ARTICLE 5

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE ACCOMPANYING FINANCIAL STATEMENTS AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

PERIOD TYPE	6 MOS
FISCAL YEAR END	DEC 31 1995
PERIOD END	JUN 30 1996
CASH	6017
SECURITIES	0
RECEIVABLES	771
ALLOWANCES	0
INVENTORY	108
CURRENT ASSETS	7103
PP&E	2080
DEPRECIATION	783
TOTAL ASSETS	9106
CURRENT LIABILITIES	2241
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	2285
OTHER SE	3895
TOTAL LIABILITY AND EQUITY	9106
SALES	4211
TOTAL REVENUES	4211
CGS	652
TOTAL COSTS	652
OTHER EXPENSES	2065
LOSS PROVISION	0
INTEREST EXPENSE	0
INCOME PRETAX	1655
INCOME TAX	581
INCOME CONTINUING	1074
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	1074
EPS PRIMARY	1.68
EPS DILUTED	1.68

End of Filing