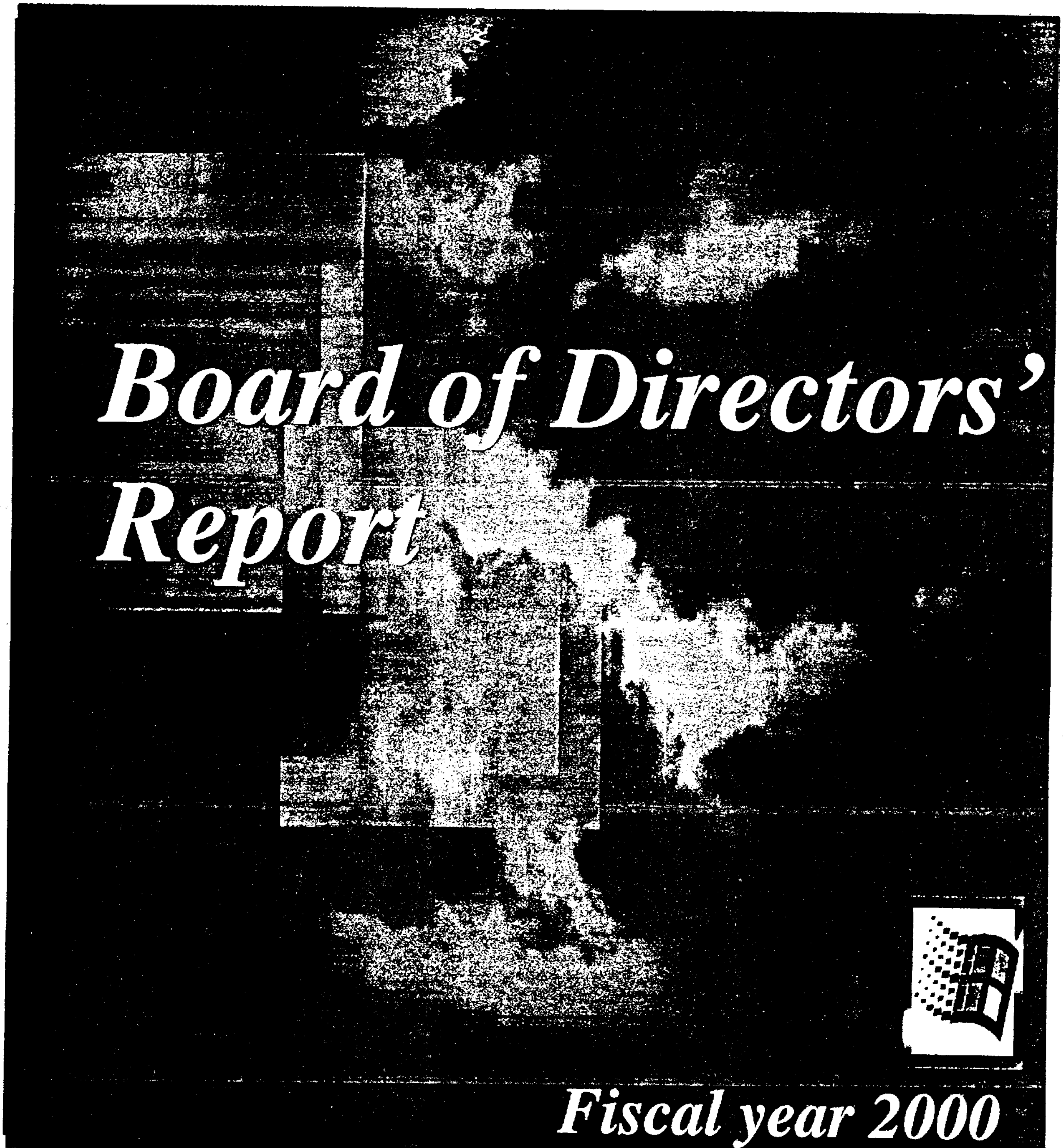
Board of Directors' Report

Fiscal year 2000


Board of Directors' Report
Fiscal year 2000

Q00-1

Q00-1 BOARD OF DIRECTORS' REPORT

Contents

This report was prepared with Word 97 for Windows. All tables were created in Excel 97 and are either embedded in the document or linked to master spreadsheets. Additionally, most of the channel and product group tables were generated via automation from the general ledger. Each of these automated tables is made accurate in its calculations by using data at a lower level than the rounded amounts shown in this report. These lower level amounts are used to calculate variances and are then rounded and displayed in this report. Therefore, individual amounts are rounded perfectly but totals and variances may not foot precisely. All other tables have individual numbers that may be rounded. While these individual numbers may not tie precisely to supporting schedules, they will foot exactly as shown in this report.

Microsoft Results

GAAP RESULTS

EXECUTIVE SUMMARY

INCOME STATEMENT

(in millions, except earnings per share)	Q00-1		Q99-1		Growth %	Q99-4		Growth %
Revenue	$5,384	100.0%	$4,193	100.0%	28%	$5,764	100.0%	(7%)
Cost of revenue	712	13.2%	649	15.5%	10%	669	11.6%	6%
Gross profit	4,672	86.8%	3,544	84.5%	32%	5,095	88.4%	(8%)
Operating expenses:								
Research and development	834	15.5%	651	15.5%	28%	940	16.3%	(11%)
Sales and marketing	903	16.8%	688	16.4%	31%	900	15.6%	0%
General and administative	143	2.7%	99	2.4%	44%	297	5.2%	(52%)
Other expenses	25	0.5%	24	0.6%	4%	55	1.0%	(55%)
Total operating expenses	1,905	35.4%	1,462	34.9%	30%	2,192	38.0%	(13%)
Operating income	2,767	51.4%	2,082	49.7%	33%	2,903	50.4%	(5%)
Investment income	397	7.4%	261	6.2%	52%	485	8.4%	(18%)
Gain on sale	156	2.9%	160	3.8%	(3%)	-	-	nm
Income before income taxes	3,320	61.7%	2,503	59.7%	33%	3,388	58.8%	(2%)
Provision for income taxes	1,129	21.0%	820	19.6%	38%	1,186	20.6%	(5%)
Net income	$2,191	40.7%	$1,683	40.1%	30%	$2,202	38.2%	(0%)
Diluted earnings per share	$ 0.40		$ 0.31		29%	$ 0.40		-
Weighted avg shares outstanding	5,527		5,434			5,521		

	Q98-1	Q98-2	Q98-3	Q98-4	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
Revenue (in millions)	$3,334	$3,792	$3,984	$4,152	$4,193	$5,195	$4,595	$5,764	$5,384
Operating income (% of net revenue)	31.8%	42.5%	46.9%	45.1%	49.7%	52.2%	48.5%	50.4%	51.4%
Net income (% of net revenue)	19.9%	29.9%	33.6%	32.7%	40.1%	38.2%	41.7%	38.2%	40.7%
Earnings per share	$0.12	$0.21	$0.25	$0.25	$0.31	$0.36	$0.35	$0.40	$0.40
Earnings per share growth	0%	50%	25%	25%	158%	71%	40%	60%	29%

Note: All historical GAAP presentations have been reclassified to reflect the change in reporting for revenue and costs associated with product support services (PSS), MS Consulting (MCS), MSN accessand MCP/MCSP certification and training.

HIGHLIGHTS

- Q00-1 revenue was $5.38 billion, an increase of 28% over the $4.19 billion in the first quarter of fiscal 1999. The reported revenue includes $150 million related to the fulfillment of the Office 2000 Technology Guarantee. In addition to the strong sales of Office 2000, the quarterly growth was fueled by continued adoption of Windows 32-bit operating systems, particularly Windows NT Workstation and Windows NT Server, and related server applications. Unearned revenue as of September 30, 1999 was $4.13 billion, declining from $4.24 billion as of June 30, 1999.
- Operating expenses include a charge for the historical practice of setting the exercise price of employee stock options (ESO) at the lowest MS stock price in July for annual grants and the lowest price in the 30 days following the start date for new hires. This charge for the first quarter was $47 million. A $56 million one-time ESO charge for accelerated vesting for certain ex-employees was also included in operating expenses in Q00-1.
- Q00-1 cost of revenue as a percent of revenue decreased to 13.2% from 15.5% in Q99-1. The decrease was driven by the mix shift to higher margin products and organizational licenses and a decrease in WebTV costs.
- Research and development totaled $834 million in the September quarter, an increase of 28% over Q99-1, primarily due to higher development headcount-related costs.
- Sales and marketing expenses totaled $903 million in Q00-1, representing 16.8% of net revenue compared to 16.4% in Q99-1 as higher relative sales expenses offset lower relative marketing.
- General and administrative costs totaled $143 million, up 44% from Q99-1 due to higher legal fees and an ESO charge for a vest acceleration. Other expenses reflect MS's share of JV activity.
- Investment income for the first quarter was $397 million, an increase of $136 million over Q99-1 due to a larger cash portfolio and realized gains on certain investments.
- Q00-1 net income was $2.19 billion, compared to $1.68 billion in Q99-1. Q00-1 results included a gain of $156 million associated with the sale of MSN Sidewalk to Ticketmaster Online-CitySearch. Q99-1 results included a gain of $160 million for the sale of the Softimage subsidiary. Excluding these gains, Q00-1 earnings per share was $0.38, representing growth of 36% over the prior year's comparable quarter of $0.28.

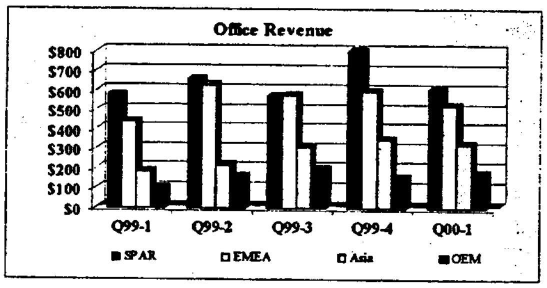
INTERNAL MANAGEMENT RESULTS

CONSOLIDATED MANAGEMENT P&L

(in millions, variance to plan)	Q00-1								
	Actual		Plan		Var %	Q99-1	Grwth %	Q99-4	Grwth %
Revsum revenue	$5,235.9	99.0%	$4,839.4	99.7%	8%	$4,239.9	23%	$5,448.9	(4%)
Revenue adjustments	51.8	1.0%	16.9	0.3%	(206%)	60.0	(14%)	(693.1)	(107%)
Net revenue	5,287.7	100.0%	4,856.3	100.0%	9%	4,299.9	23%	4,755.9	11%
Cost of revenue	411.1	7.8%	414.0	8.5%	1%	364.2	13%	383.7	7%
Gross profit	4,876.6	92.2%	4,442.4	91.5%	10%	3,935.7	24%	4,372.2	12%
Operating expenses:									
Business Divisions:									
Business & Enterprise Group	170.5	3.2%	197.4	4.1%	14%	129.2	32%	174.8	(2%)
Consumer Windows	54.8	1.0%	63.0	1.3%	13%	57.5	(5%)	51.4	7%
Streaming Media	16.0	0.3%	19.7	0.4%	19%	10.3	55%	17.3	(7%)
Business Productivity Group	219.5	4.2%	267.5	5.5%	18%	171.8	28%	267.6	(18%)
Developer Group	142.3	2.7%	152.7	3.1%	7%	107.3	33%	132.3	8%
Consumer & Commerce Group	196.0	3.7%	237.1	4.9%	17%	158.3	24%	284.5	(31%)
Business Divisions	799.1	15.1%	937.4	19.3%	15%	634.4	26%	927.8	(14%)
Home & Retail	75.1	1.4%	79.0	1.6%	5%	65.9	14%	91.2	(18%)
MS Research	43.7	0.8%	49.8	1.0%	12%	27.5	59%	34.9	25%
Unspecified & other products	5.0	0.1%	16.3	0.3%	69%	29.9	(83%)	11.3	(56%)
Business Divisions	922.9	17.5%	1,082.4	22.3%	15%	757.8	22%	1,065.2	(13%)
Product marketing:									
Business & Enterprise Group	26.1	0.5%	15.1	0.3%	(73%)	18.6	40%	27.6	(5%)
Consumer Windows	1.6	0.0%	2.9	0.1%	43%	0.9	76%	12.4	(87%)
Streaming Media	3.9	0.1%	7.2	0.1%	45%	1.1	248%	8.7	(55%)
Business Productivity Group	30.1	0.6%	90.4	1.9%	67%	8.5	256%	69.7	(57%)
Developer Group	7.5	0.1%	13.3	0.3%	44%	4.0	87%	35.7	(79%)
Consumer & Commerce Group	70.1	1.3%	117.0	2.4%	40%	21.4	228%	52.6	33%
Business Divisions	139.4	2.6%	246.0	5.1%	43%	54.6	156%	206.7	(33%)
Home & Retail	6.6	0.1%	5.6	0.1%	(18%)	4.9	34%	14.6	(55%)
MS Research	2.4	0.0%	2.6	0.1%	6%	1.2	103%	3.4	(28%)
Unspecified & other products	0.4	0.0%	0.7	0.0%	48%	0.2	110%	0.6	(41%)
Product marketing	148.8	2.8%	254.8	5.2%	42%	60.9	144%	225.3	(34%)
Sales expense:									
SPAR	182.7	3.5%	224.9	4.6%	19%	137.8	33%	191.6	(5%)
EMEA	140.1	2.7%	164.8	3.4%	15%	118.9	18%	139.3	1%
Asia	49.9	0.9%	56.3	1.2%	11%	37.9	32%	51.2	(2%)
Corp HQ	(6.8)	(0.1%)	(9.5)	(0.2%)	29%	(5.8)	16%	(7.0)	(3%)
Finished goods total	366.0	6.9%	436.6	9.0%	16%	288.7	27%	375.1	(2%)
OEM	29.4	0.6%	33.4	0.7%	12%	23.4	26%	71.4	(59%)
On-Line	22.2	0.4%	29.1	0.6%	24%	11.3	97%	28.5	(22%)
Other	(4.6)	(0.1%)	4.0	0.1%	217%	20.5	(123%)	23.6	(120%)
MCS (net) - excluding est. G&A	30.5	0.6%	51.8	1.1%	41%	24.5	25%	26.4	15%
Sales expense	443.6	8.4%	554.9	11.4%	20%	368.3	20%	525.0	(16%)
Product support (net)	187.5	3.5%	235.3	4.8%	20%	176.0	7%	200.8	(7%)
Channel marketing:									
SPAR	71.4	1.4%	113.7	2.3%	37%	62.4	15%	133.9	(47%)
EMEA	64.1	1.2%	85.2	1.8%	25%	59.3	8%	99.8	(36%)
Asia	33.3	0.6%	44.2	0.9%	25%	25.8	29%	51.1	(35%)
Finished goods total	168.9	3.2%	243.1	5.0%	31%	147.6	14%	284.8	(41%)
OEM	9.8	0.2%	6.4	0.1%	(55%)	16.8	(41%)	13.4	(27%)
On-Line	13.3	0.3%	20.5	0.4%	35%	14.7	(9%)	30.7	(57%)
Other	6.5	0.1%	10.9	0.2%	40%	4.7	37%	14.9	(56%)
Channel marketing	198.4	3.8%	280.9	5.8%	29%	183.7	8%	343.8	(42%)
Broad reach	1.1	0.0%	3.1	0.1%	65%	6.2	(82%)	15.1	(93%)
General and administrative	168.1	3.2%	205.5	4.2%	18%	114.9	46%	224.7	(25%)
Total operating expenses	2,070.4	39.2%	2,616.9	53.9%	21%	1,667.8	24%	2,599.8	(20%)
Operating income	$2,806.1	53.1%	$1,825.5	37.6%	54%	$2,267.9	24%	$1,772.4	58%
Avg worldwide headcount	32,010		33,715		5%	27,432	17%	30,633	

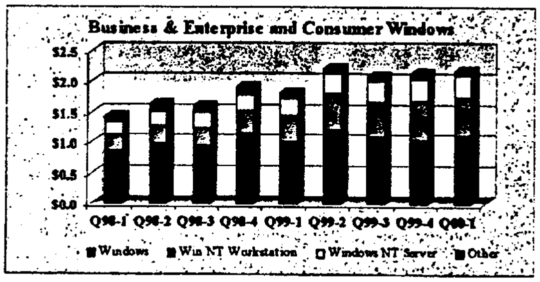
REVSUM REVENUE BY BUSINESS DIVISIONS

- Q00-1 consolidated revsum revenue was $5.24 billion, representing growth of 23% over Q99-1. Volume was fueled by strong PC shipments, organizational licensing, and, to a lesser degree, online revenue.
- Business Productivity revenue for Q00-1 was 4% over plan at $2.12 billion due primarily to Office suites, the Word/Excel bundle, maintenance, and OEM licensing, offset by stand-alone Office products and weak Exchange sales. Q00-1 Business Productivity revenue grew 22% over Q99-1, due to the continued growth in Enterprise Agreement (EA), Open, and OEM licensing of Office suites and BackOffice licensing.



- Office sales, including EAs, reached $1.26 billion in Q00-1, 6% greater than plan and 17% higher than Q99-1. Office EAs for Q00-1 grew 165% to $223 million from Q99-1, while Open licensing of Office suites grew 35% to $419 million due to strong licensing in SPAR and Asia. Select licensing of Office grew just 6% over Q99-1 to $419 million. The Word/Excel bundle in Japan grew 144% to $119 million. By region, Office suites grew 4% or $26 million in SPAR, 18% or $80 million in EMEA, and 74% or $138 million in Asia. Q00-1 Office sales in the United States were flat with Q99-1 at $465 million. Other Office family product sales (FrontPage, Publisher, and PhotoDraw) missed plan for the quarter by 61% and declined 46% from Q99-1 as a result of cannibalization from Office Pro/Premium.
- Q00-1 Exchange revenue, including allocations, was $123 million, 8% below planned levels due to slow standard server sales coupled with a shortfall in Small Business Server allocations. Small Business Server revenue was $17 million, 32% below plan and flat with the comparable quarter in the prior year, due to weak sales in the United States, EMEA, and Japan. BackOffice suite revenue was slightly below planned levels for the quarter at $197 million, with weaknesses in server and CAL licensing in the United States and certain areas in EMEA, partially offset by large Select agreements in Germany and Italy.
- Developer revenue for Q00-1 was $269 million, 16% above plan and 18% over Q99-1, led by SQL Server standard shipments, Office Developer Edition sell-in, and Visual Basic sales. Developer Tools were 16% above plan for the quarter, but declined 3% from Q99-1. As anticipated, sales of most developer tools were below Q99-1 with no new releases, except for the Office Developer Edition. SQL Server sales, including allocations, were $186 million, 6% above plan and 67% above Q99-1, led by standard server shipments in Asia and the United States, along with large BackOffice Select deals in Germany and Italy. SQL Server sales were 6% higher than Q99-4, due to a summer slowdown and low allocated suite revenue.
- Business & Enterprise revenue for Q00-1 was $1.04 billion, 3% above plan and 39% greater than Q99-1. The variance to plan was driven by Windows NTW and Windows NT Server OEM licensing and maintenance. OEM sales were 7% over plan driven by strong shipments in the quarter. The Business & Enterprise growth over Q99-1 was led by Enterprise Agreements and strong OEM licensing.
- Windows NTW OEM revenue in Q00-1 was $390 million, 8% over plan and 51% greater than Q99-1. Windows NTW OEM licenses for Q00-1 were 4.0 million, up only 3% sequentially from Q99-4's 3.8 million licenses. Windows NTW OEM mix of 32-bit operating systems declined to 17.6% in Q00-1 from the record high in Q99-4 of 18.6%. Windows NTW in the FG channel (excluding EAs and maintenance) missed plan by $19 million or 15% due to shortfalls in the United States and the UK. Enterprise Agreements grew 172% over Q99-1 in Q00-1 to $128 million.
- Windows NT Server revenue, including allocations, was $393 million, 2% greater than plan, led by strong CAL licensing, partially offset by weaker standard server shipments and allocated SBS/BackOffice suites. Windows NT Server grew 33% over Q99-1, due to standard server shipments and allocated BackOffice suites. Windows NT Server standard licenses for Q00-1 totaled 454 thousand, 3% greater than plan.
- Q00-1 Consumer Windows FG sales were $484 million, 14% over plan, led by strong PC shipments and Windows 9x FG sales in the EMEA, Brazil, and Asia (except Japan). In the OEM channel, Consumer Windows revenue totaled $992 million for the quarter, 14% over plan and 15%

greater than Q99-1. Windows 95 OEM licenses still represented 23% of all Windows 9x OEM licenses in Q00-1, but down from 33% in Q99-4. Other operating systems, Windows 3.x and MS-DOS, sold through the OEM channel have not declined as quickly as planned. In the FG channel, Windows 9x sales were 30% over plan for the quarter, but declined 31% from Q99-1. Windows 9x FG sales have decreased from Q99-1, due to declining FPP sales since the launch spike for Windows 98. Windows 9x full packaged product (FPP) sales totaled $64 million in Q00-1, compared to $111 million in Q99-1, as most regions declined with the exception of the United States, which



already had high amounts in the channel in Q99-1.

- LEPD sell-in reached $153 million, 34% over plan and 28% higher than Q99-1, due to strong back to school sales and early sell-in for the holiday season. Revenue from Learning titles was $57 million, 60% above plan, due to the success of the Encarta Reference suite ($51 million, 73% over plan). Games titles reached $37 million in Q00-1, 45% greater than plan and 15% higher than Q99-1, due to Age of Empires ($12 million in Q00-1, up $6 million from Q99-1) and sport titles sell-in. Flight Simulator titles were down 38% from Q99-1 and missed plan by $2 million in Q00-1. Productivity suites were 11% above plan at $59 million due to the Works Suite OEM sales.
- Hardware sales were $148 million, 29% above plan, due to strong sales of gaming devices. Mouse sales reached $80 million for the quarter, with strong FG sales in the United States, Canada, and the UK and the OEM channel including initial sell-in of the new Mouse offerings - the Cordless Mouse and the Intellimouse Explorer. Gaming devices sell-in totaled $48 million in Q00-1, 73% higher than planned and 55% greater than Q99-1, with the launch of Sidewinder Dual Strike, Sidewinder Game Pad Pro, and SideWinder Precision Racing Wheel. Gaming devices strongly exceeded plan in nearly all regions except the United States, which missed plan by 22%. Keyboards missed plan for the quarter at $15 million, 23% below plan with weak OEM and FG sales in July and August. Actimates sell-in of the Barney doll and Teletubbies reached $5 million, which was higher than planned, but the sale price per item was significantly lower than costs. Actimates also faced $2 million of returns within Q00-1.
- Consumer and Commerce revsum revenue for Q00-1 was $251 million, 2% higher than plan and 89% higher than Q99-1. Driving the growth was WebTV revenue of $60 million, 138% greater than Q99-1, due to new subscribers. Advertising revenue increased $22 million from Q99-1 to $25 million in Q00-1, led by a new agreement with WebMD. Expedia.com revenue averaged over $1.3 million per week in Q00-1, doubling over Q99-1.

NET REVENUE BY CHANNEL

- *Net* revenue for Q00-1 totaled $5.29 billion, $431 million (9%) over plan and $988 million (23%) over Q99-1. Total FG revenue totaled $3.32 billion, 19% over Q99-1, with the strongest growth stemming from the Asia region, 69% over Q99-1. The EMEA also reported strong growth at 21% over Q99-1. SPAR net revenue was slightly up from Q99-1 driven by lower than planned results in the United States. The OEM channel grew 28% over Q99-1 to $1.77 billion, due to strong PC shipments and Windows NTW licensing. Online revenue more than doubled from Q99-1 to $238 million, led by WebTV and advertising.

NET REVENUE BY CHANNEL

(in millions)	Q00-1						
	Actual	Plan	Var %	Q99-1	Growth %	Q99-4	Growth %
SPAR FG	$1,527.5	$1,609.9	(5%)	$1,466.2	4%	$1,592.8	(4%)
EMEA FG	1,171.9	1,042.7	12%	967.8	21%	1,015.1	15%
Asia FG	623.0	497.1	25%	367.7	69%	439.0	42%
Total finished goods	3,322.4	3,149.7	5%	2,801.7	19%	3,046.9	9%
OEM	1,773.9	1,572.2	13%	1,386.9	28%	1,653.9	7%
Online	237.8	236.8	0%	117.7	102%	223.0	7%
Other	(46.4)	(102.4)	(55%)	(6.4)	622%	(167.9)	(72%)
Net revenue	$5,287.7	$4,856.3	9%	$4,299.9	23%	$4,755.9	11%

FINISHED GOODS

- For Q00-1, total finished goods net revenue was $3.32 billion, 5% over plan, due to strong Office 2000 related product sell-through in EMEA and Asia, especially Japan.
- South Pacific and Americas Region (SPAR) missed plan by 5% at $1.53 billion, due primarily to a shortfall in the United States. United States revenue for Q00-1 was $1.19 billion, 10% below plan and down 1% from Q99-1, due to slowing demand of Office products. Q00-1 Office suites (including EAs) in the United States totaled $480 million, flat with plan and 2% higher than Q99-1. However, in the United States, Q00-1 included high levels of returns of Office. Home and Retail products sold in $83 million, $2 million higher than plan, but with high levels of returns. Developer Group sales exceeded plan by 10% for the quarter, due to strong MSDN licensing. Business and Enterprise revenue missed plan by 8%, led by weak Windows NTW sales, but partially offset by BED maintenance. Other Office family, Exchange, and BackOffice products were weaker than planned for the quarter in the United States. Latin American sales were 22% over plan and 45% higher than Q99-1 at $158 million (just below Q99-4's $164 million). With a successful "Truce" anti-piracy campaign, Brazil ($70 million, 72% over plan) led the region with some weaker results in other subsidiaries - Mexico 18% below plan, Argentina 4% below plan, and Chile 3% below plan. Columbia beat plan for the quarter at $11 million, 24% over plan, also due to an anti-piracy campaign. In Canada, sales exceeded plan by 9% (23% higher than Q99-1) at $94 million, due to Office suites and Windows 98 sales. Australia's revenue was $75 million, 12% higher than plan due to Office 2000 and Home and Retail sell-in.
- Europe, Middle East, and Africa Region (EMEA) revenue of $1.17 billion was 12% over plan ($129 million) led by Office 2000 suites sales (12% over plan) and Home and Retail sell-in. Germany revenue reached $283 million for the quarter, 31% over plan and 43% higher than Q99-1, and surpassed the United Kingdom's $248 million of revenue. Germany's results included strong Office suites sales and a large BackOffice Select agreement. France revenue was $133 million for Q00-1, 17% over plan and 14% higher than Q99-1, led by Home and Retail sell-in and Windows platform sales. The United Kingdom was 9% over plan for the quarter at $248 million, with strong sell-in of Home and Retail products, however, weak Windows NTW licensing. Sweden missed plan by 10% led by slowing Office sales. The Netherlands was 11% below plan for the quarter due to weaker Windows NTW and Exchange sales. Belgium missed plan by 22% due to weak Office sales. Italy revenue of $67 million exceeded plan 7% for the quarter due to Office suites and LEPD sell-in. MENA revenue grew 53% over Q99-1, due to Office suites, Windows NT Server, and BackOffice suite.
- Asia region was 25% greater than plan and grew 69% over Q99-1, led by the launch of Office 2000 in the region and the anti-piracy campaign in Korea. The bump from budgeted foreign exchange rates contributed to 6% of the variance to plan. Japan finished the quarter at $478 million, 24% higher than plan, led by the Office 2000 related products, particularly the Word/Excel bundle ($119 million, 58% above plan). Other strengths in Japan included Developer Tools sales, with Visual Basic Pro/Premium sales and the launch of Office Developer edition. Korea's strength in Q00-1 was the largest in the region. Korea's Q00-1 revenue was 96% over plan and grew 227% over Q99-1 to $40 million, due to the launch of an anti-piracy campaign, which drove Office suites sales and platform sales. South Asia revenue reached $51 million in Q00-1, 18% stronger than planned, led by India (22% over plan), the Philippines (39% over plan), and Thailand (21% over plan). South Asia's growth over Q99-1 was 52%, with strong growth in every subsidiary. Office suites and Windows NT Server were the largest contributors to the growth in South Asia from Q99-1. China's revenue of $13 million grew 191% over Q99-1 revenue in Q00-1, led by Office suites, Windows NT Server, and SQL Server sales. Taiwan was 9% above plan for the quarter at $23 million.

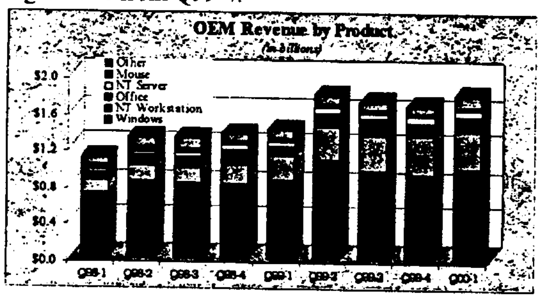
FOREIGN EXCHANGE

(in millions)	Q00-1 Variance to plan				
	Volume	FX	FX %	Total	Total %
SPAR FG	($14.8)	$1.0	0%	($13.8)	(1%)
EMEA FG	117.7	9.3	1%	127.0	12%
Asia FG	69.0	27.2	6%	96.2	21%
Total FG gross revenue	$171.9	$37.5	1%	$209.4	7%

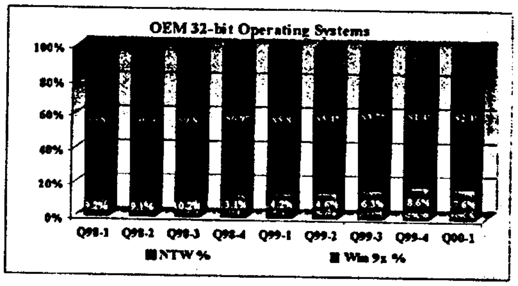
- Compared to planned rates, the strength of the Japanese yen and some European currencies caused a net positive foreign exchange bump. Budgeted foreign exchange rates were conservative. The foreign exchange rate impact on gross revenue versus plan in the first quarter was $38 million. In terms of the impact as a percentage of total FG gross revenue, the percentage was minimal.
- In EMEA, the foreign exchange variance to budgeted rates was a bump of $9 million. No subsidiary had a material variance to plan due to foreign exchange rates.
- The Japanese yen strengthened against the U.S. dollar throughout Q00-1. The average exchange rate for the Japanese yen for Q00-1 was 116, in comparison with a budgeted exchange rate of 123. As a result, Japan had a positive exchange variance of $24 million, 7% of budgeted revenue in Q00-1. In Korea, the won was stronger than anticipated, whereas the positive exchange rate variance was 15% of gross revenue, but the positive total variance to plan was 112%.

OEM

- OEM results for Q00-1 were 13% over plan at $1.77 billion led by strong OEM PC shipments. Windows 9x OEM revenue was 13% above plan, due a larger mix of Windows operating system shipments than planned. Windows NTW OEM revenue was 8% over plan at $390 million with units 14% over plan. Window NTW units shipped in the DSP channel fell 7% below plan, but still grew 9% from Q99-4.



- Windows NTW OEM unit mix of 32-bit operating systems was 17.6% in Q00-1, falling from the record high in Q99-4 of 18.6%. Shipments to the consumer market, which has a higher percentage of Windows 98, are usually the lowest in Q99-4. OEM revenue grew 28% over Q99-1, led by strong Windows NTW licensing.



COST OF REVENUE

(in millions, variance to plan)	Q00-1						
	Actual	Plan	Variance	Q99-1	Growth	Q99-4	Growth
Net revenue	$ 5,287.7	$ 4,856.3	$ 431.4	$ 4,299.9	$ 987.8	$ 4,755.9	$ 531.8
Cost of revenue							
MSN Access	43.0	46.6	3.6	38.0	5.0	37.0	6.0
WebTV	37.0	38.1	1.1	63.0	(26.0)	66.0	(29.0)
Other Online	28.0	25.8	(2.2)	(5.0)	33.0	22.0	6.0
Press	13.0	17.9	4.9	21.0	(8.0)	18.0	(5.0)
Software/licensing/programs	167.1	194.8	27.6	182.2	(15.1)	170.7	(3.6)
Hardware	97.0	66.2	(30.8)	65.0	32.0	70.0	27.0
MCP/MCSP	26.0	24.5	(1.5)	-	26.0	-	26.0
Cost of revenue	$ 411.1	$ 414.0	$ (2.8)	$ 364.2	$ 46.9	$ 383.7	$ 27.4
% of consolidated net revenue							
MSN Access	0.8%	1.0%	0.1%	0.9%	0.1%	0.8%	(0.0%)
WebTV	0.7%	0.8%	0.1%	1.5%	0.8%	1.4%	0.7%
Other Online	0.5%	0.5%	0.0%	(0.1%)	(0.6%)	0.5%	(0.1%)
Press	0.2%	0.4%	0.1%	0.5%	0.2%	0.4%	0.1%
Software/licensing/programs	3.2%	4.0%	0.8%	4.2%	1.1%	3.6%	0.4%
Hardware	1.8%	1.4%	(0.5%)	1.5%	(0.3%)	1.5%	(0.4%)
MCP/MCSP	0.5%	0.5%	0.0%	-	(0.5%)	-	(0.5%)
% of consolidated net revenue	7.8%	8.5%	0.7%	8.5%	0.7%	8.1%	0.3%

- Cost of revenue compared to plan was positively impacted by the greater mix of licensed product and higher margin products, offset partially by higher volumes of Hardware products. Q00-1 cost of revenue as a percentage of net revenue was 7.8%, 0.7 points below the budgeted amount of 8.5%.
- Compared to Q99-1, cost of revenue as a percent of net revenue decreased 0.7 points from 8.5%, led by lower WebTV costs and software, licensing, and program costs. Software, licensing and program costs were influenced by higher margin product sales and Enterprise Agreement, Open, and OEM licensing. Offsetting these gains, the reclass of MCP costs to cost of revenue in Q00-1, caused an unfavorable 0.5 points compared to prior quarters.
- WebTV costs of $37 million in Q00-1, versus $66 million in Q99-4, represented a decrease in subsidy costs. Online costs in Q99-4 included a year to date restatement of server depreciation (previously server costs were expensed in the month purchased, but are now be depreciated over 3 years).

LICENSE MIX

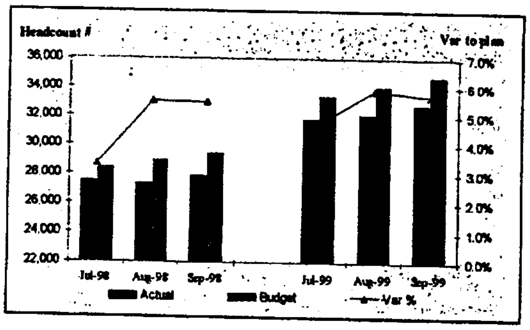
- Q00-1 packaged product sales of $843 million declined 11% from Q99-1, mostly attributable to high levels of Q00-1 Office and Office family returns and Q99-1 Windows 98 sell-in in Japan. Packaged product sales for other products, including Developer Tools, operating systems, and servers have also decreased. Hardware FG sell-in grew 21% over Q99-1 due to the release of several new products.
- Licensing represented 74.5% of Q00-1 revenue, compared to 65.5% for Q99-1. Open licensing and Enterprise Agreements were the main contributors to the growth in licensing, up 41% and 157% from Q99-1. Select licensing grew only 10% in Q00-1 driven by a 12% decrease in Windows NTW licensing and a growth of only 6% in Office sales. Open licensing growth was driven by strong Windows NT Server licensing (up 83%), SQL Server (up 183%), and Developer Tools licensing. Enterprise Agreement revenue represents 13% of FG revenue reaching $440 million. Signed new EA agreements were off to a slow start in July and August, but increased in September. There were 227 new EAs billed in Q00-1, an improvement over the 99 agreements in Q99-1, but down from the record 390 agreements in Q99-4. This is primarily driven by the new strategic focus on penetrating the Breadth/MORG space. Also, first quarter is typically slow and there was a draining of the current EA pipeline, which saw a push to close deals before the end of FY99.

OPERATING EXPENSES

(in millions, except cost per head, variance to plan)	Q00-1 Actual	Q00-1 Plan	Var %	Q99-1	Growth %	Q99-4	Growth %
Regular headcount expense	$1,152.1	$1,252.6	8%	$907.2	27%	$1,113.2	3%
Other headcount expense	166.0	164.4	(1%)	140.8	18%	178.2	(7%)
Vendors	105.0	125.3	16%	108.2	(3%)	133.5	(21%)
Infrastructure costs	251.3	356.7	30%	224.4	12%	310.9	(19%)
Marketing expenses/ TV advertising	351.6	542.7	35%	252.0	39%	588.6	(40%)
PSS/MCS cost recovery	(145.2)	(141.9)	2%	(118.9)	22%	(164.5)	(12%)
Third-party product development	122.0	200.1	39%	68.5	78%	168.6	(28%)
Other misc. expenses	67.8	117.0	42%	85.6	(21%)	271.3	(75%)
Total operating expenses	$2,070.4	$2,616.9	21%	$1,667.8	24%	$2,599.8	(20%)
Avg non-operations headcount	30,753	32,367	5%	26,336	17%	29,426	5%
People cost per head	$149,849	$154,800	3%	$137,794	9%	$151,323	(1%)
Infrastructure cost per head	$32,683	$44,083	26%	$34,076	(4%)	$42,264	(23%)
(annualized cost per average MS head)							
Contingent staff and vendors	23.5%	23.1%		27.4%		28.0%	
(as a percentage of people costs)							

(Note: excludes heads and expenses related to operations included in cost of revenue)

- Operating expenses for Q00-1 were $2.07 billion, 21% below plan, but 24% higher than Q99-1. The increased spending over Q99-1 was fueled by headcount additions and compensation increases, as well as higher marketing and third-party development spending.
- Regular headcount expense includes payroll, payroll taxes, bonuses, stock option expense, training, travel, and other related expenses. Stock option expense includes the amortization of the Black-Scholes value of granted employee stock options. Q00-1 annualized people cost per head was $149,849, 3% below planned levels. Although payroll and payroll taxes per head were relatively on plan, stock option expense was over plan due to the expense for accelerated vesting of certain ex-employees' grants. Other people-related expenses including employee recruiting, travel and entertainment were all below plan, due to lower than planned headcount levels. Average total headcount, excluding manufacturing operations, during Q00-1 was 30,753, 5% below plan.



- Other headcount expense, primarily contingent staff expenses, was $166 million for the quarter, slightly above plan. Contingent staff spending was over planned levels in Business & Enterprise, Consumer and Commerce, Developer, Home & Retail, and Information Technology. With the upcoming release of Windows 2000, other recent product releases, and slower hiring of regular heads than planned, contingent staff expense was over plan for these divisions. Other headcount expense has grown 18% from Q99-1 and was down sequentially from Q99-4.
- Infrastructure costs in the quarter totaled $251 million, 30% under plan, due to slower new headcount additions for which computer purchases were budgeted and delayed start of certain lab spending projects. Computers and some servers, are fully expensed in the quarter in which purchased.
- Marketing expenses for Q00-1 were $352 million, 35% below plan, as marketing initiatives slowly ramp up after strong spending in Q99-4. Marketing spend increased 39% from Q99-1 driven primarily by proliferated spending in Consumer and Commerce and Business Productivity Group.
- PSS revenue in the quarter totaled $65 million, slightly lower than planned levels due to delayed renewal of Premier contracts. MCS Q00-1 revenue was $97 million, $2 million higher than plan, led by subcontractor revenue and internal funding for consultants. MSC consultant external funding was $6 million under plan at $69 million.

- Q00-1 third-party product development was $122 million, 39% below plan with every division below plan due to timing of localization and acquisition spending. Third-party product development costs were 78% higher than Q99-1, driven by purchased code and intellectual property amortization.
- Other expenses, which include bad debts, taxes and licenses, and miscellaneous operating expenses, were $68 million in Q00-1. Q99-4 other expenses included $34 million for MSNBC Cable write-off of a cable JV option,, and $40 million for SoftArt intellectual rights.

SALES, MARKETING & SUPPORT COSTS

(in millions, variance to plan)	Q00-1						
	Actual	Plan	Var %	Q99-1	Growth %	Q99-4	Growth %
Sales expenses:							
SPAR FG	$182.7	$224.9	19%	$137.8	33%	$191.6	(5%)
EMEA FG	140.1	164.8	15%	118.9	18%	139.3	1%
Asia FG	49.9	56.3	11%	37.9	32%	51.2	(2%)
Corp HQ	(6.8)	(9.5)	29%	(5.8)	16%	(7.0)	(3%)
FG total	366.0	436.6	16%	288.7	27%	375.1	(2%)
MCS (net)	30.5	51.8	41%	24.5	25%	26.4	15%
OEM	29.4	33.4	12%	23.4	26%	71.4	(59%)
Online	22.2	29.1	24%	11.3	97%	28.5	(22%)
Other	(4.6)	4.0	217%	20.5	(123%)	23.6	(120%)
Sales expenses	443.6	554.9	20%	368.3	20%	525.0	(16%)
Product support	187.5	235.3	20%	176.0	7%	200.8	(7%)
Channel marketing:							
SPAR	71.4	113.7	37%	62.4	15%	133.9	(47%)
EMEA	64.1	85.2	25%	59.3	8%	99.8	(36%)
Asia	33.3	44.2	25%	25.8	29%	51.1	(35%)
FG total	168.9	243.1	31%	147.6	14%	284.8	(41%)
OEM	9.8	6.4	(55%)	16.8	(41%)	13.4	(27%)
On-Line	13.3	20.5	35%	14.7	(9%)	30.7	(57%)
Other	6.5	10.9	40%	4.7	37%	14.9	(56%)
Channel marketing	198.4	280.9	29%	183.7	8%	343.8	(42%)
Broad reach	1.1	3.1	65%	6.2	(82%)	15.1	(93%)
Total	$830.6	$1,074.1	23%	$734.2	13%	$1,084.6	(23%)

- Sales, marketing and support expenses were $831 million for the first quarter, $243 million and 23% below plan, with most of the variance stemming from the timing of new hire additions, related headcount expenses and marketing spend.
- Channel marketing was 29% under plan, resulting from prior quarter's high spend related to Office 2000 launch activities and slow ramp up of new marketing projects. Broad reach marketing in FY00 is primarily composed of TV advertising, which is expected to ramp up in Q00-2.
- Product support *net* costs were 20% lower than plan due to headcount related expenses due to an aggressive hiring plan. Offsetting the lower net costs, revenue for the quarter fell below plan due to Premier contract signings.

BUSINESS DIVISION COSTS

(in millions, variance to plan)	Q00-1						
	Actual	Plan	Var %	Q99-1	Growth %	Q99-4	Growth %
Business Divisions:							
Business & Enterprise Group	$170.5	$197.4	14%	$129.2	32%	$174.8	(2%)
Consumer Windows	54.8	63.0	13%	57.5	(5%)	51.4	7%
Streaming Media	16.0	19.7	19%	10.3	55%	17.3	(7%)
Office	69.1	83.9	18%	67.3	3%	117.9	(41%)
Office Family	15.5	16.5	6%	14.3	9%	17.1	(9%)
Productivity Appliances	34.1	46.5	27%	28.1	22%	43.4	(21%)
Server Applications	63.5	76.0	16%	37.9	68%	51.6	23%
Other business productivity	37.3	44.7	17%	24.2	54%	37.7	(1%)
Business Productivity Group	219.5	267.5	18%	171.8	28%	267.6	(18%)
Developer Group	142.3	152.7	7%	107.3	33%	132.3	8%
Portal	46.9	53.6	12%	67.4	(30%)	69.0	(32%)
Access	6.2	8.6	27%	1.9	nm	18.1	(65%)
TV	52.5	61.6	15%	31.2	68%	50.6	4%
CCG Central	30.8	43.8	30%	11.6	166%	32.1	(4%)
Commerce Platform	14.3	14.8	3%	nm	nm	31.5	(55%)
Expedia.com	9.2	9.6	4%	6.5	42%	19.4	(53%)
Other CCG	36.1	45.3	20%	39.7	(9%)	63.9	(44%)
Consumer & Commerce Group	196.0	237.1	17%	158.3	24%	284.5	(31%)
Business Divisions	799.1	937.4	15%	634.4	26%	927.8	(14%)
Home & Retail:							
Hardware	20.4	19.2	(6%)	17.9	14%	23.1	(12%)
LEPD	53.3	59.7	11%	46.6	14%	65.7	(19%)
Dreamworks	1.4	0.2	nm	1.5	(6%)	2.4	(43%)
Home & Retail	75.1	79.0	5%	65.9	14%	91.2	(18%)
Other	48.7	66.0	26%	57.5	(15%)	46.2	5%
Total	$922.9	$1,082.4	15%	$757.8	22%	$1,065.2	(13%)

- Business divsions costs in the quarter totaled $923 billion, 15% under plan due to lower headcount and related costs than budgeted. Lower third-party development spending, localization, acquisition costs also contributed to the $159 million variance to plan. Product development costs were down 13% from the higher spending in Q99-4.
- For Q00-1, the Business and Enterprise Group product development spend was $171 million, 14% under plan, led by lower regular headcount expenses, offset by contingent staff expense which was used to fill for the open headcount positions. Localization and third-party development was also below plan. Business and Enterprise Group product development spend increased 32% from Q99-1 driven by increased headcount and contingent staff costs.
- Business Productivity Group spend was $220 million, 18% below plan due to the timing of lab spending and third-product development. Payroll expenses were slightly above plan for the quarter. Compared to Q99-1, Business Productivity growth was 28%, driven by intellectual property amortization in Server Applications and increased headcount overall.
- Consumer and Commerce product development spending was $196 million, 17% below plan for the quarter, due the timing of purchased code and lab spending. Consumer and Commerce spending increased 24% from Q99-1 due to increased intellectual property amortization costs and headcount increases.
- Home and Retail product costs were 5% below plan at $75 million, but Hardware was 6% over plan. Hardware product development costs exceeded plan due to third-party development and contingent staff costs.

GENERAL & ADMINISTRATIVE COSTS

(in millions, variance to plan)	Q00-1 Actual	Plan	Var %	Q99-1	Growth %	Q99-4	Growth %
Human resources	$92.2	$96.0	4%	$72.8	27%	$82.5	12%
Information technology group	73.3	100.1	27%	50.6	45%	80.0	(8%)
Law and corporate affairs	72.2	93.8	23%	46.0	57%	90.7	(20%)
Finance and administration	106.3	117.1	9%	95.5	11%	123.7	(14%)
Executive	34.1	6.6	nm	0.9	nm	1.5	nm
Other	(21.5)	2.4	nm	(0.6)	nm	3.8	nm
Gross spending	356.6	416.1	14%	265.2	34%	382.2	(7%)
Distribution	(188.5)	(210.6)		(150.4)		(157.6)	
Net general & administrative	$168.1	$205.5		$114.9		$224.7	

- General and administrative (G&A) costs include corporate cost centers that support MS on a worldwide basis. Net expenses, after distributions, include IT project development and regional support, finance, legal and corporate affairs, HR services such as employee development, compensation, and administrative support service. Distributed costs include employee benefits, IT and support, recruiting, real estate expenses and services for the copy center and company store.

- Q00-1 gross G&A costs were $357 million, 14% under plan, led by lower headcount and related costs than planned. G&A headcount was 3,004 at the end of Q00-1, 6.9% below the plan of 3,225. Q00-1 results also included a charge for the accelerated vesting of certain employee stock options, partially offset by a credit to settlement expense. Gross G&A costs increase 34% over Q99-1, led by staff expansion in legal and information technology group. Law and corporate affairs increased 57% from Q99-1 to $72 million.

CASH FLOW SUMMARY

(in millions)	Three months ended Jun 30, 1999	Sep 30, 1999	Change
Operations			
Net income	$2,202	$2,191	($11)
Depreciation and amortization	496	440	(56)
Gain on sale	-	(156)	(156)
Unearned revenue	1,738	1,253	(485)
Recognition of unearned revenue from prior periods	(1,694)	(1,363)	331
Other current liabilities	260	(345)	(605)
Accounts receivable	(495)	64	559
Other current assets	(131)	(94)	37
Net cash from operations	2,376	1,990	(386)
Financing			
Common stock issued	248	461	213
Common stock repurchased	(1,423)	(1,034)	389
Put warrant proceeds	9	290	281
Preferred stock dividend	(7)	(7)	-
Stock option income tax benefits	869	1,215	346
Net cash from (used for) financing	(304)	925	1,229
Investments			
Additions to property and equipment	(292)	(139)	153
Purchases of investments	(15,752)	(7,227)	8,525
Maturities of investments	1,289	786	(503)
Sales of investments	11,442	3,460	(7,982)
Net cash used for investments	(3,313)	(3,120)	193
Net change in cash and equivalents	(1,241)	(205)	1,036
Effect of exchange rates on cash and equivalents	13	19	6
Beginning balance of cash and equivalents	6,203	4,975	(1,228)
Ending balance of cash and equivalents	4,975	4,789	(186)
Ending balance of short term investments	12,261	14,113	1,852
Ending cash & short term investments	$17,236	$18,902	$1,666

- Cash and short-term investments at the end of September were $18.90 billion, an increase of $1.67 billion from June 30, 1999.
- Cash from operations was $1.99 billion, a decrease of $386 million from the prior quarter primarily due to increased income tax payments, partially offset by accounts receivable payments received from Q99-4 Office 2000 sales.
- Net cash from financing was $925 million due to greater volumes of stock option exercises and $290 million from put warrant proceeds.
- Cash used for investments was $3.12 billion for Q00-1 due to new equity investments throughout the quarter, including $403 million of Rogers Communications preferred stock and warrants and $233 million of Ticketmaster common stock received in exchange for Sidewalk A&E and cash.

Operations

COST OF REVENUE SUMMARY

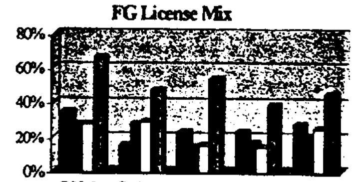
($ in millions)	Q00-1 Actual	Q00-1 Plan	Q00-1 Variance
COGS $			
FG + ROEM	$ 251.9	$ 255.6	$ 3.7
OEM (excl ROEM)	38.5	32.0	(6.5)
Online	109.7	110.5	0.8
Other	11.0	15.8	4.8
Total	$ 411.1	$ 414.0	$ 2.8
% of Consolidated Net revenue			
FG + ROEM	4.8%	5.3%	0.5%
OEM (excl ROEM)	0.7%	0.7%	(0.1%)
Online	2.1%	2.3%	0.2%
Other	0.2%	0.3%	0.1%
Total	7.8%	8.5%	0.7%

- Q00-1 cost of revenue as a percentage of net revenue was 7.8%, 0.7 points below the budget of 8.5% driven by higher than planned volumes of higher margin products.
- WebTV costs were $37 million in Q00-1, slightly below plan and down $26 million from Q99-4, driven by lower subsidy costs. MSN access costs were $43 million, $4 million lower than plan, due to lower subscribers than anticipated. respectively.

LICENSE MIX TRENDS

- Q00-1 FPP license mix increased 5.9 percentage points compared to Q99-4, due to high volumes of Hardware and LEPD products and Office 2000 in Asia.
- Compared to Q99-1, Q00-1 FPP mix declined 8 percentage points, due to the continued shift to EAs, Open, and Select.

FG License Mix



	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
WW	34.6%	15.3%	23.1%	23.3%	27.6%
SPAR	27.6%	27.6%	13.6%	17.0%	20.5%
EMEA	27.0%	29.0%	14.9%	13.8%	24.8%
Asia	65.7%	47.0%	53.5%	37.9%	44.9%

FINISHED GOODS SUMMARY

Note: The Finished Goods category represents all Software (licensing and finished packaged products), Hardware, and Programs business that is distributed or sold, including Retail OEM, but excludes OEM, Press, and Online business.

- Total Q00-1 finished goods (FG) cost of revenue (COGS) was favorable to plan by $4 million (1.4%) and 0.5 points favorable as a percentage of net revenue. The following table highlights the major category drivers for Q00-1:

($ in millions)	Q00-1 variance $	Q00-1 variance Pts.
Product costs	$ (7.4)	(0.0)
Royalties	0.1	0.0
Business operations	9.1	0.4
Obsolete/scrapped inventory	1.5	0.1
Channel costs	0.4	0.1
Total variance	$ 3.7	0.5

- Product costs exceeded plan by $7 million, but on plan as a percentage of net revenue, driven by higher standard product costs and hardware tooling costs. These were partly offset by lower volumes of Select CD-ROMs. Standard product costs were driven by a mix shift to lower margin hardware and LEPD products shipped in anticipation of the holiday season. In addition, unfavorable revenue adjustments driven by channel reserves had a negative impact on COGS as a percentage of net revenue.
- Business operations were favorable by $9 million (0.4 pts favorable) driven by lower than planned headcount and related costs, vendor costs, and lab spend due to the delay of initiatives in OPS IT and programs.
- Obsolete and scrapped inventory was $1.5 million favorable (0.1 points favorable) driven by lower than planned obsolescence and return scrap volumes (partly as a result of the Office 97 life-cycle extension in Japan). These lower expenses were partially offset by rework incurred on Actimates pursuant to a sales agreement with KayBee Toys in North America and rework related to the Duo Campaign in France. Rework related to the KayBee Toys agreement involved repackaging

the ActiMates to include TV packs and to ensure that all the units shipped to KayBee Toys were in the same packaging.

- Channel costs were slightly favorable (0.1 points favorable) driven by favorable FPP and programs freight and fulfillment costs, partly offset by licensing freight and Office 2000 technology guarantee direct fulfillment expenses.

FG & OEM COST OF REVENUE TREND

- Compared to Q99-1, COGS increased by 0.9 points as a percent of net revenue, driven by higher volumes of hardware and LEPD, despite a favorable shift in license mix from FPP to licensed product. Also of note, MCP/MCSP costs were accounted for below gross margin in FY99.
- Compared to Q99-4, COGS as a percent of net revenue increased by 0.5 points due to seasonal shift to higher COGS products such as hardware and LEPD. In addition, higher license verification program call volumes, higher costs associated with the fulfillment of Office 2000 technology guarantee, Win98 SE, and the accounting of MCP/MCSP below gross margin in Q99-4, contributed to the growth in COGS. These increases were partly offset by the absence of Java scrapping and the accounting of referral server costs below gross margin in Q00-1.

Q00-1 FG & OEM COST OF REVENUE BY BUSINESS STREAM

Note: This presentation of Cost of Revenue by business stream reflects the Finished Goods and OEM business cut by operational supply chain. See attached summary variances on bottom of next page.

PACKAGED PRODUCTS

- Software cost of revenue for Q00-1 was $12 million below plan (0.9 points favorable), caused by a favorable mix shift to licensing and lower Office 2000 volumes.
- Hardware COGS for Q00-1 was $30 million above plan (2.9 points unfavorable), driven by the volume of sales, higher freight and expediting costs than planned to meet advertising deadlines due to production delays, the KayBee Toys Actimates sale, and hardware tooling costs for new mice and keyboard products.

LICENSING

- OEM licensing COGS for Q00-1 were $2.2 million lower than plan (0.2 points favorable) due to lower miscellaneous COGS, delay in the roll-out of the Edge-to-Edge anti-piracy campaign as a result of the delay in the Windows 2000 release, and business operations expenses driven by headcount and start-up delays of key initiatives.
- Volume licensing COGS for Q00-1 were $8.0 million lower than plan (0.6 points favorable) driven primarily by select CD costs due to lower CD volumes and favorable CD pricing. In addition, business operation costs were less than plan, driven by lower headcount and start-up delays of key initiatives including Supply Chain Management projects (EMS2000, MERT) and SAP change requests.

PROGRAMS

- Subscription COGS for Q00-1 were $8 million below plan and 14.5 points favorable, driven by lower MSDN sales volume, a shift to MSDN licensing, and the timing of MCSP standard product costs versus a straight-lined budget.
- Fulfillment COGS for Q00-1 were $4 million over plan, but 3.9 points favorable driven by higher volumes and vendor fulfillment costs for the Office 2000 technology guarantee program, Windows 98 SE, and the license verification program call volumes. The reversal of the Office 2000 technology guarantee accrued in FY99, freight recoveries, and lower MCP test volumes partly offset the higher costs.

Q00-1 Business Stream Cost Of Revenue Summary Variances

	FPP		Licensing		Programs		Total	
Actuals								
Net Revenue	1,045,433	100.0%	3,761,056	100.0%	156,499	100.0%	4,962,988	100.0%
Product Costs	124,520	11.9%	5,558	0.1%	28,402	18.1%	158,480	3.2%
Royalties	5,091	0.5%	1,086	0.0%	96	0.1%	6,274	0.1%
Business Operations	21,262	2.0%	22,793	0.6%	11,312	7.2%	55,367	1.1%
Obsolete & Scrapped Inventory	11,983	1.1%	743	0.0%	1,087	0.7%	13,813	0.3%
Channel Costs	12,184	1.2%	4,207	0.1%	40,073	25.6%	56,464	1.1%
Total Cost of Revenue	175,040	16.7%	34,387	0.9%	80,970	51.7%	290,397	5.9%
Gross Margin	870,394	83.3%	3,726,668	99.1%	75,529	48.3%	4,672,591	94.1%
Budget								
Net Revenue	1,051,397	100.0%	3,402,171	100.0%	141,149	100.0%	4,594,717	100.0%
Product Costs	99,277	9.4%	11,137	0.3%	31,700	22.5%	142,114	3.1%
Royalties	3,815	0.4%	2,179	0.1%	252	0.2%	6,246	0.1%
Business Operations	26,387	2.5%	26,482	0.8%	12,557	8.9%	65,427	1.4%
Obsolete & Scrapped Inventory	13,497	1.3%	842	0.0%	1,042	0.7%	15,381	0.3%
Channel Costs	13,806	1.3%	3,994	0.1%	39,182	27.8%	56,983	1.2%
Total Cost of Revenue	156,783	14.9%	44,634	1.3%	84,734	60.0%	286,150	6.2%
Gross Margin	894,614	85.1%	3,357,537	98.7%	56,416	40.0%	4,308,566	93.8%
Variance Fav/(Unfav)								
Net Revenue	(5,963)	Pts	358,885	Pts	15,350	Pts	368,271	Pts
Product Costs	(25,243)	(2.47)	5,579	0.18	3,298	4.31	(16,367)	(0.10)
Royalties	(1,275)	(0.12)	1,092	0.04	156	0.12	(27)	0.01
Business Operations	5,125	0.48	3,689	0.17	1,246	1.67	10,060	0.31
Obsolete & Scrapped Inventory	1,514	0.14	99	0.00	(45)	0.04	1,568	0.06
Channel Costs	1,622	0.15	(212)	0.01	(891)	2.15	519	0.10
Total Cost of Revenue	(18,257)	(1.83)	10,247	0.40	3,763	8.29	(4,247)	0.38
Gross Margin	(24,220)	(1.83)	369,131	0.40	19,113	8.29	364,024	0.38

Product Development

BUSINESS DIVISIONS

INTERNAL MANAGEMENT RESULTS

Q00-1

(in millions, variance to plan)	Windows Platforms	Prod Apps & Developer	Consumer, Comm., & Other	Total
Net revenue	$2,196.7	$2,430.1	$660.9	$5,287.7
Cost of revenue	43.0	84.1	284.0	411.1
Gross margin	2,153.7	2,346.0	376.9	4,876.6
% of net revenue	*98.0%*	*96.5%*	*57.0%*	*92.2%*
Direct controllable operating expenses:				
Regular headcount expense	162.4	228.1	760.2	1,150.6
Other headcount expense	45.5	37.1	83.0	165.5
Infrastructure expense	48.2	49.2	153.5	250.9
Product development	19.4	38.2	32.0	89.5
Acquisition amortization	0.0	0.0	14.5	14.5
External localization	8.6	4.5	7.2	20.3
Product marketing	33.9	37.4	77.5	148.8
Channel mktg - controllable	0.0	0.0	15.6	15.6
Other	(0.5)	3.8	64.8	68.1
Direct controllable operating expenses	317.3	398.3	1,208.2	1,923.8
Product-related operating expenses:				
Taxes, insurance, and settlements	0.3	0.1	(13.5)	(13.2)
Product support services	76.7	86.7	(211.6)	(48.2)
Bad debt expense	7.5	6.3	7.0	20.8
R&D shared resources	8.7	(5.3)	(3.4)	0.0
Product-related operating expenses	93.2	87.8	(221.5)	(40.5)
Total operating expenses	410.5	486.1	986.7	1,883.3
Responsibility margin	1,743.2	1,859.9	(609.8)	2,993.3
% of net revenue	*79.4%*	*76.5%*	*(92.3%)*	*56.6%*
Corporate allocations	*$258.5*	*$439.5*	*($510.8)*	*$187.1*
Contribution margin	$1,484.7	$1,420.4	($98.9)	$2,806.2
% of net revenue	*67.6%*	*58.5%*	*(15.0%)*	*53.1%*

WINDOWS PLATFORMS
Q00-1

(in millions, variance to plan)	Business & Enterprise		Consumer Windows		Streaming Media		Research		Windows Platforms	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net revenue	$1,080.9	3%	$1,115.7	15%	$0.1	nm	$0.0	nm	$2,196.7	9%
Cost of revenue	26.9	17%	16.2	(6%)	0.0	nm	0.0	nm	43.0	10%
% of net revenue	*2.5%*		*1.4%*		*2.3%*		*nm*		*2.0%*	17%
Gross margin	1,054.1	(4%)	1,099.5	(16%)	0.1	nm	0.0	nm	2,153.7	(10%)
Direct controllable operating expenses:										
Regular headcount expense	90.2	6%	33.8	4%	10.0	10%	28.3	6%	162.4	6%
Other headcount expense	31.8	(18%)	8.4	14%	2.5	4%	2.8	11%	45.5	(7%)
Infrastructure expense	27.0	21%	10.3	18%	2.2	40%	8.6	(53%)	48.2	14%
Product development	12.9	47%	2.3	41%	0.6	59%	3.7	65%	19.4	52%
Acquisition amortization	0.0	nm	0.0	nm	0.0	nm	0.0	nm	0.0	nm
External localization	5.7	48%	2.5	44%	0.4	33%	0.0	nm	8.6	46%
Product marketing	26.0	(55%)	1.9	34%	3.6	45%	2.4	6%	33.9	(18%)
Channel mktg - controllable	0.0	nm	0.0	nm	0.0	nm	0.0	nm	0.0	nm
Other	(0.9)	4%	0.0	(526%)	0.0	nm	0.4	(17%)	(0.5)	(6%)
Direct controllable operating expenses	192.6	8%	59.3	14%	19.3	26%	46.1	12%	317.3	11%
Product-related operating expenses:										
Taxes, insurance, and settlements	0.1	(703%)	0.1	nm	0.0	nm	0.0	nm	0.3	nm
Product support services	39.1	34%	37.6	1%	0.0	(477%)	0.0	nm	76.7	21%
Bad debt expense	3.2	9%	4.3	8%	0.0	nm	0.0	nm	7.5	(0%)
R&D shared resources	2.6	33%	5.3	15%	1.0	34%	(0.2)	575%	8.7	26%
Product-related operating expenses	45.1	32%	47.3	2%	1.1	32%	(0.2)	524%	93.2	20%
Total operating expenses	237.7	13%	106.5	9%	20.3	26%	45.9	12%	410.5	13%
Responsibility margin	816.4	(10%)	993.0	(19%)	(20.3)	(26%)	(45.9)	(12%)	1,743.2	(17%)
% of net revenue	*75.5%*	(7%)	*89.0%*	(3%)	*nm*		*nm*		*79.4%*	(7%)
Corporate allocations	*$196.3*	(18%)	*$51.7*	15%	*$3.5*	5%	*$7.0*	8%	*$258.5*	(17%)
Contribution margin	$620.1	24%	$941.3	22%	($23.7)	24%	($52.9)	12%	$1,484.7	25%
% of net revenue	*57.4%*	20%	*84.4%*	5%	*nm*		*nm*		*67.6%*	15%

WINDOWS PLATFORMS RESULTS

- Business and Enterprise Q00-1 net revenue of $1.1 billion was 3% over plan, representing a 2% sequential decline over Q99-4, but a 40% increase over Q99-1 prior year. Primary drivers were Windows NT Server, Windows NT Server OEM, and Windows NT Workstation OEM. Including allocations from suites, Windows NT Server gross revenue totaled $636 million, which was 4% over plan and up 45% from Q99-1. Windows NT Workstation gross revenue was $392 million, which was 2% over plan and up 33% from Q99-1, driven primarily by a higher OEM mix. Q00-1 Windows NT Workstation OEM revenue of $347 million exceeded plan by 12% and was 50% greater than Q99-1. Infrastructure applications, including SMS/Proxy Server ended the quarter with $90 million in gross revenue, which was 3% over plan and 19% over Q99-1.
- Consumer Windows Q00-1 net revenue of $1.1 billion was 15% over plan on the strength of finished goods sales (16% over plan). The softness in retail Windows 9x was offset by favorable user type mix where standard product significantly outpaced the plan.

OUTLOOK

- Business and Enterprise Q00-2 net revenue is expected to be incrementally higher at $1.23 billion following a stronger-than-expected Q00-1. OEM gross revenue is expected to be approximately $550 million. Sequential growth is expected to be flat to marginal for the Windows NT Server and Window NT Workstation product lines as the market anticipates the launch of Windows 2000 later in the fiscal year.
- Consumer Windows Q00-2 net revenue is expected increase 26% sequentially from Q00-1 to $1.39 billion. This increase will be driven by Windows 9x finished goods, which will be boosted by the holiday Play Pack promotion, and seasonal OEM shipment increases. These increases will be partially offset by declining annuity business and sales of 16-bit operating systems.

AUTHOR: GLENN WISEGARVER (GLENNWIS)

BUSINESS & ENTERPRISE

INVESTMENTS & PRODUCT HIGHLIGHTS

- Release Candidate 2 of Windows 2000 Professional, Server and Advanced Server was made available in September, following the release of Release Candidate 1 and Beta 3 earlier in the year. The Windows 2000 family of products is launch date is February 17 in San Francisco at IDG World Expo's Windows 2000 Conference and Expo trade show.
- Since the release of Windows 2000 Professional Beta 3, MS delivered over 300,000 Corporate Preview Licenses worldwide. In addition, Release Candidate 2 updates are being shipped to all Corporate Preview Program customers to ensure they have the latest code.
- MS announced the acquisition of Softway Systems, a privately held maker of Interix products for interoperability between UNIX operating systems and MS Windows NT-based operating systems. This acquisition means MS customers will be able to benefit from easier management of Windows-based systems while using their existing UNIX-based infrastructure and lower total cost of ownership.
- MS announced the availability of the second beta release of MS Directory Synchronization Services (MSDSS) and the Zoomit VIA 2.1 meta-directory product six months ahead of schedule. MSDSS synchronizes data stored in the Active Directory service and Novell Directory Service.
- MS announced a new program to certify applications that meet the Application Specification for Windows 2000. This program establishes a technical standard to identify applications that are secure, manageable, and run reliably on the MS Windows 2000 family of operating systems. Applications that meet this criteria will be eligible for the new "Certified for Windows" logo to make them easy for customers to identify.
- Windows NT Workstation continued its momentum with approximately 8.2 million new licenses in Q00-1. The total number of licensed Windows NT Workstation users was over 44 million. NTW mix of OEM shipments dipped slightly from the June quarter due primarily to the strength of consumer PC shipments.
- MS announced the initiation of the Windows 2000 Professional System Builder Roadshow. The program will run in 30 cities across the U.S. targeting 20,000 OEM System Builders. Attendees receive training on methods to pre-install Windows 2000 Professional on the PCs they manufacture.
- MS, in conjunction with major personal computer OEM manufacturers, including Compaq and Hewlett Packard, implemented the Windows 2000 Ready PC program. Participating manufacturers are shipping free upgrade coupons to their customers purchasing computers with Windows NT Workstation 4.0. The coupons give the customer the right to upgrade for free to Windows 2000 Professional upon launch of the new product.

BUSINESS METRICS

(000s)	Business and Enterprise Business Metrics				
Windows NTW Finished Goods	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
WinNTW FG licenses	2,238	3,429	4,344	4,784	4,383
Windows NTW shipments					
OEM licenses	2,309	3,096	3,107	3,634	3,799
WinNTW OEM unit mix of 32-bit O/S	13.1%	14.6%	16.1%	18.6%	17.6%
WinNTW installed base	20,285	25,532	31,216	37,623	44,110
Windows NT Server shipments	385	458	432	512	483
Windows NT Server installed base	2,807	3,162	3,488	3,851	4,243
% Win NTS 4.x	76%	80%	83%	86%	88%

COMPETITION

- Novell announced Novell FireWALL for NT, a new directory-enabled Internet security solution, designed for small- and medium-sized companies, and integrates Internet security features with network bandwidth management tools.

- Novell invested $100 million in Whittman-Hart, a provider of integrated business and technology solutions for growing and middle-market companies. Novell's investment is to accelerate deployment of Novell Directory Services (NDS) in enterprise and e-business solutions.
- Sun Microsystems announced revenue of $3.12 billion for the September quarter, up 25 percent compared with the first quarter of fiscal 1999. Net income for the first quarter was $275 million, increasing 39 percent from the previous year. Earnings per share were $.33, versus analyst estimates of $0.31.
- Red Hat completed its IPO, which was valued at $100 million. Red Hat disclosed CY99 revenue was $11 million with a projected loss of $130 thousand. Red Hat also announced an update to Red Hat Version 6.1 Linux software. New features include graphical setup and installation, online updates for Red Hat Linux users, and support for Intel's Wired for Management Specification.

CONSUMER WINDOWS

INVESTMENTS & PRODUCT HIGHLIGHTS

- The Windows 98 installed base exceeds 63 million users. Windows 98 Second Edition, which launched in June, has been adopted by all major OEMs and comprised two-thirds of the 32-bit OEM shipments.
- MS released Millennium Beta 1 to testers and ISVs. The operating system, built on the Win 9x code base, is designed specifically for consumers and provides enhancements in four key areas: PC simplicity, digital media and entertainment, home networking, and the online experience. The System File Protection (SFP) targets the "It Just Works" initiative by making the PC OS more reliable and proactively preventing problems.
- MS announced support for the "Easy PC" initiative in its Millennium release of the consumer OS. Millennium will also offer increased hardware and software support for emerging devices like USB storage, five button mice, and Internet keyboards.
- MS plans to release a holiday promotion with Windows 98 Second Edition that would include a "Play Pack" containing digital songs from top artists, games and digital photography offers.
- MS patched a handful of security holes in its Internet Explorer browser and ActiveX technology that made computers vulnerable to attack by Web site operators. The new patch also plugs security holes that resulted from several ActiveX controls. These existed both in Versions 4.01 and 5.0 of the Internet Explorer. The ActiveX weakness allowed hackers to manipulate programs on a user's computer when they visited a Web page or received e-mail via MS Outlook.

BUSINESS METRICS

	Consumer Windows Division				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
32 Bit Shipment Growth Yr / Yr	21%	32%	22%	20%	32%
Win9x % OEM OS Ship	86%	85%	84%	81%	82%
Win95 Licenses	9,590,256	7,624,669	4,561,596	4,047,663	3,368,394
Win98 Licenses	5,049,001	11,270,416	12,447,564	12,826,034	15,201,186
Total Win9x	14,639,257	18,895,085	17,009,160	16,873,697	18,569,580
IE Browser Share	48%	51%	53%	56%	55%

COMPETITION

- AOL announced it would invest $800 million in Gateway, a 5 percent stake. In return, Gateway will offer AOL membership to new PC customers.
- AOL 5.0 was released, featuring longer and multiple screen names, larger welcome screen with more buttons, a channel bar for access to AOL's 18 channels, "My Places," which allows one-click access to up to five favorite areas on AOL, an AOL calendar and "You've Got Photos" features. AOL 5.0 also supports broadband high speed connections. Through a joint venture with Kodak, AOL's "You've Got Pictures" feature allows people to have their film uploaded onto AOL including tools to edit the pictures, make greeting cards, or include them in e-mails. The area has 22 times the average click through rate versus the welcome screen.

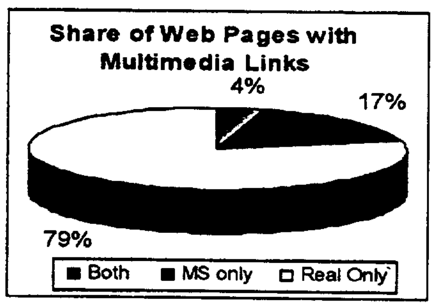
- Apple released the Mac OS 9 at a price of $99. The new OS includes a Sherlock Internet search engine, multiple-user capabilities, auto-updating, new encryption tools and voice log-in features.
- Apple announced a $400 rebate program for Mac buyers who agree to a long-term Internet access contract with CompuServe.
- Netscape released Communicator 4.7 browser that includes a Shop@Netscape button, a program to expand its commerce plan across brands.

STREAMING MEDIA DIVISION

INVESTMENTS & PRODUCT HIGHLIGHTS

- MS launched Windows Media (WM) Technologies 4. WMT 4 is a group of products including Windows Media Player 6, Windows Media On-Demand Producer, WM ASF Indexer, WM Author, WM Encoder, and WM Tools. The new version provides the industry's best audio and video quality, a flexible content rights management system, and improved e-commerce solutions.
- Windows Media Player (WMP) 6, which is part of Windows Media Technologies 4, has been downloaded over 6.3 million times since launch, which is a rate of more than one player per second. Life-to-date downloads of all Windows Media Player versions was over 40 million since WMP was first launched in June of 1998. WMP 6 features include delivering FM-Stereo-quality audio to modem users and MP3 equivalent music with files half the size.
- Sony Music Entertainment and software "jukebox" developers such as Sonic Foundry and MusicMatch announced support of MS Windows Media. Digital audio players, including Nullsoft's Winamp and MediaScience's Sonique, and portable device manufacturers, including Diamond and Casio, also announced support of MS Windows Media Technology in future product releases.
- Cirrus Logic announced that its new Maverick line of Internet audio chips will support Windows Media Audio and digital rights management technology. Maverick is a new system-on-a-chip (SOC) product that adds Internet audio functionality to personal digital appliances like pocket organizers, electronic books, and game platforms. Portable Internet audio devices is expected to grow more than 200 percent next year.

BUSINESS METRICS



COMPETITION

- AOL announced a three-year deal with Emusic.com to supply AOL users with MP3 music for purchase and download over the Internet.
- AOL acquired Spinner and Nullsoft Inc., the maker of Winamp for $400 million in stock. Winamp has an estimated 1.8 million users.
- RealNetworks announced the Gold release of RealJukebox and RealJukebox Plus. Features include digital music system, music video support allowing users to download, playback and manage music video, a CD promotion feature enabling the products to recognize music CDs and provide users with additional music content. RealJukebox will also provide support and integration with portable devices from Samsung Electronics and Innogear, a developer of hardware accessory solutions for the Palm Computing Platform.
- RealNetworks announced e-commerce and music content deals with CheckOut.com and 800.com.

PRODUCTIVITY APPLICATIONS & DEVELOPERS

Q00-1

(in millions, variance to plan)	Office		Office Family		Productivity Appls		Mac		Server Applications		Developer Group		Prod Apps & Dev	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net revenue	$1,774.5	7%	$175.9	(15%)	$5.9	(50%)	$25.1	51%	$118.1	(10%)	$330.6	4%	$2,430.1	4%
Cost of revenue	44.0	18%	6.0	28%	0.1	(12%)	0.5	9%	8.0	7%	25.5	13%	84.1	16%
% of net revenue	*2.5%*	23%	*3.4%*	15%	*1.1%*	(123%)	*1.8%*	40%	*6.8%*	(3%)	*7.7%*	16%	*3.5%*	19%
Gross margin	1,730.5	(8%)	169.9	15%	5.8	50%	24.7	(53%)	110.0	11%	305.2	(6%)	2,346.0	(5%)
% of net revenue	*97.5%*	(1%)	*96.6%*	(1%)	*98.9%*	1%	*98.2%*	(1%)	*93.2%*	0%	*92.3%*	(2%)	*96.5%*	(1%)
Direct controllable operating expenses:														
Regular headcount expense	61.3	(1%)	10.8	3%	16.2	9%	6.4	(2%)	37.0	13%	93.5	3%	228.1	4%
Other headcount expense	7.0	25%	1.5	28%	4.5	9%	0.9	37%	6.9	11%	15.8	(14%)	37.1	6%
Infrastructure expense	12.0	30%	2.1	36%	3.8	24%	1.1	34%	8.4	35%	21.3	20%	49.2	27%
Product development	7.9	23%	0.4	56%	8.8	49%	0.0	97%	12.1	(119%)	8.9	31%	38.2	22%
Acquisition amortization	0.0	nm	0.0	nm	0.0	nm	0.0	nm	0.0	100%	0.0	nm	0.0	100%
External localization	0.6	89%	1.4	(25%)	0.6	59%	0.2	(467%)	0.1	97%	1.7	58%	4.5	67%
Product marketing	2.0	82%	0.7	nm	3.0	6%	0.9	41%	23.2	69%	7.6	55%	37.4	65%
Channel mktg - controllable	0.0	nm	0.0	nm	0.0	nm	0.0	nm	0.0	nm	0.0	nm	0.0	nm
Other	(0.1)	nm	(0.0)	nm	(0.2)	nm	0.0	nm	3.3	6%	0.8	(136%)	3.8	1%
Direct controllable operating expenses	90.7	21%	16.8	9%	36.6	26%	9.5	17%	90.9	43%	149.6	12%	398.3	25%
Product-related operating expenses:														
Taxes, insurance, and settlements	0.0	(134%)	0.0	(112%)	0.0	nm	0.0	nm	0.0	(91%)	0.0	(38%)	0.1	(117%)
Product support services	35.7	18%	6.3	19%	0.7	39%	0.5	16%	11.9	39%	31.6	18%	86.7	22%
Bad debt expense	4.5	15%	0.5	1%	0.0	(38%)	0.0	(59%)	0.3	18%	1.0	33%	6.3	(15%)
R&D shared resources	5.2	(32%)	6.0	33%	1.0	41%	1.0	32%	(9.2)	(16%)	(9.4)	(7%)	(5.3)	9%
Product-related operating expenses	45.5	11%	12.8	25%	1.7	40%	1.5	27%	3.0	56%	23.2	20%	87.8	21%
Total operating expenses	136.2	18%	29.7	17%	38.3	27%	11.0	19%	93.9	44%	172.8	14%	486.1	24%
Responsibility margin	1,594.3	(11%)	140.2	14%	(32.5)	(20%)	13.7	(414%)	16.1	(136%)	132.4	(48%)	1,859.9	(16%)
% of net revenue	*89.8%*	(4%)	*79.7%*	(1%)	*(554.5%)*	59%	*54.4%*	(241%)	*13.7%*	(141%)	*40.0%*	(43%)	*76.5%*	(12%)
Corporate allocations	*$244.0*	21%	*$29.4*	21%	*$5.2*	6%	*$4.6*	17%	*$54.3*	28%	*$101.3*	(50%)	*$439.5*	(21%)
Contribution margin	$1,350.2	20%	$110.8	(12%)	($37.7)	19%	$9.0	410%	($38.2)	68%	$31.1	42%	$1,420.4	36%
% of net revenue	*76.1%*	12%	*63.0%*	3%	*(642.6%)*	(62%)	*35.9%*	305%	*(32.3%)*	65%	*9.4%*	37%	*58.5%*	31%

PRODUCTIVITY APPLICATIONS & DEVELOPER BUSINESS RESULTS

- Office and Office Family Q00-1 net revenue of $1.95 billion was 5% over plan, and exceeded Q99-1 net revenue by 38%. Sequentially, net revenue was 8% over the prior quarter.
- Server Applications (Exchange and the BackOffice Suite) Q00-1 net revenue of $118 million was 10% under plan, flat sequentially and 6% below Q99-1.
- Productivity Appliances Q00-1 net revenue of $6 million was 50% under plan. On a sequential basis, net revenue was up 6%. Gains in Embedded Systems sales were offset by declines in Handheld PCs and Palm-sized PCs.
- Q00-1 Business Productivity operating expenses were $127 million, or 29%, less than plan. The majority of this variance can be attributed to product marketing, which was $61 million or 67% under plan (45% of the full year plan was in Q00-1). Other variances related to timing differences, driven by slow ramp up of computer/lab, product development, and localization expenses.
- Developer Q00-1 net revenue of $331 million was 4% over plan, representing 5% sequential growth over Q99-4, and a 19% increase over Q99-1 prior year. Primary revenue driver was SQL Server, both stand alone as well as allocations from Back Office. Sales of Developer Tools, particularly sales of Visual Studio and the Developer Edition of Office, exceeded plan by $18 million, or 14%.
- Developer Q00-1 cost of revenue was 13% under plan. The standard product costs of MSDN were favorable, due to the shift from MSDN Universal to MSDN Library. Direct controllable operating expenses were $21 million favorable, or 12%. The drivers were product marketing, which was $9 million favorable, due to timing of commitments. Product development was $4 million favorable due to the delay of certain external licensing activity and lab expènses were favorable $4 million, directly related to the delay in facility build out and departmental moves.

OUTLOOK

- Office and Office Family Q00-2 net revenue is expected to be $2.13 billion as seasonal sales drive volume licensing programs
- Server Applications revenue is expected to be $150 million in Q00-2 driven by seasonal sales and increased EA recognition. Corporate lockdown on IT Infrastructure spending may limit growth. Productivity Appliances Q00-2 net revenue is expected to be $8 million, 46% under plan, driven by Palm-sized PC sales growth.
- Developer Q00-2 net revenue is expected to be slightly higher at $360 million. Continued growth in SQL Server is anticipated to be offset by weakness in Developer Tools. We anticipate Developer Tools revenue to decrease until the launch of Visual Studio 7.0.

OFFICE AND OFFICE FAMILY

INVESTMENTS & PRODUCT HIGHLIGHTS

- During the first 16 weeks after the Office 2000 launch, approximately 2.3% of the legal Office installed base, excluding annuity license agreements, upgraded to the new version. This metric is down slightly from the Office 97 launch (2.7%).
- Office 2000 suite license sales via the Reseller and DMR partner segments increased 22% vs. Office 97. Our largest DMR partner, CDW, has increased U.S. volume by >100% vs. the prior launch.
- The license mix of Office Premium exceeded expectations and now accounts for 21% of the Office suite boxes sold through the Finished Goods channel.
- Office 2000 is perceived as a release focused on Web integration and meeting the needs of the corporate customer. Generating excitement among influential end users who don't see the value in web-centric features continues to be a concern. Research at launch suggests that less than 20% of this key group sees Office 2000 as a major release. Mossberg (WSJ) said, "The bottom line for consumers and small businesses is this: If you have a very old version of Office and a fairly new PC, or you need to post a lot of business documents on the Web, it makes sense to upgrade to Office 2000. Otherwise, forget it."
- At the end of July, Microsoft became aware of a security issue with the ODBC database driver that is installed as a part of Excel 97. An updated driver was posted to the Office Update website.
- An announcement was made that Office will be offered as a hosted service, including an offering from MSN's bCentral.
- Microsoft Project installed base now exceeds 4 million customers.
- Recently, C/Net said of FrontPage, "we don't think you could pick a smarter WYSIWIG HTML editor than FrontPage 2000." FrontPage unit share is currently 54% in the US Retail and DMR segments.
- On August 25th, PhotoDraw 2000 Version 2 was released to manufacturing and has already earned placement on PC/Computing's A/List for business graphics.
- Outlook Express 5 Macintosh Edition was named Best of Show in July at the Macworld.
- The Digital Dashboard Starter Kit and Outlook 2000 Team Folders Wizard were released to the Web in September. As a part of the Knowledge Management initiative, these technologies make it easier to build digital dashboard solutions and offer new tools for collaboration.

BUSINESS METRICS

	Office Business Metrics					
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1	FY00 Plan
Suite licenses (in thousands)	7,913	10,649	11,856	13,739	12,385	50,771
Growth (trailing 4 quarters)	35%	30%	31%	32%	41%	15%
Suite revenue per license	$164	$155	$140	$149	$130	$135
Office retail & DMR unit share	77%	80%	78%	85%	88%	[illegible]

COMPETITION

- Corel and Inprise announced an alliance to accelerate commercial mainstreaming of Linux technology. Corel also announced an agreement with EBIZ that will allow WordPerfect 8 for Linux to be preloaded onto its Element-L and Personal Internet Appliances. Corel and DirectWeb announced a partnership to bundle WordPerfect Office 2000 and CorelDRAW with DirectWeb branded computers. DirectWeb offers a subscription-based service.
- Sun Microsystems announced the acquisition of StarDivision, including StarOffice. StarOffice 5.1 is offered free of charge via download from Sun's Website. Sun has also announced StarPortal that will provide a no-charge hosted version of StarOffice.
- Justsystems' newest word processor, Ichitaro 10, became available. e-Talk, a speech enabled version, was announced and is expected to ship by the end of 1999.

SERVER APPLICATIONS

INVESTMENTS & PRODUCT HIGHLIGHTS

BackOffice™

- Exchange licensed 4.9 million seats this past quarter, slightly higher than last quarter's record. The life-to-date total is now 39 million seats.
- The 4th Annual Microsoft Exchange Conference (MEC) was attended by a record 6,000 customers and partners and over 100 exhibitors.
- MS announced Microsoft Exchange 2000 Server and Microsoft Exchange 2000 Server Enterprise, as the next version of Exchange Server, replacing the Platinum codename.
- Beta 3 of Microsoft Exchange 2000 Server was distributed through the Corporate Preview Program to the conference's attendees or can be downloaded from the web. The beta will also be included in TechNet and the Microsoft Technical Beta Program.
- Exchange Server 5.5 Service Pack 3 was released, including issues fixes as well as the following new features:
  - Mailbox Manager Service – to enforce corporate e-mail retention policies.
  - Anti-virus interface – provides an interface to plug in anti-virus software.
  - Additional migration and connector tools.
- The Radicati Group Inc. released a study indicating that 44% of Fortune 1000 companies who responded have standardized on Exchange as their messaging platform, compared with 30% choosing either Lotus Notes or Novell GroupWise.
- MS and British Telecom will conduct a trial of wireless Internet services covering 4 corporations, including 1,000 mobile phone users in the UK and Norway. This trial uses Microsoft microbrowser technology, Exchange, and IIS technology.
- MS and British Telecom announced a worldwide agreement to develop new Internet services and products, based on WinCE and Microsoft MSN™ Mobile service technology, that will enable consumers to access rich, interactive content on a wide variety of new and existing mobile devices. MS and BT have committed $50m of initial funding for the project.
- MS completed the acquisition of Sendit AB for $126 million.

BUSINESS METRICS

(Worldwide units)	Server Applications Business Metrics					
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1	FY00 Goal
1. New Exchange Clients	2,009,322	2,788,257	2,791,878	3,127,578	3,097,978	13,573,592
2. New BackOffice Clients	1,144,160	1,862,323	2,327,048	2,345,103	2,824,884	9,057,927
3. Exchange attach rate to NTS	13%	11%	12%	11%	12%	13%

Notes on Methodology:
1. New Exchange Clients include usage-based allocations from BackOffice & Small Business Servers
2. BackOffice CALs include Emerprise Agreements

COMPETITION

- Lotus has extended Domino's search capabilities. The upgrade features a new web interface and relies on Java and HTML templates to let developers add search capabilities to existing web applications.
- IBM released updates to its Server Applications Suite, including Version 6.1 of DB2, Lotus Domino Release 5 (R5) and Lightweight Directory Access Protocol (LDAP) directories. They are also studying the need for a similar suite based on Linux.
- Lotus has decided to disassemble its entire eSuite division (the java applet effort) and redistribute the resources to other parts of Lotus. The eSuite product was tied to the success of the network computer.
- MS is collaborating with Lotus to integrate Windows Media technologies into Lotus Notes R5 and Domino R5 collaboration software.

PRODUCTIVITY APPLIANCES

INVESTMENTS & PRODUCT HIGHLIGHTS

- Total Windows CE licenses shipped in Q00-1 were 300 thousand, up 25% over Q99-1. Palm-sized PCs (PPC), Handheld PCs (HPC), and Embedded licenses each accounted for approximately 100 thousand licenses. Lifetime Windows CE licenses now exceed 2 million.
- Microsoft acquired England-based STNC Ltd., which focuses on communication protocol implementations in mobile devices. STNC's product suite enables customers to read e-mail, view their personal information, and access the Internet. The company, which has 40 employees, will become a fully integrated extension of Productivity Appliance's Wireless Business Unit.
- ActiveSync 3.0 was launched. ActiveSync 3.0 has a redesigned architecture and user interface, eliminating the need to install Dial-up Networking and to enable remote access server. ActiveSync also automatically detects the selected port speed (up to 115 kbps) and updates the PC's serial port. In addition, Ethernet and dial-up connections are now supported, including the wireless implementations of those standards.
- MS and BT announced a worldwide agreement to develop mobile multimedia applications and equipment. Wireless PPCs and Smartphones based on Windows CE will be used as clients to deliver these new applications.
- Microsoft announced the availability of Platform Builder 2.12. New features include a fully integrated kernel debugger, Internet Explorer 4.0 for Windows CE, enhanced security features, and Microsoft Message Queue.
- Four worldwide Solution Centers were opened to support Windows CE implementations. The centers are located in Redmond, Munich, Taipei, and Tokyo. In addition, MS launched a training program for Windows CE developers.

BUSINESS METRICS

	Productivity Appliances Business Metrics				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
Handheld PC Units (HPC/HPC Pro)	158,159	108,164	128,244	81,120	100,313
Palm-sized PC Units	83,952	105,345	108,245	88,667	103,804
Embedded Licenses	1,536	18,530	34,410	56,717	100,163
Share of PC Companion (HPC) Segment	44%	34%	70%	75%	70%
Share of Palm-sized PC Segment	20%	15%	19%	15%	15%
Share of Total Handheld Computers	31%	21%	27%	27%	25%

COMPETITION

- Handspring launched their Visor family of PPCs. There will be three models ranging in price from $149 to $249. The Springboard expansion slot is the key differentiator versus Palm devices. This allows the Visor to be used in a variety of ways such as a pager, GPS, audio player, or gaming device. Visor will be available through Handspring's website through the holiday season, with retail availability slated for January 2000.
- 3Com announced the proposed spin-off of Palm Computing, with expected IPO date of early next year. The spin-off is expected to be worth between $5 billion and $10 billion. On the product front, Palm introduced the IIIe model, priced at $249, targeted at the consumer market with less memory than the Palm IIIx and no conduit for MS Outlook.
- Sun revamped their network computer strategy, launching the Sun Ray 1 Enterprise Appliance. Sun Ray clients link to Solaris servers that handle all applications processing. The client's role is limited to user input and rendering the display. The Sun Ray also includes a built-in smart card reader that combines with Sun's Hot Desk technology to enable users to log into any Sun Ray terminal.
- Psion introduced the EPOC-based Series 7 HPC, targeted at students and mobile professionals. The Series 7 features a large-size keyboard, a 100MHz processor, 16MB of memory, and a 7.7-inch touch color screen. This follows the launch of the NetBook, targeted at enterprises and featuring 32MB of memory and built-in Java compatibility.
- Nokia announced plans to license the PalmOS to implement Palm's user interface and applications to run on the Symbian platform. The goal is to enable devices to leverage all Palm and EPOC software. The first products are not expected for 12 months.

TOOLS DIVISION

INVESTMENTS & PRODUCT HIGHLIGHTS

- Microsoft introduced Windows DNA 2000, an integrated platform for building and operating distributed Web applications and Internet-based Web services.
- Microsoft announced the availability of the Windows DNA Interoperability Center. The resource site is designed for developers creating applications based on Windows DNA that integrate with existing enterprise applications.
- MS introduced Visual Studio 6.0 with Windows 2000 Developer's Readiness Kit. The kit includes a set of technologies and training materials for developing distributed Web applications.
- Microsoft hosted DevDays '99, a multi-city event designed to help developers take advantage of Windows 2000 as a Web development platform. The event provided workshops and technical sessions to get information about building secure, reliable and scalable Web-based applications using Windows 2000 and COM+.

BUSINESS METRICS

	Developer Tools Business Metrics					
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1	FY00 Goal
1. VB language usage	49%	50%	50%	46%	50%	51%
2. Tools suite penetration	33%	48%	45%	40%	49%	50%
3. Revenue per license	$ 353	$ 488	$ 462	$ 434	$ 446	$ 450

Note on methodology:
1. Percentage of U.S. developers using MS Visual Basic language
2. Percentage of Visual Studio & MSDN Universal licenses sold as a % of total Pro and Ent licenses
3. Revenue per license of Visual Studio and its standalone products (excl. academic sales)

COMPETITION

- Sun Microsystems Inc. agreed to acquire business-software developer Forte Software Inc. in a stock swap valued at about $540 million. Forte brings a Java-based distributed applications development tool along with application integration software.
- Oracle announced new programming tools, including pre-built Java software code for developers building e-commerce Web sites. Oracle also revamped its developer portal Web site, where programmers can learn about software programming technology and seek advice from other developers or from Oracle technicians.
- IBM launched a developer portal offering resources and information about building e-business infrastructures. The portal, called developerWorks, emphasizes Java, XML and Linux. Additional information is available on security, Unicode and Web architecture.
- IBM will ship new versions of its VisualAge development tool for the Java programming language, and update its WebSphere application servers in October.
- Pervasive Software will ship Tango 2000, a visual development studio that adds support for object-oriented data and XML. This version adds support for COM objects and Java Beans, in addition to support for XML.

DISTRIBUTED APPLICATIONS

INVESTMENTS & PRODUCT HIGHLIGHTS

- Beta 1 for the next version of SQL Server, code named "Shiloh" was shipped. Shiloh is designed to exploit Windows 2000 support for more processors and system memory, and supports XML.
- Updated SQL performance benchmarks include the best 8-way SMP performance on Windows NT, and the top 32 TPC price/performance results.
- MS announced a set of four integrated "middleware" products, which will function on top of the Windows 2000 Server, available in Summer 2000. These products are part of Windows DNA, Microsoft's platform for building the Business Internet. These products will

leverage the application services built into Windows 2000 such as COM+, IIS, and MSMQ.

- MS announced BizTalk Server, a new product that supports the BizTalk Framework for business process integration.
- MS announced AppCenter Server, a new product that simplifies deployment and management of Windows DNA-based applications across high availability "server farms" or "web clusters".
- MS announced Host Integration Server, the next version of SNA Server, which provides bi-directional network, data and application integration with a variety of legacy hosts.
- MS announced Commerce Server 4.0, the next generation of industry's leading packaged business-to-consumer commerce software.

BUSINESS METRICS

(Worldwide units)	Distributed Applications Business Metrics					
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1	FY00 Goal
1. New SQL Clients	1,081,000	1,715,000	2,028,000	2,064,000	2,238,000	9,200,000
2. New SQL Servers	47,500	61,400	68,000	74,800	73,300	310,000
3. Client to Server Ratio	23	28	30	28	31	30
4. SQL attach rate to NTS	14%	15%	17%	16%	16%	17%

Notes on Methodology:
1 & 2. New SQL Clients and Servers include usage-based allocations from BackOffice & Small Business Servers
4. SQL Attach Rates to NTS include usage-based allocations from BackOffice & Small Business Servers

COMPETITION

- SQL revenue during fiscal year 1998, was about 17% of Oracle's database revenue. This increased to 23% in fiscal 1999, and was 35% in Q00-1.
- Oracle's applications license and database license business growth were both below Wall Street expectations in their latest quarterly results.
- Oracle targeted DotComs and Hosters with new product bundles. Oracle.com, promoted at $9,995, includes the Oracle8i database, Application Server, Jdeveloper toolkit, and WebDB. The "iHost" suite bundles Oracle8i, Application Server, Internet Directory, and security and management tools.
- While keeping Oracle Applications hosting to itself, Oracle announced initiatives for application service providers, business-to-business portals, and on-line procurement. In the meantime, Oracle 11i slips six months behind release schedule.
- Oracle formed a new strategic business unit focused on product development, marketing, and support for Oracle's Linux initiatives. Oracle also unveiled XML and WebDB products for Linux.
- Oracle announced partnerships with H-P, to support H-P's "e-speak" middleware database technology, and to jointly sell Oracle CRM and Business Online solutions on HP systems.
- Oracle announced price increases on select products. However, an accidental leak to the WSJ revealed general discounting to larger enterprises, ranging from 42% to 94%.
- Informix announced plans to acquire Cloudscape in order to enter the remote and embedded database market.
- Informix partnered with Sun to introduce the first in a series of business and marketing intelligence solutions for the telecommunication industry.
- Sybase announced further support for Linux, including its Adaptive Server Enterprise product.
- Over 65 companies are converging on the middleware space to compete in the development, deployment, and management of n-tier applications in what will be a multibillion-dollar market by 2002. The winners in this space will be those able to deliver a suite of tools, middleware, and database to rapidly develop and scale applications for the Business Internet.
- IBM is successfully marketing bundles of disparate technologies for e-business. IBM announced upgrades of the WebSphere Application Server product family, and Net.Commerce. Visual Age for Java now bundles a copy of WebSphere, tightening the link between tools and middleware.
- Sun-Netscape Alliance announced the iPlanet Commerce Integration Suite bundling the Netscape Application Server and a new version of ECXpert Software for building online trading communities that leverage existing systems between customers, partners, and suppliers.

CONSUMER, COMMERCE, AND OTHER

Q00-1

(in millions, variance to plan)	LEPD		Hardware		CCG Total		Press		Other		Con. Comm. & Oth	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net revenue	$116.1	23%	$125.9	38%	$241.5	2%	$33.0	(20%)	$144.5	260%	$660.9	31%
Cost of revenue	29.6	(5%)	95.8	(45%)	108.4	3%	12.7	29%	37.4	10%	284.0	(7%)
Gross margin	86.4	(30%)	30.0	(19%)	133.1	(6%)	20.4	13%	107.1	nm	376.9	(58%)
% of net revenue	*74.5%*	(6%)	*23.8%*	14%	*55.1%*	(4%)	*61.7%*	(9%)	*74.1%*	nm	*57.0%*	(20%)
Direct controllable operating expenses:												
Regular headcount expense	30.2	8%	10.1	4%	114.9	13%	8.9	22%	596.1	9%	760.2	10%
Other headcount expense	5.9	(0%)	1.9	(42%)	24.8	(3%)	1.1	(11%)	49.3	(1%)	83.0	(2%)
Infrastructure expense	6.7	12%	1.8	1%	29.2	26%	2.2	24%	113.6	37%	153.5	34%
Product development	3.4	30%	6.5	(25%)	20.1	37%	2.1	46%	(0.2)	127%	32.0	32%
Acquisition amortization	2.8	16%	0.0	nm	11.7	(0%)	0.0	nm	0.0	nm	14.5	3%
External localization	2.9	46%	0.1	75%	2.9	52%	1.2	nm	0.0	96%	7.2	45%
Product marketing	3.9	1%	2.1	(64%)	71.2	37%	0.4	50%	0.0	nm	77.5	34%
Channel mktg controllable	0.0	nm	0.0	nm	13.2	36%	2.4	(15%)	0.0	nm	15.6	31%
Other	0.3	(499%)	0.0	nm	11.1	17%	0.4	47%	53.0	49%	64.8	45%
Direct controllable operating expens	56.2	12%	22.5	(10%)	299.0	23%	18.6	18%	811.9	18%	1,208.2	19%
Product-related operating expenses:												
Taxes, insurance, and settlements	0.0	(552%)	0.0	(556%)	1.7	(9%)	0.0	(7%)	(15.2)	433%	(13.5)	322%
Product support services	3.6	16%	1.1	17%	18.8	13%	0.0	nm	(235.1)	(17%)	(211.6)	(17%)
Bad debt expense	0.4	5%	0.4	14%	5.2	(18%)	0.0	(76%)	1.1	359%	7.0	4%
R&D shared resources	1.4	(4%)	(0.3)	(30%)	(6.7)	(22%)	0.1	(3%)	2.2	(193%)	(3.4)	(51%)
Product-related operating expenses	5.4	10%	1.1	3%	18.9	10%	0.1	32%	(247.1)	(11%)	(221.5)	(11%)
Total operating expenses	61.6	12%	23.7	(9%)	317.9	23%	18.7	18%	564.8	21%	986.7	20%
Responsibility margin	24.8	(808%)	6.3	(77%)	(184.9)	(35%)	1.7	(202%)	(457.7)	(36%)	(609.8)	(39%)
% of net revenue	*21.4%*	(677%)	*5.0%*	(28%)	*(76.5%)*	(36%)	*5.1%*	(278%)	*nm*		*(92.3%)*	(53%)
Corporate allocations	*$27.2*	20%	*$11.3*	22%	*$42.5*	10%	*$1.9*	5%	*($593.6)*	(15%)	*($510.8)*	15%
Contribution margin	($2.3)	94%	($4.9)	54%	($227.3)	32%	($0.2)	87%	$135.9	nm	($98.9)	75%
% of net revenue	*(2.0%)*	95%	*(3.9%)*	67%	*(94.1%)*	33%	*(0.5%)*	84%	*nm*		*(15.0%)*	81%

CONSUMER & COMMERCE GROUP BUSINESS RESULT SUMMARY/OUTLOOK

- Net revenue for the Portal was $4.5 million or 8% below plan due primarily to a slow hiring ramp on sales heads against an aggressive FY00 advertising revenue target of $250 million set late in August. Advertising revenue represents 73% of Portal's total revenue. The revenue variance was shared equally at approximately $1 million each for Search, Sidewalk, Computing Central and Entertainment. Due to an impressive run rate over Q99-1 (500+%) and strong bookings in Q00-1 ($115 million), Portal revenue is expected to reach the full year goal. Operating expenses were favorable by $37 million or 24% due to an underspend in international marketing of $11 million, delayed product development and localization expenses of $7 million in MSN.com and communications.

- Internet Access (IA) missed planned subscriber growth by 50,000, ending the quarter at 2 million. Net revenue beat plan by $5 million or 5% due to higher average revenue per user. Operating expenses were favorable by $28 million primarily due to a delay in marketing spend, $20 million, and lower cost of goods sold from fewer subscribers, $5 million. MSN IA expects strong growth in Q00-2 with continued support for the $400 rebate offers as well as marketing initiatives and branding efforts surrounding the release of MSN 5.0. Revenue is forecasted to grow by 9% versus Q00-1. Q00-2 subscribers are expected to climb by 500,000.

- WebTV Q00-1 net revenue of $59 million was 1% better than plan due to higher revenue per subscriber. There were 891,000 net subscribers at the end of Q00-1, 3% lower than plan. Cost of revenue for Q00-1 was 3% less than plan due to fewer than planned subscribers and favorable network connection costs. Operating expenses for Q00-1 were 17% favorable to plan due to slower than planned hiring and delays in product development and marketing spending.

- Q00-1 revenue for Business Portal/LinkExchange totaled $4 million, 15% under plan and down slightly from the $5 million total of the prior quarter. The quarter over quarter decline was due to lower banner network advertising revenue, offset by an increase in business services revenue. The variance to plan is due to the banner network excess inventory program not getting off the ground, and the timing of revenue bookings for the domain name registration service. Operating expenses were less than plan by $5 million or 24% due primarily to $4 million of marketing underspend which was held for a blitz to correspond with the bCentral launch in Q00-2. Contribution margin loss for the quarter of $13 million was 22% better than plan, and includes $9 million of amortization expense for the LinkExchange purchase.

- Personal Finance net revenue was $3 million or 39% above plan due to a faster than planned ramp of the Money2000 product. With only a little over a month since launch it is too early to tell how this will affect the full year estimates. However it is a solid start to achieving the record revenue year as planned. First quarter net revenue represents 13% growth over last year. Operating expenses were favorable by $300,000 or 2% due primarily to reduced localization expenses in the Money group. This is consistent with the decision to localize the product in fewer markets. Contribution margin was $4 million or 30% favorable to plan. the $4 million favorable contribution margin variance was slightly offset by an unfavorable variance in the Tax product.
- MS's share of the TransPoint JV net expense for the quarter was $3 million favorable to plan as a result of a smaller JV loss of $2 million and allocations of $400,000. The JV will not incur any measureable revenue until a major consumer launch in the Q00-3 timeframe, but benefited from under-spending $1 million in marketing and $1 million in lower people costs, connectivity, and interest income. JV losses at $13 million for the quarter grew $5 million or 65% from a year ago from increased people costs in operations, development, and sales, but were flat versus the prior quarter.
- In late September a 'MSN Day' was held for nearly 150 press and industry analysts in downtown Seattle. The new CCG vision of delivering the 'Everyday Web' to consumers and business was announced, with a specific focus on consumer services (communication, search, and commerce), business services, and 'anytime, anywhere, on any device' services. The day also marked the launches of the new MSN Search, bCentral, and MSN Internet Access 5.0, along with the first announcement of the Expedia IPO filing.

HOME AND RETAIL BUSINESS RESULTS

- Home & Retail Division (HRD) revenue of $242 million in Q00-1 grew 4% compared to Q99-1. Revenue was higher than expected due to strong OEM and international FG revenue, offset by a change in accounting policy to reserve 100% of HRD channel inventory. Restating Q99-1 for the change, revenue grew 47%. Operating expenses were 20% higher than Q99-1, but 7% under budget primarily due to lower people related expenses. As operating expenses outpaced the growth in net revenue, responsibility margin for Q00-1 of $31 million was down $33 million in comparison to Q99-1. Restating Q99-1 for the change in channel reserve policy, responsibility margin increased $34 million.

HOME AND RETAIL OUTLOOK

- Net revenue in Q00-2 is planned to increase 59% to $385 million representing a 4% growth over Q99-2. The increase over Q00-1 is normal seasonality reflecting higher sales during the holiday period. Growth over prior year is low as there has been some shift of revenues this year from second to first quarter with earlier releases of Encarta and Games titles and improved holiday preparation in EMEA. HRD has met or is on schedule to meet all planned releases for the first two quarters of FY00. In addition HRD has been successful in implementing a direct to store distribution model in the U.S. with 9 of 13 accounts scheduled to go direct this year already converted to the new model.

CONSUMER PORTAL

INVESTMENTS & PRODUCT HIGHLIGHTS

- In July, Commerce Services sold off the Arts & Entertainment (A&E) portion of the Sidewalk business to TicketMaster-CitySearch (TMCS) for a gain of $156 million. TMCS is now the MSN partner delivering a co-branded local site and will be using MSN yellow pages (YP) technology for their own YP's.
- Q00-1 reflects the continued shift in focus for the Commerce Services team toward building the MSN shopping experience. MSN Auctions launched in September in partnership with FairMarket (FM). Listings are posted within MSN and the FM network (which includes sites such as Lycos and Excite) providing an unduplicated reach of 46 million users.
- MSN Messenger (IM) launched on July 22 and signed up 3 million users by the end of the quarter. Simultaneously, IM launched localized versions in 5 different languages and shipped a Macintosh version in September. It also garnered lots of positive press in the battle with AOL for open instant messaging standards.
- The newest version of MSN Search launched on September 23, featuring an integrated web directory from Looksmart. Overall traffic is up 36% since launch in Q99-2 with over 7 million daily queries.
- MSN CarPoint announced intentions to create a joint venture with car manufacturers led by Ford Motor Company to create a simpler, better way for customers to design and order the car they want. The new company will develop the auto industry's first build-to-order car-buying system, due to debut in the Q00-3.
- MSNBC Interactive widened its lead over CNN for the #1 independent news site for average reach during the quarter. Nine of the top 10 record days for unique users occurred during the quarter arising from the Kennedy/Bissette and hurricane events.

BUSINESS METRICS

	Consumer Portal Business Metrics				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
Digital Media Market - EOP Reach % (Q00-1 = Aug99)					
MSN Network Consolidated	31.8%	38.2%	43.0%	43.7%	46.1%
Hotmail	12.7%	15.8%	18.5%	18.9%	20.7%
Search	n/a	6.1%	9.1%	8.8%	9.7%
MSNBC	9.8%	7.4%	9.1%	9.0%	9.4%
Sidewalk/Commerce Services	2.2%	3.8%	6.2%	8.3%	6.5%
Money Central	n/a	2.5%	3.6%	3.6%	3.5%
CarPoint	1.1%	1.6%	1.5%	2.1%	2.9%
Shopping	n/a	1.2%	1.0%	1.2%	2.4%
HomeAdvisor	n/a	0.5%	0.7%	1.0%	1.5%
Slate	n/a	n/a	1.1%	1.2%	1.2%
MSN Business Metrics					
# of Advertisers	253	345	335	425	600
Sellout Ratio	15%	24%	22%	28%	27%
Pure Banner CPM	$ 18.40	$ 15.75	$ 12.96	$ 13.55	$ 11.90
Search (EOP, # of monthly queries) (000's)	27,004	91,138	106,077	143,962	154,479
Hotmail (EOP # of accounts) (000's)	25,662	31,693	40,206	44,835	45,913
Instant Messenger (EOP # of accounts) (000's)	n/a	n/a	n/a	n/a	3,081
Sidewalk (# of merchants)	n/a	5,114	6,540	6,745	6,960
CarPoint (New car referrals) (000's)	215	197	325	377	438
HomeAdvisor (EOP active home listings) (000's)	138	167	286	355	521

SMALL BUSINESS PORTAL

INVESTMENTS & PRODUCT HIGHLIGHTS

- The launch of Microsoft bCentral was announced at the MSN Strategy Day in September. Building off of the LinkExchange product base, bCentral is a new 'business portal' site created specifically to meet the needs of small and growing companies. Microsoft bCentral provides a comprehensive and integrated suite of services to help growing companies leverage the Internet to improve their business. The site delivers services in three key areas: getting a business started online by connecting to the Web and building a Web site; promoting and marketing online to reach new customers; and managing a business more effectively. The bCentral site became available in beta version on September 30, and will officially launch during Q00-2.

MSN INTERNET ACCESS

INVESTMENTS & PRODUCT HIGHLIGHTS

- MSN Internet Access improved its service offering with the addition of toll-free technical support and extending its coverage to 24 hours a day, 7 days a week.
- MS announced an agreement with eCharge to offer an innovative payment option for subscribers to MSN IA. Subscribers can select eCharge during installation and have their service charges billed directly to their home phone bill. This will provide an alternative to consumers who are concerned about the privacy and the security of using their credit card online.
- In July, MS announced a deal with LAN Plus to resell MSN IA. Under this agreement, consumers will receive a 400 MHz PC when they sign up for a 36-month contract at a prepay price of $17.99 a month.
- MSN IA launched a $400 rebate offer on PC through MEI, Staples and several other retailers. Consumers signing up for a 36-month contract with MSN will receive an instant rebate on a PC of their choice. To date, more than 200,000 subscribers have taken advantage of this offer.

BUSINESS METRICS

- Worldwide MSN IA subscriber base of 2 million was 50 thousand below plan for Q00-1. Average revenue per subscriber (ARPU) of $19.62 was up from $18.99 in Q99-4.
- Churn rate for active accounts was behind plan at 5% for Q00-1.
- Usage per subscriber continued to grow to 27 hours as we added more unlimited subscribers. Unlimited subscribers were using an average of 33 hours per month.

	MSN Internet Access Business Metrics				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
New trials (000's)	467	548	617	437	500
EOP subscibers (000's)	1,735	1,819	1,824	1,821	1,926
ARPU	$14.73	$15.98	$16.64	$18.99	$19.62
Hours/subscriber - U.S.	17	20	24	25	27
Cost/hour - U.S.	$0.27	$0.26	$0.27	$0.26	$0.26

WEBTV NETWORKS

INVESTMENTS & PRODUCT HIGHLIGHTS

- At the end of Q00-1, WebTV had 891,000 subscribers, with 500,000 on WebTV Classic, 363,000 on WebTV Plus, 15,000 on WebTV Satellite and 13,000 on Sega Dreamcast. WebTV added 66,000 new subscribers worldwide, 3% year over year increase versus Q99-1. Gross margin for the quarter was over $6.00 per subscriber.
- WebTV registered initial subscribers on the second-generation WebTV Classic and WebTV Plus set-top products. WebTV Classic has a faster processor and modem, a smaller form factor and printing capability. WebTV Plus has more memory and a faster processor. Retailers have lowered prices on prior versions to reduce inventory.
- Thomson Multimedia has become the fifth major WebTV OEM in the United States to produce the new WebTV Plus set-top box. Thomson will distribute product through their standard retail channel and launch WebTV distribution through Radio Shack.
- EchoStar announced that EchoStar and WebTV will offer new personal television services for DISHPlayer later this fall. The new satellite receiver that will provide digital video recording, enhanced TV Pause, program skip, fast-forward and rewind along with on demand news, weather, sports and entertainment.
- In September, Sony/Columbia TriStar began enhanced broadcasts of Wheel of Fortune and Jeopardy. All WebTV Plus and Satellite customers have the ability to play these interactive game shows at home on their televisions.
- In September, the WebTV Platform product unit released the beta version of Microsoft TV Client.
- Thomson Multimedia unveiled TAK, a subsidiary jointly owned with Microsoft to develop interactive television hardware and services. Microsoft will own 30% of the new company, which plans to sell Thomson Multimedia television sets equipped with hardware for interactive services by the middle of next year.
- Microsoft and Liberty Media announced that they will invest $493 million in a joint venture with Dutch cable-TV firm United Pan-Europe to seek content and distribution opportunities in Europe.

BUSINESS METRICS

	WebTV Business Metrics				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
Subscribers EOP (000's)	447	641	753	825	891
Revenue per subscriber	$ 18.31	$ 21.59	$ 22.23	$ 21.84	$ 22.69
Gross margin per subscriber*	$ (4.47)	$ (0.83)	$ 0.03	$ 4.26	$ 6.35

*Excludes customer acquisition costs and bad debt

NETWORK SOLUTIONS GROUP

INVESTMENTS & PRODUCT HIGHLIGHTS

- In July, Microsoft and Rogers Communications of Canada announced an agreement where Rogers agreed to license TVPAK client and server technology for serving 1 million Advanced Digital Set-Top Boxes, and develop and deliver advanced TV services incorporating MSN Hotmail, Microsoft Passport, MSN Search, and MSNBC. Microsoft also invested approximately $400 million in Rogers.
- MS announced an agreement with, and a $15 million investment in, DSL.net, a Digital Subscriber Line (DSL) service provider focused on serving cities with populations under 900,000. The agreement calls for Microsoft to develop and DSL.net to deliver a co-branded MSN portal providing a range of MSN services for small- and medium-sized businesses.
- Through September, 18 customers had signed Commercial Service Provider Agreements, allowing them to deliver software services to third parties. Only two of the eighteen have begun offering their services to third parties, resulting in revenue of $20,000 for Microsoft.

PERSONAL FINANCE

INVESTMENTS & PRODUCT HIGHLIGHTS

- MS Money 2000 launched successfully in August supported by strong industry and partner interest. MS Money 2000 won the most recent PC Magazine Personal Finance review, previously awarded to Intuit's Quicken product. PC Magazine says "If you're shopping for personal finance software for the first time, consider Money 2000 first. And if you're already using a version of Quicken or Money that's more than a year old, you should give Money 2000 serious consideration as well." MS Money team also reached agreements with major financial institutions (Citibank, American Express, E*Trade) to sponsor Money 2000.
- TaxSaver 99 U.K. edition was released on store shelves on June 16. In the October version of PC Magazine (U.K.), MS TaxSaver was rated "[TaxSaver] the clearest of the three packages reviewed here -- particularly if you're completing your tax return for the first time". The U.S. edition of TaxSaver is expected to launch in Q00-2.

TRANSPOINT JOINT VENTURE

INVESTMENTS & PRODUCT HIGHLIGHTS

- On July 21, 1999 TransPoint announced that its e-bills service will be offered in the new version of MSN Money Central. This offer marked TransPoint's first portal agreement and will provide convenient e-bill access to more than 27 million consumers who visit MSN.com monthly.
- TransPoint has increased the total number of billing entities providing bill presentment through its service to 12 by the end of September.

MSNBC CABLE JOINT VENTURE

INVESTMENTS & PRODUCT HIGHLIGHTS

- MSNBC Cable maintained its market share for total day news audiences. Industry ratings dropped for all competitors from the high news quarter in Q99-4 from Columbine and Kosovo news events exceeded Q00-1's shorter news spikes from the Kennedy/Bissette and hurricane news events.
- MSNBC Cable is the seventh fastest growing cable network from a year ago with carriage exceeding 52 million U.S. households, but still well behind CNN's carriage of 77 million U.S. households.

BUSINESS METRICS

	MSNBC Cable Business Metrics				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
Advertising revenue ($ millions)	$ 9.0	$ 17.9	$ 16.6	$ 24.7	$ 19.2
Subscriber revenue ($ millions)	$ 13.0	$ 13.5	$ 14.2	$ 15.0	$ 17.3
Carriage (Go-out) (000s)	43,341	45,603	47,837	49,117	51,725
Ratings (average)	0.33	0.33	0.31	0.35	0.29
Households (average) (000s)	141	146	144	171	147

CONSUMER & COMMERCE GROUP

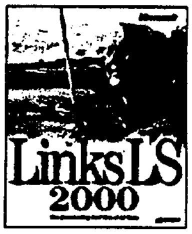
COMPETITIVE SUMMARY

- AOL reported September quarter revenue of $1.47 billion, up 47% from the comparable quarter of the prior year and 7% sequentially. EPS was $0.15, above the analysts consensus estimates of $0.13. AOL announced 1.1 million brand subscribers additions, while the CompuServe 2000 service (with a $400 rebate) added a net 378,000 subscribers in the quarter.
- AOL initiated the worldwide rollout of AOL 5.0 with new services and features such as You've Got Pictures, My Calendar, New AOL Search, and AOL-Plus for broadband connectivity.
- AOL reached collaborative agreements with Lycos, EarthLink, MindSpring, Juno, Novell, and Voyager.net to offer their customers co-branded AOL Instant Messenger clients. Also, AOL has partnered with Apple to create instant messaging products for the Mac, and has licensed AOL Instant Messenger to FaceTime Communications to integrate into its customer-service product.
- AOL made changes in Europe to stimulate their stagnant subscriber growth in the face of aggressive competition. AOL UK initiated a new pricing plan to reduce telecom charges for Internet access, and AOL Europe launched Netscape Online, a free access service in the UK, and a new flat rate pricing plan in Germany.
- AOL continued to rack up sizable advertising and e-commerce deals including Travelocity.com ($200 million over 5 years) and American Greetings ($100 million over 6 years).
- For the quarter ended September 30, 1999, Yahoo reported pro forma net income of over $40 million on revenues of $155 million, up 134% year over year. Traffic continued to grow with 105 million users worldwide (up 31% from June) in September generating average daily page views of 385 million (up 24% from June).
- Yahoo launched new international properties in China and Mexico with localized content and services, extending their global reach into 21 countries.
- Yahoo released several new services to encourage users to spend an increasing share of their online time on Yahoo sites. These include Yahoo! Bill Pay (in partnership with Checkfree), Yahoo! Mobile, Yahoo! Digital (in partnership with Beatnik, Inc., EMusic.com, and Liquid Audio, Inc.), Yahoo! Briefcase, and Yahoo! Greetings. Yahoo also expanded their auction service to provide local auctions in Japan, Singapore, France, Germany, Spain, and Sweden.
- Travelocity, the online travel service, will acquire a smaller rival, Preview Travel, in a deal that will challenge Microsoft's Expedia to be the largest travel site on the Web. Travelocity is part of the Sabre Group, the reservation system that is controlled by the AMR Corporation, American Airlines' parent. Sabre will own 70% of the combined company, which will use the Travelocity name, and the existing holders of Preview stock will own 30%. The deal will likely close early next year.
- ISPs EarthLink and MindSpring agreed to merge in an all-stock transaction that would create the country's second-largest Internet access provider with a combined 3 million subscribers, trailing only America Online. The merger is expected to be completed during the Q00-1.
- Philips Electronics and TiVo, Inc. announced plans for the national retail availability of the Philips Personal TV Receiver with TiVo's Personal Television Service. The Philips Personal TV Receiver is a digital video recording set-top device that allows TV viewers to control live television and personalize their viewing options by using the TiVo Personal Television Service.
- AOL announced plans to invest in TiVo and partner with the company to expand its interactive TV business. As part of the agreement, AOL and TiVo will collaborate to bring consumers interactive events by combining TiVo's personal television service with AOL TV's interactive television offerings
- Sony invested $28 million for a 9% ownership of TiVo. Their alliance will provide Sony with a seat on TiVo's board of directors and the ability to produce new TiVo based Sony boxes incorporating a Sony TiVo "Network Showcase". TiVo raised over $80 million in their initial public offering in September.
- Cablevision announced plans to buy about $1 billion of digital set-top boxes from Sony Corp. of America, marking the entry of the Japanese consumer-electronics giant into the market for cable-television set-top boxes.

LEARNING, ENTERTAINMENT AND PRODUCTIVITY

INVESTMENTS & PRODUCT HIGHLIGHTS

- Entertainment Business Unit released holiday titles Flight Simulator 2000, Age of Empires 2: Age of Kings, Links LS 2000 and Pandora's Box. Flight Simulator now features the Concorde supersonic airliner, while Age 2 allows gamers to build and battle medieval kingdoms. Links LS 2000 is the latest version of the market leading golf game from Access Software which was acquired last spring. Pandora's Box is a collection of visually stunning puzzles designed by Microsoft game designer Alexi Pajitnov- the creator of Tetris.



- Consumer Productivity released Works 2000 and Works Suite 2000, the home productivity software suite. Works 2000 contains a spreadsheet, database, calendar, and address book along with the redesigned Task Launcher assisting users in accessing applications quickly. Works Suite 2000 includes MS Word 2000, Encarta 2000, Money 2000, Home Publishing 2000, Expedia Streets & Trips 2000 and Picture It! Express 2000.
- The Learning Business Unit released Encarta Reference Suite 2000 containing new versions of Encarta Encyclopedia and World Atlas, a new dictionary product and free access to Encarta Online. Also released was the second version of Encarta Africana. Encarta World English Dictionary is the first newly written dictionary in over 20 years. More than 320 expert editors and consultants from more than 20 English-speaking countries used e-mail to compile some 400,000 authoritative references in the dictionary.
- Internet Gaming Zone (www.Zone.com) saw membership increase 33% or 2.4 million since June to 9.8 million members, while peak concurrent usage grew 29% to 46,000 simultaneous users. Average games served per day increased 26% from June to 323,000. The Zone also began live beta testing of the highly anticipated online adventure game Asheron's Call. Due in stores in November, Asheron's Call will have both retail finished goods and online subscription revenue stream.

BUSINESS METRICS

	Learning, Ent. and Productivity Metrics				
	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
Learning					
FG Revenue ($M)	$29.4	$61.7	$2.9	$8.8	$49.0
FG Avg Selling Price	$ 51.35	$ 45.91	$ 70.28	$ 26.99	$ 39.16
% Intl	*72%*	*63%*	*41%*	*64%*	*78%*
Entertainment					
FG Revenue ($M)	$ 28.6	$92.2	$14.8	$8.9	$32.5
FG Avg Selling Price	$ 31.65	$ 30.94	$ 25.43	$ 29.35	$ 24.64
% Intl	*63%*	*53%*	*56%*	*54%*	*54%*
Consumer Productivity					
FG Revenue ($M)	$ 29.2	$51.7	$21.8	$17.1	$24.6
FG Avg Selling Price	$ 36.28	$ 43.36	$ 35.72	$ 29.75	$ 31.41
% Intl	*31%*	*54%*	*48%*	*41%*	*48%*
Total LEPD					
FG Revenue ($M)	$ 87.3	$205.5	$39.4	$34.9	$106.2
% Intl	*55%*	*56%*	*50%*	*50%*	*64%*

- Learning, Entertainment & Productivity (LEPD) FG sell-in revenue for the quarter was up 204% from Q99-4 and up 22% from Q99-1. Sales are up over Q99-4 on new versions of the Encarta and Works lines and holiday orders for newly released game titles. Revenue growth over Q99-1 can be largely attributed to earlier availability of Encarta and earlier preparation for holiday in EMEA in Q00-1.
- Price reductions in Learning's Encarta line and Consumer Productivity titles are reflected in falling Average Selling Prices (ASP) from prior year. Entertainment ASP is down from Q99-4 due to a mix shift toward the lower price Sports titles. The international mix in Q00-1 was up compared with prior year due to the earlier availability of International Learning titles and weakness in U.S. Consumer Productivity sales.

COMPETITION

- Mattel earnings will fall significantly below estimates this quarter due largely to troubles in the Learning Company unit. Licensing revenue shortfalls, returns from struggling distributors, and increased goodwill amortization all combined to put the unit up to $100 million off their earnings estimate for the quarter.
- Sega released the Dreamcast video game console in the United States selling over 500,000 units in the first two weeks. Sales of the consoles and game titles continue to be brisk, in line with expectations.
- Electronic Arts teamed up with Michael Jordan for an exclusive spokesperson and appearance agreement to promote EA's NBA Live basketball Game.

HARDWARE

INVESTMENTS & PRODUCT HIGHLIGHTS

- The Hardware division shipped several significant, new products in Q00-1. The solid state Intellimouse Explorer which went into production in early August replaces the mouse ball mechanics with a patented "Intellieye" optical sensor which scans the surface 1,500 times per second to track movement. It features a translucent case bottom with a red light for marketing appeal.
- Two new flat keyboards have also shipped this quarter. The Natural Keyboard Pro and the Internet Keyboard are both flat designs with Internet and media keys. These products will compete in the flat market, which is approximately twice the size of the ergonomic market.

BUSINESS METRICS

	Hardware Business Metrics Average FG Selling Price		
	Q99-1	Q00-1	Var%
Mouse	$28.84	$25.03	(13%)
% OEM	57%	45%	
Keyboards	$42.87	$29.09	(32%)
% OEM	45%	35%	
Gaming Devices	$46.41	$46.40	(0%)
% Intl	56%	77%	

- Q00-1 Hardware gross revenue was up 10% from Q99-1. By channel, the finished goods were up 19% as each of the core products, mice, game devices, and keyboards were up but offset by a decline in Actimates. OEM revenue was down 9% from last year, although the units were up a solid 36%. The disparity was driven primarily by mouse sales where the average selling prices were down from $8.46 in Q99-1 to $5.55 this quarter.
- Mouse finished goods revenue was up strongly at 40% on a 61% increase in units. Nearly half of the unit increase is due to new products, the solid state and the cordless mice. Both new products are strategic in the competition with Logitech. This is the first offering in the cordless market; an area that Logitech has owned previously, but so far they have not announced a solid state product.
- Gaming Devices finished goods revenue was up 59% over last year due largely to new products: the non-force feedback steering wheel, and Sidewinder Dual Strike. The steering wheel product family also benefited from a full quarter of sales for the force feedback unit which was introduced last year. This was especially true in the international markets and explains the shift in the mix from domestic to international sales. The Dual Strike is a two handed gamepad that allows hands to pivot independently for additional control of movement in three-dimensional games.
- Keyboard finished goods revenue was up 60% due to the new flat keyboards noted previously. Offsetting the new keyboards was a decline of 11% in ergonomic sales on a 13% unit increase. OEM sales were also up 20% on a 51% unit increase. The OEM business is expected to improve since the flat products are better suited to the OEM market.

COMPETITION

- Logitech introduced the WingMan Gamepad Extreme, which like the MS Freestyle Pro features motion sensing technology that turns body motion into on-screen action. The device uses accelerometer technology to measure forward, back, and side-to-side tilting motions. The product is bundled with a Starwars game and retails for $40. Logitech has also introduced an entry level gamepad at $10 aimed at young and casual gamers.
- In July, ThrustMaster announced a definitive agreement to sell the assets of their game controller hardware business to Guillemot Corp. of France for $15 million. Thrustmaster, who has struggled in the game device business, is focusing exclusively on opportunities in the Internet community and communications. Guillemot is a large manufacturer and reseller of computer peripheral products including 3-D graphics, sound cards, and game controllers.
- In October, Logitech began shipping a force feedback mouse bundled with three games at a retail price of $100. Using the FEELit technology from Immersion Corp, the mouse provides tactile response to various actions in the software. On the desktop, the mouse enables users to "feel" icons, buttons, and scroll bars as the mouse slides over these items, and creates a sense of friction when dragging, resizing, or scrolling.

PRESS

(in millions, variance to plan)	Q00-1			Q99-1	
	Actual	% Net rev	Var %	Actual	% Net rev
Net revenue	$ 33.0	100.0%	(20.1%)	$ 41.5	100.0%
Cost of revenue	12.7	38.3%	29.4%	18.1	43.5%
Gross margin	20.4	61.7%	(13.0%)	23.4	56.5%
Controllable expenses:					
Regular headcount	8.9	26.8%	22.3%	7.3	17.7%
Other headcount	1.1	3.2%	(11.4%)	1.4	3.5%
Infrastructure	2.2	6.6%	23.8%	2.0	4.7%
Product development	3.4	10.2%	15.7%	1.4	3.5%
Other misc expenses	0.5	1.2%	49.2%	(0.2)	(0.8%)
Marketing	2.8	8.4%	1.4%	1.8	4.5%
Total controllable expenses	18.7	56.7%	18.3%	13.8	33.2%
Responsibility margin	1.6	4.9%	238.4%	9.7	23.3%
Corporate allocations	1.8	5.5%	4.0%	1.1	2.7%
Contribution margin	$ (0.1)	(0.4%)	90.5%	$ 8.5	20.6%

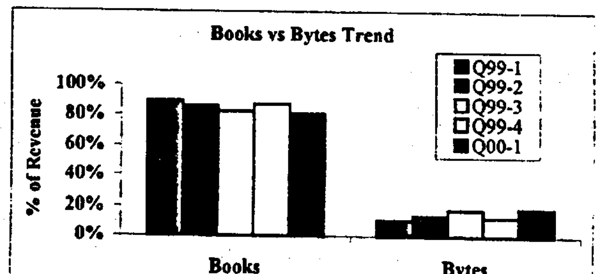
- Net revenue for Q00-1 was $33 million, $8.3 million (20%) below plan due to lower than expected Office2000 reorders and a slow summer in the retail channel. Net revenue is $8.5 million below the same quarter in FY99 due to the high sell-in related to Windows 98 in Q99-1. Cost of revenue for Q00-1 was under plan as a percent of net revenue by 5.1% due to a favorable product mix and lower than plan cogs rates. Controllable expenses were under plan $4 million in Q00-1 or 18.3% primarily due to a delay in work force planning conversions.
- The top ten titles for Q00-1 were responsible for 26% of the total revenue.

Top 10 Titles for Q00-1

($ in thousands)

Rank	Title	Shipping months	Net revenue	% Net rev	Rev/Unit
1	MPI Win 98 English OEM OLC Starts Here	23	$ 2,923	8.3%	$ 1.19
2	Networking Essentials, Second Edition	23	1,277	3.6%	48.81
3	MCSE Core Requirements Training Kit	19	1,219	3.5%	134.67
4	Microsoft Windows NT Server 4.0 Resource Kit	35	611	1.7%	67.86
5	ALS Networking Essentials, Second Edition	15	571	1.6%	54.49
6	ALS Microsoft Windows NT Network Administration	16	550	1.6%	54.25
7	Microsoft Office 2000 Resource Kit	5	529	1.5%	25.56
8	Microsoft Windows NT Technical Support Training	29	509	1.4%	45.66
9	MPI Win 98 German OEM OLC Starts Here	29	491	1.4%	1.95
10	Microsoft Windows NT Network Administration Training	29	483	1.4%	36.03
	Q00-1 Top 10 Titles		$ 9,163	26.1%	$ 3.25

- Press is making headway on the shift in its business model from books to the higher margin "bytes" products such as OEM and ebooks. In Q00-1, 19% of revenue was generated by "bytes" versus 11% in Q99-1.



KEY PRODUCT RELEASE SCHEDULE

Business Unit/Product	RTM Act/Fcst (a)	RTM Plan
Consumer Portal		
MSN.com Homepage	Nov-99	Q00-2
MoneyCentral 7.0	Jul-99	Q00-1
HomeAdvisor 3.0	Sep-99	Q00-2
Shopping Channel 2.0	Nov-99	Nov-99
CarPoint 4.0	Nov-99	Q00-1
HomeAdvisor 4.0	Q00-3	Q00-3
MoneyCentral 8.0	Q00-3	Q00-3
Desktop Finance		
Money 2000	Aug-99	Q00-1
TaxSaver (U.S.)	Q00-2	Q00-2
MSNBC		
Expanded Weather Personalization	Nov-99	Q00-2
Decision 2000 Data Feed	Feb-00	Q00-3
TransPoint		
SR4 Consumer Launch	Q00-2	Q00-2
MSN Internet Access		
MSN Internet Access 5.0	Oct-99	Oct-99
WebTV Service		
WebTV Service Upgrade (HipHop)	Oct-99	Oct-99
Thomson eTV (WebTV integrated TV)	Feb-00	Sep-99
Mercury Satellite Platform (DirecTV)	Apr-00	Jan-00
Jupiter Satellite Platform (Echostar)	Jul-00	Jul-00
WebTV Plus DVR Platform	Jun-00	Jun-00
Learning, Entertainment and Productivity		
NBA Drive 2000	Jul-99	Jul-99
NFL Fever 2000	Jul-99	Jul-99
Pandora's Box	Jul-99	Jul-99
FlightSim 2000	Sep-99	Sep-99
Age of Empires 2	Sep-99	Sep-99
Access/Links LS 2000	Sep-99	Sep-99
Asheron's Call	Oct-99	Oct-99
Federation	Feb-00	Feb-00
Starlancer	Feb-00	Sep-99
Train Simulator	Apr-00	Apr-00
Motocross Madness 2	Mar-00	Mar-00
Midtown Madness 2	Apr-00	Apr-00
Encarta Ref Suite 2000	Aug-99	Aug-99
Enarta World English Dictionary	Aug-99	Aug-99
Encarta Africana 2000	Sep-99	Sep-99
Works 2000	Aug-99	Aug-99
Works Suite 2000	Aug-99	Aug-99
Home Publishing 2000	Aug-99	Aug-99
Picture It 2000	Sep-99	Sep-99

Business Unit/Product	RTM Act/Fcst (a)	RTM Plan
Office & Office Family		
Project and Project Central	Jan-99	Dec-99
Consumer Windows		
Millenium	Q00-4	Q00-4
Internet Explorer 5.01	Q00-2	Q00-2
Internet Explorer 5.5	Q00-4	Q00-4
Neptune	Q01-4	Q01-4
Business & Enterprise		
Windows 2000 Server	Dec-99	Q00-2
Windows 2000 Professional	Dec-99	Q00-2
Windows NT Embedded 4.0	Aug-99	Aug-99
Windows Express Network	Sep-99	Sep-99
Windows NT Services for Unix 2.0	Dec-99	Dec-99
Streaming Media		
Windows Media Technologies 4.0	Aug-99	Jun-99
Windows Media Technologies 5.0	Q00-4	Q00-4
Server Applications		
Microsoft Exchange Server 2000	Q00-3	Q00-3
BackOffice 5.0	Q01-1	Q01-1
Small Business Server 5.0	Q01-1	Q01-1
Developer Tools		
Visual Studio 7.0	Sep-00	Apr-00
Office Developer 9.5	Sep-99	Dec-98
Distributed Applications		
SQL Server 7.5	Jun-00	2H-FY00
Commerce Server 4.0	May-00	May-00
BizTalk Server	Jun-00	Jun-00
"Babylon" Server	Aug-00	Aug-00
AppCenter Server	Jun-00	Jun-00
Productivity Appliances		
WinCE Toolkit (VB, VC++, VJ++) 6.x	Feb-00	Jun-99
WebPhone	Dec-99	Feb-99
Palm Size PC 3.0	Dec-99	Aug-99
Windows CE 3.0	Feb-00	Sep-99
Smartphone	Aug-00	Dec-99
Auto PC 3.0	Sep-00	Dec-99
Hardware		
Entry level gamepad (Blaze)	May-99	May-99
Flat Keyboard	Jun-99	Jun-99
OEM Mouse	Jul-99	Jul-99
Ergo Keyboard w/ internet keys - retail	Jul-99	Jul-99
Solid-state Mouse - retail	Aug-99	Aug-99
Ergo Keyboard w/ internet keys - OEM	Aug-99	Aug-99
Wireless Mouse	Sep-99	Sep-99
Rapid motion game controller (Dual strike)	Sep-99	Sep-99
Non force feedback steering wheel	Sep-99	Sep-99
5-Button solid state mouse	Apr-00	Apr-00
Flat Keyboard w/ internet keys	Feb-00	Feb-00

(a) Forecast dates quoted are the current internal projections for the Release to Manufacturing (not the dates that have been quoted externally)

Sales, Marketing &
Product Support

CONSOLIDATED SALES, MARKETING & SUPPORT

Q00-1

(In millions, variance to plan)	SMAR		EMEA		Asia		Total FG		OEM		On Line		Other		
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Total
Net revenue	$1,527.5	(5%)	$1,171.9	12%	$623.0	25%	$3,322.4	5%	$1,773.9	13%	$237.8	0%	$86.9	250%	$5,287.7
Costs of revenue	130.4	6%	88.6	(11%)	32.9	11%	251.9	1%	38.6	(21%)	109.7	1%	11.0	30%	411.1
Gross margin	1,397.1	(5%)	1,083.3	12%	590.2	28%	3,070.5	6%	1,735.3	13%	128.1	(1%)	75.9	746%	4,876.6
% of net revenue	*91.5%*		*92.4%*		*94.7%*		*92.4%*		*97.8%*		-		-		*190.2%*
Controllable expenses															
Regular headcount expense	118.5	16%	81.3	13%	25.9	10%	225.7	14%	16.0	17%	10.9	(23%)	9.4	49%	262.1
Other headcount expense	2.9	(8%)	3.0	24%	1.0	(10%)	6.8	8%	0.3	(36%)	0.5	82%	0.3	49%	8.0
Vendors	3.9	53%	6.0	17%	1.5	27%	11.3	35%	0.1	11%	0.1	(62%)	0.8	70%	12.3
Infrastructure	25.3	23%	16.8	18%	8.9	9%	51.0	19%	3.6	3%	3.2	(15%)	2.2	18%	60.0
Other misc expenses	0.7	87%	2.2	53%	1.5	44%	4.4	65%	6.8	7%	7.2	(29%)	(16.6)	nm	2.0
Sales expense:	151.3	20%	109.3	16%	38.8	12%	299.4	18%	27.0	12%	21.9	(23%)	(3.8)	115%	344.4
Marketing	145.8	40%	64.1	25%	33.3	25%	243.3	35%	13.1	15%	82.8	(40%)	8.5	40%	347.6
Net PSS	112.7	20%	32.7	24%	16.6	14%	162.0	20%	1.8	10%	16.9	(16%)	0.0	nm	180.7
Net MCS	18.4	(45%)	10.2	(30%)	1.5	(48%)	30.1	(41%)	0.0	nm	0.0	na	0.0	nm	30.1
General and administrative costs	11.4	19%	10.0	13%	2.6	7%	24.1	15%	0.4	35%	0.4	(38%)	0.1	31%	24.8
Total controllable expenses	439.6	29%	226.3	20%	92.8	18%	758.7	26%	42.3	13%	121.9	(35%)	4.7	88%	927.5
Responsibility margin	957.5	13%	856.9	26%	497.4	43%	2,311.8	23%	1,693.0	14%	6.2	(110%)	71.2	(326%)	3,949.0
% of net revenue	*62.7%*		*73.1%*		*79.8%*		*69.6%*		*95.4%*		*2.6%*		*81.9%*		*74.7%*
Shared resources	27.5	8%	21.9	8%	8.8	8%	58.2	8%	2.1	(1%)	0.0	na	(27.7)	(45%)	32.5
Corporate allocations	334.8	11%	218.7	11%	98.2	11%	651.7	11%	284.7	13%	166.0	18%	9.3	22%	1,110.3
Contribution margin	$595.2	35%	$616.3	51%	$390.4	72%	$1,601.9	49%	$1,406.3	21%	($159.7)	(39%)	$89.7	(468%)	$2,806.2
% of net revenue	*39.0%*		*52.6%*		*62.7%*		*48.2%*		*79.3%*		*(64.9%)*		*103.2%*		*53.1%*

FINISHED GOODS P&L SUMMARY

- Q00-1 finished goods (FG) net revenue exceeded $3.3 billion, a 19% increase over Q99-1 (16% in constant dollars). Growth in the quarter was attributed primarily to strong results in Japan, parts of Europe and Latin America, partially offset by slower sales in the United States and Eastern Europe. Foreign currency variations versus budgeted rates added an additional bump of $37 million (1%) revenue variance.

- The top 10 subsidiaries for the quarter moved around a bit from the end of the FY99, with the United Kingdom and Germany switching spots, while Brazil entered the list at the number 8 spot and Sweden fell from the list (see next page). Among the top subsidiaries, Brazil and Germany exceeded net revenue plans for the quarter by 72% and 31% respectively. Brazilian net revenue increased 65% over the same quarter last year due to anti-piracy efforts. German net revenue increased 43% over the same quarter last year due to the signing of a $35 million Select deal with the German Ministry of Labor. The United States and the Netherlands were the only top 10 subsidiaries that did not reach planned levels for the quarter, 10% and 11% below plan, respectively. Poor United States results were due in part to slow demand for MS Office and the re-structuring of the breadth-account selling model, while the Netherlands cited large enterprise customers waiting to deploy Windows 2000 and Office 2000 simultaneously.

- Q00-1 revenue adjustments were $21 million versus a plan of $57 million. The majority of the adjustment variance was due to see-through of excess Office 2000 inventory at the end of FY99.

- Q00-1 sales expense was 18% below plan in absolute dollars, with actual headcount 8% below planned levels. Actual sales and marketing headcount increased 7% over the prior quarter. The positive variance is due to an overly aggressive growth target for headcount and headcount related expenses early in the fiscal year. On a per head basis, people costs were 6% under plan, and up only 6% over the same quarter last year. Per head infrastructure expenses were also 11% below plan in Q00-1 and grew only 4% over the prior year quarter.

SUBSIDIARY FG NET REVENUE RANKING

(Including Retail OEM revenue)

(in millions)	Q00-1 Actuals	Q00-1 Plan	Q00-1 Var %	Q99-1	% Growth	% of Total
1 United States	$1,187.5	$1,314.4	(10%)	$1,198.4	(1%)	35.7%
2 Japan	477.9	384.4	24%	281.1	70%	14.4%
3 Germany	283.4	215.9	31%	198.7	43%	8.5%
4 United Kingdom	247.8	227.8	9%	211.0	17%	7.5%
5 France	132.6	113.6	17%	116.3	14%	4.0%
6 Canada	94.4	86.5	9%	76.9	23%	2.8%
7 Australia	74.7	66.4	12%	69.0	8%	2.2%
8 Brazil	69.6	40.6	72%	42.3	65%	2.1%
9 Italy	67.2	62.6	7%	60.0	12%	2.0%
10 Netherlands	58.9	66.1	(11%)	52.3	13%	1.8%
11 Switzerland	48.4	42.3	14%	37.7	28%	1.5%
12 Sweden	42.8	47.4	(10%)	54.4	(21%)	1.3%
13 Korea	40.1	20.4	96%	12.3	227%	1.2%
14 Spain	29.3	28.0	5%	27.4	7%	0.9%
15 Belgium	27.0	34.6	(22%)	28.0	(4%)	0.8%
Others	440.9	398.5	11%	336.0	31%	13.3%
FG Total	$3,322.4	$3,149.7	5%	$2,801.7	19%	100.0%

- Q00-1 net marketing expense was $243 million or 7% of net revenue, compared with a plan of 12%. This was a decrease of $216 million from Q99-4 due to reductions following the Office 2000 launch. Net marketing expense increased 27% over the same quarter last year primarily in the SPAR and Asia regions, increasing 37% and 29% respectively. The increase in SPAR was mainly due to U.S. based content creation, high advertising media costs, and more direct competitive response advertising.
- Q00-1 net product support services (PSS) costs were 5% of net revenue, one and a half points below plan and 21% below plan in absolute dollars. PSS revenue was $65 million, 3% below plan due primarily to weakness in the new Professional Support offering launched in the United States. Quarterly support costs of $181 million were $45 million under budget driven by low payroll, computer and vendor expenses, primarily in the United States.
- MS Consulting Services (MCS) posted a $33 million contribution margin loss in the quarter versus a planned loss of $55 million, attributable to favorable variances in lower employee stock option grants, recruiting, travel, training, and computer expenses. All regions exceeded budgeted revenue per head for the quarter.
- Q00-1 FG responsibility margin was 69.7%, 10 points better than plan and in line with the same quarter last year. SPAR profitability was 62.9%, EMEA was 73.1%, and Asia's profitability was 79.8%, a 7-point increase over the same quarter last year.

RevSum/Net Revenue Summary

Q00-1 FG RevSum Revenue

(Including Retail OEM revenue)

(in millions)	South Pacific & Americas				Europe, Middle East & Africa				Asia				WW Finished Goods			
	Actual	Plan	% Var	Growth vs Q99-1	Actual	Plan	% Var	Growth vs Q99-1	Actual	Plan	% Var	Growth vs Q99-1	Actual	Plan	% Var	Growth vs Q99-1
Business & Enterprise	$316.0	$333.9	(5%)	27%	$254.0	$247.0	3%	30%	$71.2	$61.6	16%	69%	$641.2	$642.4	(0%)	32%
Consumer Windows	77.4	70.1	10%	20%	30.4	20.8	46%	(44%)	20.1	21.8	(8%)	(73%)	127.9	112.7	13%	(34%)
Business & Productivity	872.3	899.0	(3%)	6%	720.2	658.0	9%	20%	375.8	312.7	20%	68%	1,968.3	1,869.7	5%	20%
Developer Group	137.9	124.0	11%	6%	66.9	65.6	2%	11%	63.6	42.5	50%	72%	268.4	232.1	16%	18%
Home & Retail Group	104.4	96.3	8%	5%	101.2	52.0	95%	56%	10.7	8.9	21%	(10%)	216.3	157.1	38%	23%
Consumer & Commerce	9.1	7.7	18%	34%	1.0	3.1	(68%)	45%	0.8	0.4	111%	(76%)	10.9	11.2	(3%)	1%
Other	59.8	59.7	0%	281%	6.3	6.6	(5%)	123%	2.5	0.7	262%	nm	68.6	67.0	2%	271%
Total FG Gross Revenue	$1,576.9	$1,590.7	(1%)	14%	$1,180.1	$1,053.1	12%	20%	$544.7	$448.5	21%	39%	$3,301.6	$3,092.2	7%	20%

- Q00-1 FG revsum revenue was $3.3 billion, 7% above plan and up 20% over the same quarter last year. Key drivers include strong volume licensing of Office suites worldwide, and wide acceptance of the Word/Excel product in Japan. Volume licensing, including Select, Open, and earned revenue from Enterprise Agreements (EAs), amounted to $2.1 billion in the quarter, up 8% sequentially and 33% over the same quarter in the prior year. Q00-1 volume licensing represented the third highest quarter of revenue. The primary drivers of growth were Open, which rose $192 million, and EAs, with recognized revenue up $269 million. Select revenue in Q00-1 remained relatively flat with 3% growth, however, this could be considered positive in light of the continuing migration of expiring Select customers to Enterprise Agreements.

(in millions)	Q00-1		
	Gross revenue	Unearned	Earned
SPAR	$184.6	-$71.1	$255.7
EMEA	$142.7	-$24.5	$167.2
Asia	$14.2	$0.4	$13.8
FG Total	$341.4	-$95.3	$436.7

- There were 227 new EAs billed in Q00-1, an improvement over the 99 agreements in Q99-1, but down from the record 390 agreements in Q99-4. This is primarily driven by the new strategic focus on penetrating the Breadth/MORG space. This new focus also explains the disparity between the number of EAs billed and the associated revenue when comparing Q00-1 to Q99-1. Despite this disparity, however, average $/PC remains at or above $200 as entity penetration increases. Also, first quarter is typically slow and there was a draining of the current EA pipeline, which saw a push to close deals before the end of FY99. Gross billings were $341 million in Q00-1, down from the $637 million record in Q99-4, but surpassing the same quarter of the prior year by $160 million. The largest new EAs signed during Q00-1 were with American Express (68,000 desktops, 3 yrs, $35 million total revenue to MS), SK Group in Korea (30,000 desktops, 3 yrs, $13 million total revenue to MS) and Computer Associates (15,000 desktops, 3 yrs, $10 million total revenue to MS).

- Q00-1 net revenue in SPAR was $1.5 billion, 5% under plan and an increase of only 4% over Q99-1. Revenue in the United States was 10% under plan and down 1% over the same quarter last year due to slow U.S. demand and weak field execution in July and August. Canada, rebounding from a weak FY99, exceeded budget by 9% in the quarter with net revenue of $94 million, a growth rate of 24% over Q99-1. Latin America net revenue of $158 million exceeded plan by 22% in the quarter. Brazil, which was 83% above its revenue plan due to their "Truce" anti-piracy campaign, led the region. Apart from Brazil, only 4 out of 12 other Latin American subsidiaries were above their revenue plans for the quarter, however the region is showing an impressive 56% growth over Q99-1. Net revenue in the South Pacific beat plan by 12% in the quarter, and was 8% higher than Q99-1 in constant dollars. Constant dollar revenue growth was 9% and 1% in Australia and New Zealand, respectively. There was a continuing shift from Select to Enterprise Agreements, as SPAR billed 123 EAs in Q00-1, which represents a 124% growth over Q99-1. Revenue per desktop also grew 5%, to an average of $198.

- EMEA revenue remained strong in the quarter, as Q00-1 net revenue of $1.2 billion was 12% above plan and grew 21% over Q99-1 (24% in constant dollars). Growth in the quarter was primarily attributable to Germany, France, and Italy, offset by seasonal slowness in other parts of Europe. Germany, with net revenue of $283 million and a 30% constant dollar variance, signed a $35 million Select deal with the German Ministry of Labor and grew 43% over Q99-1. France's strong quarter put them 17% ahead of plan and up 14% over the prior year quarter with net revenue of $133 million. Most of the slowness in Europe is attributable to Sweden, Belgium, and Eastern Europe. Sweden, which is feeling the impact from the end of its "Home PC" campaign, is currently 10% under plan and down 21% from Q99-1. Belgium's negative 22% variance to plan was attributed to large and medium enterprise customers waiting to deploy Windows 2000 and Office 2000 simultaneously. EMEA volume licensing showed a 3% decrease from Q99-4, mainly due to decreases in Open revenue, which declined 16% from that period, but still showed a respectable 26% growth over Q99-1. Eighty-five new Enterprise Agreements were signed in the quarter, representing 14% of the full year budgeted new agreements. Recognized EA revenue ended the quarter 12% above plan and 217% above the prior year.

- Q00-1 net revenue in Asia was $623 million, 25% over plan (19% in constant dollars). Net revenue of $478 million in Japan improved 70% over the comparable quarter (41% in constant dollars) driven by strong volume licensing of Office suites, BackOffice client access licenses, and stand-alone Excel and Word applications. The worst of the economic recession in Japan appears to be in the past. Korea also had a very strong quarter, as net revenue of $40 million was 227% higher than the quarter a year ago. Revenue in Korea was driven by government supported software anti-piracy initiatives and increased emphasis on Enterprise Agreements.

WORLDWIDE SALES GROUPS

- In July, the annual MS Global Summit took place in San Francisco and was attended more than 6,100 sales and support employees. The primary objective of the event was to review FY00 strategic initiatives, highlight best practices and successes, and to provide motivation and recognition.
- In July, the Small and Medium Enterprise Group hosted Fusion 99, the fifth annual business symposium for the worldwide community of Microsoft Certified Solution Providers (MCSPs). With more than 3,500 MCSPs were in attendance, Bill Gates and Jeff Raikes delivered keynote addresses.
- In July, EDS and MS announced an alliance whereby EDS will certify up to 7,000 Microsoft Certified Systems Engineers (MCSEs) worldwide over the next three years. This was 75% larger than the next comparable partnership.
- In September, MS and USWeb/CKS unveiled a strategy for delivering integrated, managed e-business solutions. At a joint technology lab to be built on the MS campus, USWeb/CKS and MS will develop iFrame, a standardized line-of-business application architecture based on Windows DNA 2000.
- In September, the Education Group launched the TechNet for Education Program, a program to give IT managers in schools, colleges and universities technical tools.
- Microsoft Technical Briefing 99 was held in September in San Diego, California and was attended by over 4,000 technical personnel and 250 speakers. The goal of the event was to ensure the field sales and support organizations understand MS product, technology, and service strategies.
- The worldwide Microsoft Certified Professional (MCP) community grew to over 610,000 members by the close of Q00-1. Key program enhancements in the quarter include the Microsoft Certified Professional Practice Test Provider program and a new track for the "Microsoft Certified Systems Engineer for Windows 2000".
- The MS Healthcare Users Group conference was held in San Diego during the quarter. As part of the keynote, Bill Gates announced Windows Distributed interNet Applications (DNA) for Healthcare, leveraging on the recent announcement about Windows DNA 2000. At the conference, there were more than 145 companies demonstrating healthcare solutions based on the MS platform.

SOUTH PACIFIC AND THE AMERICAS (SPAR)

- The U.S. economy in Q00-1 grew at its slowest pace in four years as businesses accumulated inventories at a slower rate. GDP rose at a revised 1.6% annual rate in the second quarter, down from the previous estimate of 1.8% and the lowest reading since a 0.4% rate in the second quarter of 1995. The need to rebuild stockpiles is expected to accelerate growth for the remainder of 1999. Consumer spending, which accounts for two-thirds of economic activity, rose to a 4.8% annual rate in the second quarter. Inflationary pressure eased in the quarter, as the government's implicit price deflator rose 1.3%, revised down from a prior estimate of 1.5%.
- Everett Vass was hired as General Manager of the South Central district. He came to MS from Tivoli Systems, where he was Sales Director for Latin America. Matt Pease was named General Manager of Northern California in July, and the General Manager of Gulf States district resigned during the quarter.
- The Latin America region split into five sub-regions to increase geographic focus. Brazil and Mexico are now independent sub-regions, while the remaining 11 subsidiaries have been grouped into the new sub-regions: Andean, South Cone and Caribbean, and Central America.
- Total retail Office 2000 sales results from the first 90 days exceeded Office 97 results on both a unit and revenue basis by 8% and 6%, respectively. Results were not as strong as forecasted, due to weaker then expected end user demand and lagging performance at CompUSA, the largest retailer of MS Office. CompUSA was at 41% of their 90 day forecast, but key retail actions are being taken to help boost sales of Office 2000. Total retail sales of Office 2000 are forecasted to come in at 82% of the first half FY00 plan.
- CompUSA is currently going through changes that have unfavorably impacted performance. They are at just 51% of their FY00 year to date plan for all products, and are showing a 33% decline year over year. CompUSA completely restructured their commercial business to a call center approach and focused the retail business on margin generation rather than market share. The MS Home and Retail sales group has hired TMG to provide dedicated CompUSA outlet coverage, secured Office advertising, and additional Office promotions.
- MS implemented Retail 2000, a direct shipping relationship with retail partners to increase speed to market. Currently nine accounts are actively participating, with thirteen accounts expected to be direct with MS by year-end. The result will be a one to two week faster time to shelf for key new products.
- Canada's GDP grew for the 12th consecutive month, a string of gains not seen since 1988. July GDP was up 0.4%, led by growth in the manufacturing sector. Estimates of annual expansion are now in the range of 3.5% - 4.0%.
- MS and Rogers Communications announced a series of agreements under which the companies will work together to accelerate the deployment of interactive television services to millions of Canadian homes. As part of these agreements, Rogers has chosen to license both the MS TV client and server software to support at least 1 million advanced set-top boxes. MS also made a $400 million investment in Rogers.
- For the second year in a row, MS Canada has been awarded first place in a global customer satisfaction survey. The survey, conducted in 23 countries around the world by Teleperformance, measured how effectively businesses handle customer satisfaction over the telephone. MS Canada topped the list with an overall score of 18.12 out of 20. IBM and Apple Canada also participated but did not make the top 10.
- In Australia, work continues toward compliance with the new goods and services tax law to be implemented on July 1, 2000. In light of the changes to the tax law, the subsidiary is exploring the option of remaining a commissioned subsidiary or moving to a buy/sell subsidiary model.
- Australia's economy remains stable. There is a possibility of a 0.5% raise in interest rates late this year. The Australian dollar is showing signs of strengthening, currently around 0.66 U.S. dollars, on the back of stronger gold and commodity prices, and the expectation of an interest rate rise. Recent state elections in Victoria are not expected to impact the subsidiary.

EUROPE, MIDDLE EAST, AND AFRICA (EMEA)

- In Q00-1, EMEA Finished Goods channel performance was solid, with net revenue of $1.17 billion driving the period 12% above plan and 21% over Q99-1 (12% and 23% in constant dollars). Responsibility margin of 73% was 8 points above plan and 2 points over Q99-1. Licensing mix continued to move away from FPP, led by strong sales of Enterprise Agreements and Open. Select and Open licensing grew by 12% and 26% (15% and 28% in constant dollars) respectively over Q99-1. Earned revenue from Enterprise Agreements increased to $167 million, and a total of 85 new Enterprise Agreements were signed during the quarter, the largest one with SAP AG in Germany covering 23,000 desktops for a total of $16 million over a three-year period.
- The U.S. dollar weakened sequentially a bit relative to most of the European currencies during the quarter, with the exception of the U.K. pound and the Swedish krona. Currency fluctuations had a limited positive impact of 1% on EMEA FG revenue.
- Recent improvements in global economic conditions are slowly seeing their way into Europe. Unemployment in the 11 Western Europe economies declined to 10.2% from 10.9% a year ago. European nations with greater than 10% unemployment include Belgium, France, Germany, Italy and Spain. Both the Netherlands and Switzerland experienced lower unemployment rates than the United States at 3.2% and 2.4% respectively.
- In Hungary, Tamas Hercegh was tapped as the new General Manager of MS Hungary. Tamas came to MS from Cap Gemini, where he was the Managing Director of the Hungarian subsidiary. Prior to Cap Gemini, Tamas held regional positions for Xerox and Olivetti in Eastern Europe.
- During the quarter, MS moved two offices in the EMEA region. After 9 years in its previous location, MS Belgium moved to a new office closer to the airport. Improved facilities enhance the work environment, and the location offers better visibility for MS. MS South Africa also moved offices as additional space was needed to host a growing employee base in the subsidiary.
- In July, MS announced the acquisition of Sendit AB, a leading provider of Mobile Internet solutions, for approximately $128 million. MS will concentrate efforts in further developing Sendit's business in Sweden and will integrate this facility with its other research and development sites in the United States. The acquisition represents MS's first product development center in the Nordic region.
- In September, MS announced the opening of a new office serving Tunisia and Algeria. EMEA's President, Michel Lacombe, held a press conference and met with a number of government officials (IT Minister, Telecom Minister) to emphasize MS's commitment to the local market.
- The impact of the devastating earthquakes in Turkey and Greece has yet to be seen in the financial performance of these subsidiaries. Through the end of Q00-1, Turkey and Greece were ahead of planned FG revenue by 48% and 51%, respectively. This picture will most likely change however, since the Turkish government has issued governmental purchase restrictions that only allow investments to repair earthquake damage.
- CHS, a large EMEA distributor, is experiencing more financial difficulties and owed $43 million to MS in EMEA at the end of the quarter. MS took action to reduce the CHS credit limit from $35 million to $18 million and froze future shipments of packaged product to CHS until the existing accounts receivable is reduced.
- According to IDC, Q99-4 EMEA PC shipments grew 16.3% over Q98-4, led by 19.3% growth in Western Europe. Internet growth and aggressive pricing of low end PCs fueled the growth. In the business market, Y2K compatibility is still a strong stimulant to corporate renewals and is expected to drive the small business sector until the millennium. The EMEA forecast for Q00-2 is 16.7% growth, slightly greater than Q99-2's growth.

AUTHOR: CLAUDE CHANGARNIER (CLAUDEC)

Asia

- Recently released economic statistics for Japan indicated that GDP grew 0.2% in Q99-4 over the same quarter of the previous year. This is the second consecutive quarter of economic growth in Japan. The current forecast for GDP in CY99 is slight growth, compared to a 2.9% decline in CY98. An improving economy in Japan has helped improve MS's business in the Asian region. In constant dollars, gross FG revenue for the region was up 20% in Q00-1 over Q99-1.
- Q00-1 net FG revenue for the region exceeded plan by 19% (measured in constant dollars). All subs in Asia except Hong Kong exceeded their Q00-1 net revenue plans. The region's Q00-1 net FG revenue grew 46% over Q99-1 net revenue. Korea's Q00-1 results were particularly impressive, with net FG revenue growing 191% over Q99-1 as a result of their anti-piracy campaign and increased emphasis on signing Enterprise Agreements with the large conglomerates (chaebols).
- Foreign investors have been increasing their purchases of the Japanese yen due to the improved economic outlook. In September, the yen rose to an exchange rate of 103 against the US dollar, the highest level in three years. The average exchange rate for the yen for Q00-1 was 116, in comparison with a FY00 budget exchange rate of 123 and the prior year exchange rate of 139.
- In Q00-1, management approved a new office facility in Osaka, Japan. The new facility will have a maximum capacity of 78 employees, up from the existing 30. The total lease and capital commitment for the new office aggregated was $3 million.
- In Q00-1, MS Asia approved a $760,000 thousand equity investment in a joint venture with Systex Investment Corporation and Compaq in Taiwan. The purpose of the joint venture is to develop electronic commerce applications and to provide Internet-related products and services. Under the proposed investment, MS would have a 25% interest in the venture.
- Over 40% of the PCs shipped in Japan have a word processing program and a spreadsheet program preinstalled ("PIPC business"). Following the launch of Office 2000 products in July, Word/Excel product revenue in MS Japan rose to $119 million for the quarter, an annual growth of 103%. PIPC sales now makes up 22% of the total revenue for the region.
- All Asian localized versions of Office 2000 were launched in Q00-1. The Japanese version was sold into the channel in Q99-4, with the street date of July 9th. Revenue from Office 2000 suites (excluding the Word/Excel 2000 product) in Q00-1 was $105 million, representing 53% of total Office suite revenue for the region.
- Billings of EAs were $13 million in Q00-1, up from $1 million in Q99-1. This increase is due in part to large EAs signed in Korea with the Samsung Group and the SK Group. The agreement with the SK Group covers 30,000 desktops, making it the largest EA in Asia.
- PC shipments in Japan exceeded expectations. The IDC Q99-4 shipment estimates were 2.2 million units, up 40% from Q98-4. Consumer purchases led the Japanese market, triggered by Internet and e-mail penetration. The corporate PC market also had significant growth, spurred by demand for replacement PCs, Y2K countermeasures, and the temporary legislation of a PC taxation system. IT managers in Japan are expected to focus on existing PCs and Y2K compatibility without purchasing significant new hardware in Q00-2. As a result, PC demand is expected to fall slightly in Q00-2, but to rise again in subsequent quarters.
- During FY00 annual planning last spring, PC consumption for the total Asia region was forecasted to grow 16% in FY99 and 14% for FY00, while Japan's consumption was forecasted to grow 21% in FY99 and 10% in FY00. Recent information for Japan indicates FY99 grew 25% and that FY00 will exceed 17% growth. PC shipments in other Asian markets are also expected to exceed forecasts.

OEM

(In millions, variance to plan)	Q00-1		
	Actual	Plan	Var%
Net revenue	$1,773.9	$1,572.2	13%
Costs of revenue	38.6	32.1	(21%)
Gross margin	1,735.3	1,540.2	13%
% of Net revenue	*97.8%*	*98.0%*	
Controllable expenses			
Regular headcount expense	16.0	19.3	17%
Other headcount expense	0.3	0.3	(36%)
Vendors	0.1	0.2	11%
Infrastructure	3.6	3.7	3%
Other misc expenses	6.8	7.3	7%
Sales expense	27.0	30.8	12%
Marketing	13.1	15.4	15%
Net PSS	1.8	2.0	10%
Net MCS	0.0	0.0	nm
General and administrative costs	0.4	0.5	35%
Total controllable expenses	42.3	48.8	13%
Responsibility margin	1,693.0	1,491.4	14%
% of Net revenue	*95.4%*	*94.9%*	
Shared resources	2.1	2.0	(1%)
Corporate allocations	284.7	326.4	13%
Contribution margin	$1,406.3	$1,162.9	21%
% of Net revenue	*79.3%*	*74.0%*	

BUSINESS HIGHLIGHTS

- OEM net revenue of $1.8 billion for the quarter was 28% over the comparable prior year and 13% over plan.
- Asia, with $311 million in revenue, continued to experience the strongest growth, increasing 42% over Q99-1. China and Korea grew by 253% and 159%, respectively, which was tempered by Japanese growth of 28%. EMEA grew 22% over Q99-1 and was 3% ahead of plan. The United States had 26% growth over Q99-1 and was 11% over budget.
- The multinational accounts were the fastest growing segment for the quarter. Revenue of $1.1 billion was up 33% over Q99-1, led by the top five multinationals (Compaq, Dell, IBM, HP, Gateway), who as a group grew 37%. The market share for the top five multinationals increased by 5 points to approximately 47%. This growth came at the expense of both the named and system builder accounts.
- OEMs reported 4 million units of Windows NT Workstation in Q00-1, up 61% from Q99-1. NTW penetration on business machines shipped by multinationals was estimated at 40%.
- Hardware revenue of $42 million for Q00-1 was 15% over plan, driven by Intellimouse sales, which showed a unit growth of 44% over Q99-1 resulting from price reductions.
- OEM cost of revenue was $39 million, which was 21% unfavorable due to delayed availability of cost-reduced versions of mouse products.
- Q00-1 responsibility margin was 95.4%, half a point greater than plan and slightly more than a one-point increase from Q99-1.

SIGNIFICANT OEM CUSTOMERS

(in millions)	Q00-1			Growth from Q99-1	
	Actual	Plan	Variance	$	%
Top 10 multinationals					
Dell	$ 284.3	$ 227.9	$ 56.4	$ 114.6	68%
Compaq	212.4	180.2	32.2	65.5	45%
IBM	137.1	108.2	28.9	23.4	21%
Gateway	112.4	108.0	4.3	13.7	14%
Hewlett-Packard	86.4	89.3	(2.8)	9.0	12%
Toshiba	48.3	36.5	11.8	8.4	21%
Fujitsu	45.5	31.3	14.2	14.3	46%
NEC	40.2	37.3	2.9	7.1	22%
Siemens Nixdorf	39.0	30.9	8.1	8.8	29%
Packard Bell NEC	28.7	27.6	1.1	(1.2)	(4%)
Other multinationals	48.4	62.5	(14.1)	6.8	16%
Total multinationals	1,082.6	939.7	143.0	270.3	33%
System builders	362.1	341.8	20.3	79.6	28%
Named accounts	322.9	292.9	30.0	34.2	12%
Embedded systems	27.6	19.7	7.8	14.5	111%
Gross revenue	1,795.2	1,594.1	201.1	398.6	29%
Revenue adjustments	(21.4)	(21.9)	0.4	(10.4)	93%
Net revenue	$ 1,773.8	$ 1,572.2	$ 201.6	$ 388.2	28%

OEM REVENUE BY CUSTOMER

- Dell continues to be the top revenue producer due to strong application and server revenue. Dell shipped the most units in the United States and trailed Compaq by 5 market share points on a worldwide basis.
- Compaq's application revenue increased as they shipped more MS product in their small business and consumer lines. For the first time, applications revenue has reached 10% of their total revenue.
- Though Gateway ships Office SBE or Works Suite on all non-corporate PCs, the revenue per application was down as the product mix shifted toward Works Suite. This is the first quarter where unit shipments of Works Suite exceeded Office.
- Hewlett-Packard has regained the top position in the U.S. retail market through aggressive pricing. Their small business Brio line, which accounts for 10% of their units, ships Office SBE on several models.
- Toshiba has introduced a new line of built-to-order PCs in the United States to compete in the "white-box" market. It is sold exclusively through the VAR channel and can be co-branded with the channel partner's name.
- Fujitsu and Siemens have formed a joint venture for PC manufacturing and marketing. The new entity is the second largest OEM (behind Compaq) in Europe.

MARKETING EXPENSE

MARKETING SPEND QUARTERLY TREND

(in millions)	Q98-1	Q98-2	Q98-3	Q98-4	Q99-1	Q99-2	Q99-3	Q99-4	Q00-1
SPAR	$118.1	$139.0	$135.7	$231.4	$100.5	$179.3	$142.5	$302.2	$144.7
EMEA	40.0	88.9	68.8	109.4	60.0	100.2	85.8	101.6	64.1
Asia	22.6	37.5	26.3	34.9	26.1	41.5	26.6	54.3	33.3
FG Total	$180.7	$265.4	$230.8	$375.7	$186.6	$321.0	$254.9	$458.1	$242.2
Growth over same quarter, prior year	28%	14%	(0%)	31%	3%	21%	10%	22%	30%
Spend as a percentage of net revenue	8%	10%	9%	15%	7%	10%	8%	15%	7%
Broad Reach	$19.4	$43.1	$41.8	$23.6	$6.2	$29.7	$28.6	$15.1	$1.1

- Net FG marketing expense for Q00-1 was $242 million, 7.3% of net revenue compared to a plan of $369 million, or 11.7% of net revenue.
- Q00-1 spend decreased $216 million from Q99-4. Q99-4 marketing spend was high due to the launch of Office 2000. The sequential decrease is typical as new fiscal year programs ramp up.
- Q00-1 spend represented 17% of full year plan, in line with the historical average.

- Historical percentage spend by quarter:

	Q1	Q2	Q3	Q4
FY97	16%	26%	26%	32%
FY98	17%	25%	22%	36%
FY99	15%	26%	21%	38%
FY00	17%			

Q00-1 FG MARKETING SPEND

	(in millions)	SPAR	EMEA	Asia	Total
Initiatives	Customer partner satisfaction	$23.2	$11.0	$3.9	$38.2
	Grow $/PC	6.3	11.9	4.6	22.8
	KM/collaboration platform	9.0	5.4	11.3	25.6
	LOB apps platform	8.2	5.4	3.7	17.3
	NT/Windows penetration	20.9	2.5	1.7	25.0
	Online	1.4	2.1	1.3	4.8
	Brand Image & PR	22.0	4.5	1.1	27.6
	Reseller marketing	17.2	1.0	0.3	18.5
	Other	36.6	20.3	5.5	62.4
		$144.7	$64.1	$33.3	$242.2
	% of net revenue	9.4%	5.5%	5.3%	7.3%
Categories	Advertising	$37.2	$13.2	$10.4	$60.8
	Tradeshows & seminars	27.7	15.6	9.1	52.4
	Reseller & partner mktg	25.4	4.3	2.1	31.8
	Marketing materials	10.9	7.4	5.9	24.1
	Public relations	9.2	4.7	0.8	14.7
	Direct marketing	8.9	3.3	0.6	12.8
	Program marketing	8.0	2.7	0.1	10.8
	All other	17.4	13.0	4.3	34.6
		$144.7	$64.1	$33.3	$242.2
	FY00 plan	$865.2	$393.4	$179.5	$1,438.1
	% FY00 plan spent	16.7%	16.3%	18.6%	16.8%

- SPAR FG spent the highest percentage of net revenue on marketing at 9.4%. The U.S. creates materials/programs that subsidiaries can leverage, advertising media costs are relatively higher in the U.S., and the U.S. does more direct competitive response advertising when competitors target MS.

- Fifty-five percent of Q00-1 spend was charged to the six strategic initiatives.
- Seventy percent of spend was spent on advertising (25%), net tradeshows and seminars (22%), reseller and partner marketing (13%), and marketing materials (10%).

MICROSOFT CONSULTING SERVICES (MCS)

(in millions, except cost per head)		Q00-1 Actual		Q00-1 Plan	Var %
MCS External Revenue		$90.9		$94.8	(4%)
MCS Internal Revenue		6.3		0.6	1,014%
Total MCS Revenue		97.2		95.4	2%
People		94.3		111.4	15%
Contingent staff/Vendors		18.1		15.9	(14%)
Infrastructure		10.5		15.0	30%
Other/Marketing/G&A		1.1		0.6	80%
Total Operating Expenses		124.1		143.0	13%
Responsibility Margin		(26.9)		(47.6)	(43%)
Headquarters Allocations		3.6		4.2	15%
Estimated General and Administrative		2.8		2.7	0%
Contribution Margin		$(33.3)		$(54.6)	(39%)
MCS Practice average headcount		2,454		2,607	6%
MCS Headquarters average headcount		47		52	10%
Subcontractor margin		$4.2		$4.1	2%
Consultant revenue per head*	$	122.63	$	116.17	6%
People costs per head*	$	153,688	$	170,976	10%
Infrastructure expenses per head*	$	17,176	$	23,048	25%

*Annualised

MCS HIGHLIGHTS

- In Q00-1, the MCS business produced a contribution margin loss of $33 million, versus a budgeted loss of $55 million, and a Q99-1 loss of $27 million. SPAR delivered a contribution margin loss of $18 million against planned loss of $34 million, attributable to favorable variances in employee stock option, recruiting, travel and entertainment, training, and computer expenses. EMEA finished Q00-1 with a $13 million loss against a budgeted loss of $18 million, while Asia lost $2 million against a budgeted loss of $3 million. All regions exceeded budgeted revenue per head for the quarter, and are below plan on both people cost per head and infrastructure cost per head metrics.
- Year to date worldwide MCS headcount was 6% below plan, with average headcount growing 32% year over year, and 6% over June 1999.
- In Australia, Westpac Banking Corporation signed up 100,000 customers to its Online Banking service in the first 12 months. Westpac had spent over $1 million (Australian dollars) to deploy an FICS Online Banking solution on the UNIX platform only to find the system architecture would not scale. MCS successfully recommended the Microsoft Solutions Framework (MSF) approach based on MS Windows DNA technology.
- In Detroit, Dominos Pizza, a long standing Novell account, signed a three-year commitment to the Microsoft platform to roll out 700 Windows NT servers in corporate owned stores and will offer the Windows NT solution to 2,400 franchised establishments by calendar year 2000. In this timeframe, MCS has secured SQL 7.0 adoption for Line Of Business mission critical applications. Dominos is a member of early adopters program for Shiloh (SQL 7.5).
- In France, La FNAC, the leading French distributor of PCs, software, consumer electronics, books and music recently bought Alibabook, the largest book distributor in France. This result gave MCS the opportunity to win back the largest e-commerce reference account in France from Sun and Oracle. The site itself would rely 100% on MS technology, including Windows NT Enterprise, SQL Server, IIS, Site Server Commerce edition, WLBS, MSCS, Exchange, and Office.

PRODUCT SUPPORT SERVICES (PSS)

(in millions)	Q00-1 Actual				Q00-1 Budget			
	Costs	Revenue	Net PSS	Recovery %	Costs	Revenue	Net PSS	Recovery %
SPAR	$156.3	$43.6	$112.7	27.9%	$187.5	$46.2	$141.3	24.6%
EMEA	$50.0	$17.3	$32.7	34.6%	$59.6	$16.5	$43.1	27.6%
Asia	$21.0	$4.4	$16.6	21.0%	$23.8	$4.5	$19.3	18.8%
FG Total	227.3	65.3	162.0	28.7%	270.8	67.1	203.7	24.8%
Online	16.9		16.9	0.0%	20.1		20.1	0.0%
OEM	1.8		1.8	0.0%	2.0		2.0	0.0%
Total Business	$246.0	$65.3	$180.7	26.5%	$292.9	$67.1	$225.8	22.9%

BUSINESS HIGHLIGHTS

- Q00-1 net support costs were 4.9% of net FG revenue versus a plan of 6.5% due to below plan PSS headcount-related costs. Quarterly support costs of $181 million were $45 million under budget driven by low payroll, computer, and vendor expenses, particularly in the United States. Q00-1 average regular headcount was 7.4% below a plan of 5,123, creating the payroll variance. The low incident volumes for the Office 2000 launch, and timing differences on computer refreshes, Y2K and training expenses drove other variances. Support revenue is 2.7% below plan primarily due to weaknesses in the new Professional Support offering launched in the United States.
- To prepare for the upcoming release of Windows 2000, PSS developed over 30 days of classroom training content for support professionals. In addition, direct customer experience was gained through beta programs such as: the Corporate Preview Program, which involves approximately 600,000 customers, the Joint Development Program with 50 Enterprise Depth customers, the Rapid Deployment Program with 50 Marketing Betas, Microsoft's internal deployment, and the Premier Early Assist program. Online resources were expanded with new knowledgebase articles, troubleshooting wizards, and support webcasts to ensure customers have easy access to Windows 2000 information.
- PSS has developed a three-year strategic plan called Ascent. Several elements of that strategy were implemented during the quarter, including sales of the new Alliance support offering to customers such as Reed Elsevier, Arthur Andersen, USinternetworking and Pricewaterhouse Coopers. New service delivery processes in the United States were introduced including the Expert Finder tool, which is designed to improve collaboration and call redirection between support professionals.
- EMEA announced the new Ascent offerings in October. During Q00-1, several pilots were launched to determine how customer satisfaction and operational effectiveness could be improved through a global delivery model. In one pilot, developer incidents from the LATAM region and after-hours support for the U.K. customers are now routed to the U.S. delivery team. In addition, the regional escalation center in China now to handles some developer incidents each day from the United States to strengthen their skills. The convergence of PSS onto a common incident tracking tool continued with the conversion of Italy and the upgrade of U.S. Compass users onto the Annapurna system.
- Online Support usage continues to grow, with a 16% increase in customers using the U.S. sites. The Association of Software Professionals (ASP) honored two of Microsoft's Professional Online Support sites, one for Resellers and Consultants and the other for Developers, as one of the top 10 support sites.
- U.S. customer satisfaction in Q00-1 did not reflect a statistically significant change with preliminary estimates at 66% "very satisfied" versus 67% in Q99-4. MS Systems Management Server incident volumes increased and delays occurred worldwide after the release of SMS version 2.0. Support resources are being realigned and weekly meetings with the business division are underway to address technical issues.

General &
Administrative

GENERAL AND ADMINISTRATIVE

(in millions, variance to plan)	Q00-1			
			Variance	
	Actual	Plan	$	%
Gross expenses				
Human Resources	$92.2	$96.0	$3.8	4%
IT	73.3	100.1	26.8	27%
Legal & Corporate Affairs	72.2	93.8	21.6	23%
Finance & Administrative Services	106.3	117.1	10.9	9%
Other	12.6	9.1	(3.5)	(39%)
	356.6	416.1	59.5	14%
Distributed expenses				
Benefits	55.0	54.3	(0.6)	(1%)
Services	18.5	19.0	0.5	3%
Recruiting	14.1	17.3	3.2	18%
Facilities	53.7	54.8	1.2	2%
IT	41.2	53.4	12.2	23%
	182.5	198.9	16.3	8%
Allocated expenses				
Other Human Resources	14.0	17.0	3.0	17%
Other IT	32.4	47.0	14.6	31%
Legal & Corporate Affairs	72.2	93.8	21.6	23%
Finance & Administrative Services	42.8	50.3	7.5	15%
Other	12.6	9.1	(3.5)	(39%)
	174.1	217.3	43.2	20%
Under/(over) distributed expenses	(6.0)	(11.8)	(5.8)	nm
Net General & Administrative	$168.1	$205.5	$37.4	18%

See Appendix for G&A definitions

- Q00-1: Total gross G&A costs were $60 million under plan in Q00-1 driven by information technology, legal, and corporate affairs costs. Information technology expenses were $27 million under plan primarily due to delays in network infrastructure spend. Legal and corporate affairs were $22 million below plan due to the timing of spend for corporate dues and professional fees. Other expenses were $4 million over plan due to $29 million in employee stock option expense related to the acceleration of stock option vesting in employee severance packages, offset by $20 million in settlement credits from MS liability carriers related to litigation claims.

BENEFITS

Employee Benefit Rates	Basis	Q00-1 Actual	Plan	Var	Var %
Healthcare pmts and fees	Per Enrollee	$ 706	$ 620	$ (86)	(14%)
401(k) employer match	Per Participant	639	667	28	4%
Health club	Per Participant	237	245	8	3%

- Costs of employee benefits, including health coverage, 401(k) plan and health club dues were at plan for Q00-1.
- The MS Healthcare plan is self-insured through a tax-exempt trust and administered through several healthcare providers. On a per enrollee basis, healthcare costs were above plan due to the timing of claims that transitioned into Q00-1 when the company switched to a new healthcare claims administrator. The per enrollee variance will diminish to about 3% over plan by the end of the fiscal year.
- The employer match for 401(K) was below plan on a per-participant basis due to lower average wages of participants than planned.
- Health club fees represent costs for employee memberships at the Pro Club and Columbia Athletic centers in the Puget Sound area and were slightly below plan on a per-participant basis.

RECRUITING

(in millions, except new hires, variance to plan)	Q00-1 Recruiting Costs Actual	Plan	Var %	New hires (salaried) Actual	Plan	% of Plan
BD & Research	$ 7.2	$ 9.0	20%	557	411	136%
Sales	1.4	1.6	13%	210	236	89%
Sales Support	3.3	4.6	28%	186	205	91%
OG & LCA	2.2	2.1	(7%)	182	190	96%
Total	$ 14.1	$ 17.3	18%	1,135	1,042	109%

- Recruiting costs are distributed to customer divisions based on number of new hires. Costs include employment advertising, agency fees, candidate travel, and recruiting staff's people and infrastructure expenses.
- For Q00-1 recruiting costs were 18% below plan due to delayed spend for candidate travel and advertising and lower costs associated with hiring contingent staff into employee positions.
- The number of salaried hires were 9% over plan for Q00-1, primarily due to increased hiring activity in the business divisions and in research. Approximately 36% of the Q00-1 hires in the business divisions and research were from contingent staff conversions, versus 20% planned.

FACILITIES AND CAPITAL SPENDING

($ in millions, square feet in thousands)	Q00-1 Capital Spend Square Feet	Mix	Actual	Plan	Variance
Puget Sound	5,938	51%	$58.1	$85.9	$27.8
Other domestic	2,437	21%	53.5	56.1	2.6
International	3,229	28%	4.7	2.8	(1.9)
Total	11,604	100%	$116.3	$144.8	$28.5

- Construction of the Pinehurst project, located on the Redmond campus, continued during Q00-1. By Q00-2, this $91 million project will add 145,000 square feet to the portfolio. Pinehurst will be the new site of the Executive Briefing Center and the New Home of the Future. After Pinehurst is placed in service, Buildings 12-15 will be demolished and the 490,000 square foot St. Andrews project will begin construction.
- The Issaquah Highlands master planning continued during the quarter for this potential 3 million square foot campus.
- The sales lease back of the Ireland properties is under contract with signing expected to be completed in Q00-2.
- The plan to relocate the Munich, Germany properties to one campus continued during Q00-1. When this project is complete, 300,000 square feet will be added to the portfolio and the remaining sites in Germany will terminate their leases or sub-leases.

PUGET SOUND CAPITAL SPENDING

($ in millions)	Q00-1		
	Actual	Plan	Variance
New Space	$47.6	$60.0	$12.4
Tenant improvements	10.5	25.9	15.4
Total	$58.1	$85.9	$27.8

- New space includes Troon, Pinehurst, St. Andrews and various new leased sites. The variance in spending for new space was primarily due to delayed starts on Cedar Court and Café 9. In addition, the James River Building retrofit was cancelled and a new building is planned for this property. The variance in tenant improvements on existing space was primarily due to the timing of retrofits on Buildings 16-18 and the delay in Building 11 upgrades.

CORPORATE PROCUREMENT

Metric	Q99-1	Q00-1
Number of Transactions	320,367	393,037
Cost Per Transaction	$ 4.65	$ 4.25
Transactions Paid within Standard Terms	85%	92%

Standard Terms = payment within 30 days of invoice

- Corporate Procurement weekly average transaction volumes increased 23% in Q00-1 over Q99-1 due primarily to the growth rate of MS and expansion into new businesses.
- Q00-1 cost per transaction decreased 9% to $4.25 from Q99-1 while normalized gross expenses increased 12% year over year. Additionally, invoices processed electronically (as a percentage of total invoices) increased from 92% in Q99-1 to 99% in Q00-1, reflecting the continued adoption of our online tools.
- In Q00-1, the number of new vendor set-ups totaled 1,186 in North America, an average of 91 per week; versus 126 in Q99-1. Of the 91, 30% were contractors and consultants.

INFORMATION TECHNOLOGY

- Completed the migration of the corporate domain to Windows 2000 Native mode with 51,000 desktops now running Windows 2000.
- Key application rollouts and upgrades during the quarter included U.S. Compass/Clarify, Siebel Sales Enterprise 0.95, SAP 4.5, Store 2.0, and Microsoft Service Enterprise 1.0 (Congo replacement).
- Applications and infrastructure were modified to support the launch of the new Ascent service.
- Achieved 99.9958% availability on Microsoft.com cluster in part due to Helios (an in-house built load balancing software working with Windows Load Balancing System), which is now managing 500 servers from one Helios server.

Treasury &
Investor Relations

CAPITAL MARKET ACTIVITIES

INVESTMENT PORTFOLIO MANAGEMENT

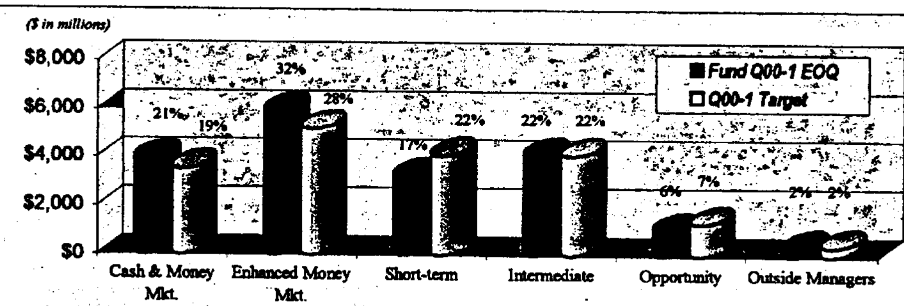
FAMILY OF FUNDS: PORTFOLIO ALLOCATIONS & ABSOLUTE RETURNS

($ in millions)	Cash & Money Mkt #1	Enhanced Money Market #2	Short Term #3	Intermediate #4	Opportunity #5	Outside Managers** #6	Total
Fund allocation							
Q99-4 Avg	32%	18%	21%	22%	6%	1%	100%
Q00-1 Avg	26%	26%	19%	20%	7%	2%	100%
Cash balances *							
Q99-4	$ 4,485	$ 4,017	$ 3,441	$ 3,433	$ 1,214	$ 347	$ 16,937
Q00-1	$ 3,899	$ 5,931	$ 3,226	$ 4,067	$ 1,021	$ 340	$ 18,484
Annualized rate of return (pre-tax)							
Q99-4	5.0%	5.9%	2.4%	-1.2%	-2.4%	31.7%	4.0%
Q00-1	5.5%	5.7%	5.6%	5.7%	4.4%	10.5%	5.8%

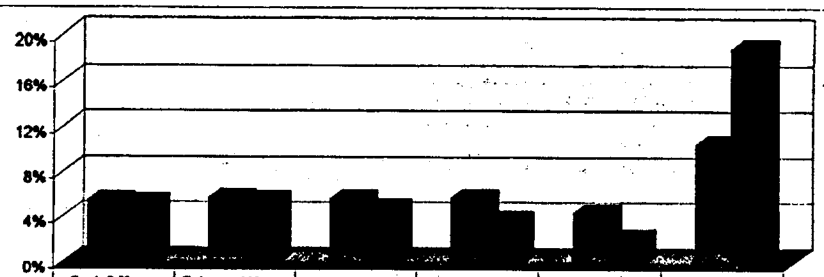
* Net Asset Value at market of Treasury-managed portfolio, includes certain assets classified as other assets on the balance sheet, but excludes certain foreign currency operating balances
**Outside Managers Cash Balance includes additional AOG funds

- Q00-1 economic income represented interest income of $249 million, less capital losses of $53 million plus $4 million of economic value from tax-advantaged investments, and a gain in market value of $13 million.
- Q00-1 marked the beginning of the Family of Funds 2.0 (FoF 2.0) transition period. Allocation targets reflect FoF 2.0 transition allocation objectives and a bearish interest rate view. The uncertainty of corporate liquidity needs combined with bearish interest rate expectations drove Fund allocations during the quarter.
- Continued strength of both the United States and global economy prompted the Fed to raise the Federal Funds rate 25 basis points at the August 24th FOMC meeting. The Fed adopted a neutral bias, but emphasized their commitment to preemptively fight inflation. Higher interest rates expectations and Y2K concerns created an incentive for companies to issue debt during the quarter to lock-in financing rates. This resulted in higher than normal corporate debt issuance, $42 billion more year-over-year. Lack of liquidity and heavy supply pressured the market and contributed to Q00-1 corporate spread widening, 2 and 5 year spreads widened 13 and 12 basis points respectively. In early September, the Fed attempted to smooth liquidity concerns by announcing new year-end lending policies to ensure market equilibrium. Despite the quarter-over-quarter rise in interest rates, the FoF achieved a 5.8% annualized rate of return, up 1.8% from Q99-4.

FAMILY OF FUNDS: PORTFOLIO NET ASSET VALUE (NAV) ALLOCATIONS



Q00-1 FAMILY OF FUNDS: RELATIVE PERFORMANCE VERSUS BENCHMARKS



	Cash & Money Mkt	Enhanced Money Mkt	Short-term	Intermediate	Opportunity	Outside Managers
■ Fund	5.46%	5.72%	5.62%	5.73%	4.37%	10.47%
■ Benchmark	5.30%	5.55%	4.82%	3.77%	2.17%	18.86%

**Outside Managers Cash Balance includes additional AOG funds

PORTFOLIO PERFORMANCE

- Q00-1 economic conditions and Fed activity translated into a bearish fixed income market. Treasury yields were volatile intra-quarter, oscillating in a 25 basis point trading range. Yields rose month-over-month in July and August, traded back down in September to close 8 to 13 basis points (bps) higher quarter-over-quarter.

	Yield	Increase
3-month T-bill	4.85%	8 bps
1-year T-note	5.18%	13 bps
2-year T-note	5.60%	8 bps
5-year T-note	5.76%	11 bps
10-year T-note	5.88%	9 bps
30-year T-bond	6.05%	8 bps

- Average portfolio durations, a measure of interest rate sensitivity, were held slightly short to neutral versus benchmarks throughout Q00-1. Durations ranged between 98.6% and 100% of benchmarks, consistent with the bearish interest rate outlook and the objective to limit duration impacts.
- The upward trend in interest rates and spreads during Q00-1 produced lackluster fixed income asset class performance. Funds 1 through 5 however achieved positive rates of return and outperformed their respective indices. Funds 1 and 2 outperformed by 4 unannualized bps, while Funds 3, 4, and 5 delivered excess returns of 19, 47, and 54 unannualized bps respectively.
- MS international equity portfolios gained 2.5% (10.5% annualized) on the quarter compared to 4.4% (18.9% annualized) for the EAFE Index. The portfolio's below-market exposure in Japanese equities accounted for most of the variance in returns relative the EAFE. Despite under-performance this quarter, inception-to-date Fund 6 has returned 15.5% (24.1% annualized), outperforming the index by 6.6%.
- For Q00-1, the FoF aggregate portfolio returns out-performed their respective benchmarks by 63 bps ($27 million) and out-performed the risk-free rate of return (measured by the Salomon Brothers 3 Month T-Bill Index) by 84 bps ($37 million). The MS security lending program through Met West contributed $1 million to Q00-1's returns.

PORTFOLIO "CATASTROPHE" HEDGE PROGRAM

- Under the FoF's "Catastrophe" Hedge Program, MS hedges against a quarterly pretax mark-to-market (MTM) loss exceeding the lower of 10% of forecasted quarterly net income or the expected pretax MTM loss (for Funds 3, 4 and 5) resulting from 2 standard deviations rise in interest rates. In Q00-2, given a budget of $3 million, MS purchased payer swaptions for $4 million and sold receiver swaptions for $1 million for a net cost of $3 million, hedging 87% of the exposure above a pretax MTM loss of $337 million from funds 3, 4, and 5. This risk-limiting program is designed to cap the negative valuation impacts on the portfolio that would be expected in an environment of rapid and significant increases in U.S. interest rates.
- The $1 million receiver swaptions were sold to reduce the cost of hedging. These options will cap our pretax MTM gain from funds 3, 4, and 5 at $298 million. PMG also took advantage of a market opportunity to purchase payer swaptions and sell receiver swaptions with maturities of 6 months, compared to 3 months maturities, to help lower hedging costs and provide some protection over year-end.

ACCOUNTS RECEIVABLE

- Worldwide gross accounts receivable decreased from $2.7 billion at the end of Q99-4 to $2.4 billion. The majority of the decrease came from the United States, where the accounts receivable balance decreased 48% sequentially. The primary driver behind the decrease was the sell through of Office 2000 products, which had extended 60-day payment terms. In addition, the accounts receivable balance of GTIS ($26 million) was moved to a "notes receivable" aging, following the signing of a long-term promissory note. Aging deteriorated with "current" decreasing from 94% to 91% and over 60-day delinquency remained flat at 2% quarter over quarter.
- Worldwide days sales outstanding (DSO) remained flat at 44 days quarter over quarter.
- The reserve for sales returns and concessions at September 30, 1999 decreased to $414 million from $559 million at June 30, 1999. This balance was composed primarily of probable returns of packaged product, prepaid OEM minimum commitments, and OEM and organizational licensing credits and pricing concessions. The decrease reflects lower channel inventory of Office 2000 products.
- The allowance for doubtful accounts remained flat sequentially. For doubtful accounts, revenue will not be recognized until collected. Revenue for these customers is on a "cash basis", thus there is no gross up of accounts receivable and the allowance for doubtful accounts. As of June 30, 1999, there were five "cash basis" accounts. This number grew to seven in the current quarter. Two of these accounts are discussed on the following page (GTIS and CHS).

($ in millions)	DSO				Aging Summary				
	Q99-2	Q99-3	Q99-4	Q00-1	Total	Current	1-30	31-60	60+
Finished goods									
EMEA	42	36	35	45	$ 516	$ 494	$ 14	$ 2	$ 7
Asia	59	53	57	57	298	275	19	1	3
United States	47	40	42	34	474	456	20	(4)	1
Canada	49	41	40	54	64	36	26	1	1
South Pacific	79	78	69	67	47	44	3	0	(0)
Latin America	93	102	97	101	172	152	8	8	5
Total finished goods	49	44	44	47	1,570	1,456	89	8	17
OEM	40	43	46	39	850	750	52	6	42
Other					20	18	1	0	0
Total accounts receivable	46	43	44	43	$ 2,440	$ 2,224	$ 142	$ 13	$ 60
						91%	*6%*	*1%*	*2%*
Clearing accounts					(61)				
Reserves for sales returns					(414)				
Allowance for doubtful accounts					(205)				
Customer deposits					(10)				
Rebates & other					(163)				
Earned but unbilled revenue					639				
Accounts receivable-net					$ 2,225				

ACCOUNTS RECEIVABLE OF THE TEN LARGEST CUSTOMERS WORLDWIDE

- Total accounts receivable for the top ten worldwide customers accounted for 47% of the total accounts receivable at the end of Q00-1, down from 50% at the end of Q99-4.
- CHS continues to struggle financially and its credit lines with vendors have been reduced. In Q00-1, the company's credit line in EMEA was cut from $35 million to $18 million. As a result, CHS is on credit / shipping hold until the balance falls below $18 million. In Latin America, the current exposure is holding at $35 million, while the OEM credit line is capped at $17 million. In the meantime, CHS is reorganizing the company to strengthen its balance sheet, while it waits for a third-party cash infusion.
- GTIS, a discontinued distributor due to the "Retail 2000" program, is unable to pay its debt. As a result, MS placed them on a payment plan whereby the company will re-pay $26 million, plus interest charges of approximately $1 million by March 31, 2000. Approximately $7 million in inventory will be returned before October fiscal month end and the promissory note will be adjusted accordingly. MS would prefer the balance be paid earlier, as the company is currently up for sale.
- MicroAge announced a pre-tax profit of $800 thousand for its August quarter. Including a restructuring charge for staff reductions and office closings, the company posted a loss of $5 million, compared to a second quarter loss of $165 million. MicroAge is a MS large account reseller (LAR) and Pinacor (subsidiary of MicroAge) is a MS distributor. On a non-consolidated basis, Pinacor is profitable, while MicroAge continues to lose money.
- 3 Soft, one of our largest Canadian LAR, disputed a $26 million dollar "Enterprise Account" billing. 3 Soft claimed MS supplied the wrong price information and as a result, 3 Soft under-billed its Enterprise customer (State Farm Insurance). MS has since verified the pricing is correct, but 3 Soft short paid the invoice by $5 million in October. Due to the late payment made in October, the Canadian FG DSO increased 14 days quarter over quarter. We are presently working with 3 Soft to resolve the short payment issue.

(in millions)	Total		Aging Summary			
	Balance	Percent	Current	1-30	31-60	Over 60
Ingram	$ 254	10%	$ 246	$ 7	$ 0	$ 1
Dell Computer	226	9%	212	2	1	12
Compaq Computer	153	6%	141	12	0	(1)
Tech Data	126	5%	129	1	(1)	(2)
CHS	93	4%	85	8	(1)	1
Fujitsu	73	3%	78	(5)	(0)	(0)
Siemens Nixdorf	67	3%	57	11	(0)	(1)
Software Spectrum	54	2%	46	2	1	5
Merisel	50	2%	47	3	(0)	0
Gateway 2000	50	2%	48	0	(2)	3
Total ten largest	1,145	47%	1,089	40	(3)	19
Other	1,294	53%	1,135	102	16	41
Total Q00-1	$ 2,440	100%	$ 2,224	$ 142	$ 13	$ 60
Total Q99-4	$ 2,688		$ 2,515	$ 79	$ 37	$ 57

Aging mix:	Current	1-30	31-60	Over 60
Q00-1 Top ten largest	95%	4%	(0%)	2%
Q00-1 Total	91%	6%	1%	2%
Q99-4 Total	94%	3%	1%	2%

EQUITY INVESTMENTS & OTHER ASSETS

(in millions)	Cost			Market Value (if public)		
Equity investments and other assets	Q00-1	Q99-4	Change	Q00-1	Q99-4	Change
AT&T	$ 5,007	$ 5,000	$ 7	$ 4,549	$ 5,380	(831)
Comcast	1,062	1,055	7	3,411	3,283	128
Nextel Communications	600	600	-	1,130	836	294
United Pan-Europe Communications	332	332	-	698	629	69
NTL, Inc	518	511	7	674	629	45
WorldCom (hedged)	13	14	(1)	443	477	(34)
Rogers Communications	404	-	404	405	-	405
Qwest	200	200	-	263	294	(31)
Ticketmaster Online CitySearch	223	-	223	229	-	229
CMG Info Services (hedged)	3	3	-	208	209	(1)
Apple (hedged)	150	150	-	196	190	6
Rhythms NetConnections	30	30	-	146	250	(104)
Lernout & Hauspie	60	60	-	131	133	(2)
Wink Communications	30	30	-	127	30	97
Verisign (hedged)	7	7	-	103	101	2
Other equity investments	1,344	1,301	43	446	629	(183)
	9,983	9,293	690	$ 13,159	$ 13,070	$ 89
Joint ventures	79	67	12			
Other investments	2,216	1,852	364			
Mark-to market *	2,632	3,160	(528)			
Total equity investments	14,910	14,372	538			
Other assets						
Intellectual property rights	685	533	152			
Accumulated amortization	(406)	(381)	(25)			
L/T loans and other	864	732	132			
Total other assets	1,143	884	259			
Total equity investment and other assets	$ 16,053	$ 15,256	$ 797			

* Privately held securities and certain preferred stocks redeemable into common stock or cash (Comcast, NTL) cannot be marked-to-market for GAAP reporting.

- New equity investments totaling $717 million were added in Q00-1, consisting primarily of $223 million of Ticketmaster Online CitySearch stock received in exchange for Sidewalk A&E and $493 million in cash: Rogers Communications for $404 million, USWeb warrants for $15 million, Akamai Technologies for $15 million, DSL Net for $15 million, Tuttle Decision Systems for $12 million, and Thrunet for $10 million.
- Additional equity investments totaling $36 million occurred in Q00-1 including Vadem for $7 million, several capital calls totaling $4 million, stock dividends totaling $15 million were received from Comcast, NTLI and Rogers Communications and a $7 million upward adjustment of the AT&T investment.
- Reductions in investments totaled $47 million, included a 25% reduction in Citrix (pretax gain of $35 million), 7% each of WorldCom and Proginet (pretax gains of $31 million and nearly zero, respectively), and 100% each of Hi/fn, Dialogic, Unisys and Amazon, (pretax gains of $21 million, $16 million, $7 million and nearly zero, respectively).
- Market value of investments in public companies increased a total of $89 million in Q00-1. New investments added $659 million, including Rogers Communications for $405 million and Ticketmaster for $229 million. Existing investments' market values decreased a net of $570 million, primarily due to decreases in AT&T for $831 million, Rhythms NetConnections for $104 million, offset by increases in Nextel Communications for $294 million, Comcast for $128 million, United Pan-Europe Communications for $69 million, NTL, Inc. for $45 million, and the IPO of Wink Communications for $97 million.
- Q00-1 joint ventures increased $12 million from Q99-4 consisting of funding net of operating results. Other investments increased $364 million in the quarter for the strike roll of "Tracers" (tax-free security based on derivatives of MS stock).
- Intellectual property rights in Q00-1 increased $127 million from the acquisition of Sendit AB for $127

million, STNC Ltd for $17 and Vadem handwriting software for $8 million, less $25 million of scheduled amortization for Q00-1.

- LT loans and other assets increased a total of $132 million during the quarter. The Apple equity hedge increased in value $148 million along with a $33 million increase due to the marketing alliance with USWeb. Long-term loans increased $5 million, primarily from new loans to Entropic and Softek Info Systems, and an increase in the amount due from Avid. Long-term Rent deposits increased $5 million in Japan. Goodwill decreased $59 million as a result of amortization.

NEW DEALS

- Visio – On September 15, MS announced the acquisition of Visio in a $1.3 billion stock pooling transaction. Visio is the leader in business drawing and technical diagramming software. The company employs 618 people and has an installed base of 3.2 million current users. Its mission is to develop and distribute the leading software for creating, storing, and exchanging drawings in business. Visio recognized revenue and net income of approximately $192 million and $40 million, respectively, over the last twelve month period ended June 30, 1999.

- Softway Systems – On September 21, MS announced the acquisition of substantially all the assets of Softway Systems Inc. MS paid $2.5 million plus assumption of certain liabilities. In addition, MS agreed to allocate $2 million to an employee pool for the payment of on-hire and retention bonuses for Softway employees joining MS.

  Softway is a privately-held developer of Interix products for interoperability between UNIX and Windows NT-based systems. Interix products allow users to run their UNIX applications on Windows NT while taking the time they need to rewrite and migrate their code to run natively on Windows. The products include a POSIX.2-compliant subsystem that ensures compatibility between Windows and UNIX solutions. MS has relied on this product to ensure that Windows NT meets federal customer requirements for interoperability with, and migration from, UNIX.

- USWeb/CKS – On September 29, MS announced a strategic alliance with USWeb/CKS to develop the USWeb/CKS Internet framework, or iFrame. MS will provide $67.5 million over 12 months to fund efforts to develop and market iFrame-based managed application services and technologies. In 18 months, USWeb/CKS will begin paying royalties to MS on service offerings involving those technologies. MS will also pay USWeb/CKS $14.9 million in exchange for a warrant to purchase 1 million shares of USWeb/CKS common shares at $27.59 a share at any time during the next five years. USWeb/CKS will certify a minimum of 750 engineers as MCSE/D's and jointly, the companies will establish a technical lab in Redmond to develop and test hosted applications. MS will own the developed IPR.

  USWeb/CKS is a publicly-traded company that provides Internet-related professional services. The company has over 3,000 employees and works with companies to define strategies and implement innovative ways to build their businesses by combining the expertise of strategy, Internet technology, and marketing communications.

- InfoImage – On September 15, MS invested $5 million into InfoImage Inc in return for 1,000,000 12% Series B Preferred shares. Additionally, MS received 450,000 warrants at a strike price of $4.50 and one board seat. MS will also allow InfoImage the option to draw down an additional $5 million tranche of Series B shares to help pay for their planned rollup strategy of traditional Lotus Notes integrators who will move to the MS platform.

  InfoImage was founded in 1992 and is based in Phoenix, Arizona with offices in 11 cities across the U.S. The company is one of the largest Lotus Notes Business Partners in the United States. InfoImage's relationship has been on the decline for the past year as IBM Global services continues to compete against its reseller channel. As a result, the company is moving its focus to the MS platform.

- Equinix – On September 8, MS invested $1.9 million into Equinix in exchange for 237,500 Series B Preferred shares. This was a follow-up investment on MS's purchase of 2,000,000 Series A shares.

  Equinix builds and operates Internet Business Exchanges that act as hubs for companies that provide Internet services, sell Web content and operate communications networks. These exchanges are physical locations where the hardware is housed.

- Akamai Technologies – On September 27, MS announced a strategic alliance with Akamai which incorporated MS Windows Media Technologies into the Akamai network for content delivery. In addition, Akamai agreed to port its FreeFlowSM proprietary software to MS Windows Server operating systems. MS invested $15 million into

Akamai in exchange for Series F preferred stock at a valuation of $1.4 billion (a slight discount to the low end of the current IPO filing range).

Akamai Technologies is a privately held company headquartered in Cambridge, MA. Akamai provides a global Internet content delivery service that improves web site speed and reliability, and enables richer, more engaging Web site content. Currently, Akamai has over 1,200 servers deployed in 15 countries across 25 different telecommunications networks.

- Data Return – On September 10, MS agreed to invest $5 million in Data Return's upcoming IPO. MS will also receive an additional number of warrants with a nominal value of $3.75 million (struck at the at the lowest mid-point of all the filings). In addition, Data Return agreed to license to MS rights to specific IP relating to hosted e-commerce and knowledge management solutions.

  Data Return is a leading private-held provider of NT-based hosting solutions for customers looking to outsource their business applications.

- iBeam Broadcasting – On October 15, MS agreed to invest $10 million in exchange for Series D preferred stock. MS will also receive 218,120 warrants to purchase Series D Preferred Stock at a strike price equal to the price of the original preferred stock investment ($5.96). In addition, iBeam has agreed to a strategic alliance with Windows Media Technologies for co-marketing, joint sales calls and tighter technological integration of Windows Media Technologies into the iBeam network.

  iBeam Broadcasting, a privately held company headquartered in Sunnyvale, CA, has created a distributed network infrastructure to deliver CD-quality audio and broadcast quality video over the Internet. iBeam utilizes satellites from Hughes to bypass the congestion of Internet backbones to deliver content to iBeam servers on the edge of the Internet (point to multipoint distribution).

- Asia Global Crossing – On September 8, MS announced a joint venture with Softbank and Global Crossing to bring increased broadband connectivity to the Asian region, particularly terrestrial and undersea fiber. MS and Softbank each agreed to invest $175 million for a 3.5% equity stake in the venture. This equity stake grows once the market value of the entity reaches $5 billion, from 3.5% to a maximum of 19% once the market value of the entity reaches $7.5 billion. In addition, MS and Softbank have committed to purchasing a total of $200 million of capacity over the next three years.

  Global Crossing, a public company headquartered in Hamilton, Bermuda with executive offices in Los Angeles, is building and operating an advanced IP-based, data-centric network, an end-to-end fiber-optic platform for data, voice, video and Internet transmissions. Global Crossing recently completed the acquisition of Frontier GlobalCenter to complement its undersea cable assets with terrestrial long haul (primarily U.S.) and hosting services.

- Speednet – On August 11, MS announced a joint venture with Softbank and TEPCO to bring high speed Internet connections to consumers at a low fixed price (including communication charges). In addition, the joint venture will offer free Internet access to public schools within the service area for 10 years. Softbank, MS and TEPCO will each own 31% of the venture. The initial capital commitment was $15.5 million (total capitalization of 6 billion yen), of which $7.5 million has been funded.

- Genedax – On September 14, MS agreed to invest $2 million in Genedax at a pre-money valuation of $7.3 million. MS will also receive 105% warrant coverage struck at the same $2/share price.

  Genedax is an early-stage EDA software vendor based in Portland. They intend to launch their first COM+ based EDA product in January 2000.

- Modern Africa Fund – On September 23, MS agreed to invest $5 million into the Modern Africa Fund. The fund targets infrastructure investments throughout the Southern Africa region and was founded by financial institutions Citicorp and SocGen. The fund has approximately $125 million in committed capital and will target the majority of the investment capital toward telecommunications and technology opportunities.

- DSL.net – On July 6, MS agreed to invest $15 million in the company's Series E round at a pre-money valuation of $390 million. DSL.net agreed to use the MSN small business portal as their default offer. DSL.net is a provider of DSL services in second tier geographies, primarily in the North East.

- FairMarket – On August 30, MS agreed to invest $8.75 million in FairMarket's Series D round financing, purchasing 1.25 million shares at $7/share. MS also received warrants to purchase an additional 4 million shares at $1.71/share. Excite and TMCS also invested in the round with a combination of cash and assets. FairMarket intends to be the "auctions inside" sight for a variety of portal, content and commerce sights. They are planning a second quarter 2000 IPO.

- Thrunet – On September 21, MS agreed to invest $10 million dollars (3.02 million shares at

$3.31/share) in Thrunet for a 5% stake. MS also has an option to increase its stake by an additional 4.5 million shares at $7.79. MS and Thrunet have also executed a broad business agreement that includes jointly developing a portal in Korea. Thrunet is the leading provider of broadband Internet services in Korea and has filed their S-1 for a fall IPO. Lehman Brothers is the lead underwriter.

- Tuttle Decision Systems – On August 2, MS invested $12 million in Tuttle Decision Systems Inc., a provider of real time mortgage pricing information and services. Concurrently we entered into an agreement to integrate Tuttle's services into the MS Home Advisor loan service in order to provide consumers with access to real time, and therefore more accurately priced, mortgage information. The securities we purchased are Series A participating preferred stock equal to 20% of the outstanding shares of Tuttle and a warrant to purchase an additional 10% of Tuttle's outstanding shares.
- Sale of Sidewalk A&E Assets – On July 19, MS sold the Sidewalk A&E assets to Ticketmaster-CitySearch (TMCS) and simultaneously entered into a 4-year distribution deal driving local A&E traffic to a new co-branded site. Under the terms of the agreement, MSN will create the MSN Entertainment Channel with all of the local arts and entertainment content and programming to be delivered by TMCS. In consideration for the sale of assets and the distribution deal, MS received 7 million shares of Class B common stock, 3 million warrants exercisable into Class B common at a strike price of $30 and a term of 5 years (however for every $1 that the stock price exceeds $30, the strike price will be reduced by $1) and 1.5 million warrants exercisable into Class B common at a strike of $60 and a term of 5 years.
- Rogers Communications Inc. – On July 12, MS and invested $400 million in Rogers Communications, the leading cable system operator in Canada. MS purchased Rogers 5.5% convertible preferred securities, that are convertible into Rogers Class B shares at a conversion price of CDN $35 per share. The coupon on the preferred securities is payable at Rogers option in cash, class B shares or additional preferred securities. In addition, MS received 5.33 million 3-year warrants to purchase Rogers Class B shares at an exercise price of CDN $35 per share. As part of the partnership, Rogers has agreed to deploy MS TV PAK client and server software as well as deploy a Rogers interactive television service that utilizes key MSN and WebTV technologies and services.
- Globo Cabo S.A. – On August 16, MS announced an agreement to invest $126 million into Globo Cabo, the leading cable provider in Brazil. The investment by MS is expected to close in November, will be a combination of preferred and common stock totally 210,000,000 shares at $.60 per share, equivalent to approximately 11% of Globo Cabo. Additionally, MS will receive an option to purchase an additional 52,000,000 shares at the equivalent price. Coincident with the investment, MS will enter into a strategic partnership with Globo Cabo to provide advanced broadband and Internet TV and PC services to Globo Cabo subscribers. MS and Globo Cabo will explore the creation of a joint portal in Portuguese. As part of the investment and partnership, MS will obtain a seat on the Board of Directors of Globo Cabo.
- United Global Communications: In late September, MS agreed to enter into a joint venture with Liberty Media and UPC, the European subsidiary of UGC. MS and Liberty Media will each own 25% of the JV and UPC will own half. Liberty Media recently purchased 4.8 million UGC "B" shares from Apollo and these will be contributed to the joint venture. MS will contribute approximately in $110 million in cash. UPC will contribute 2.7 million UGC "A" shares and approximately $200 million in cash. MS, LM and UPC will take board seats at UGC. This is strategically important to MS since the joint venture will control 44% of the UGC votes and UGC is an important international cable player.

RISK MANAGEMENT & HEDGING ACTIVITIES

STOCK REPURCHASES

	Shares Adjusted For all Splits	Amount (millions)	Average Cost
FY90	28,566,000	$47	$1.63
FY91	87,516,000	$197	$2.25
FY92	31,677,240	$135	$4.26
FY93	50,056,000	$250	$5.00
FY94	69,112,000	$348	$5.03
FY95	93,352,000	$698	$7.47
FY96	108,000,000	$1,384	$12.81
FY97	148,100,000	$3,101	$20.94
FY98	77,658,706	$2,469	$31.79
FY99	43,759,670	$2,950	$67.40
Deferred Repurchase	-28,025,414		
FY00	12,126,076	$1,034	$85.30
LTD	721,898,278	$12,611	$17.47

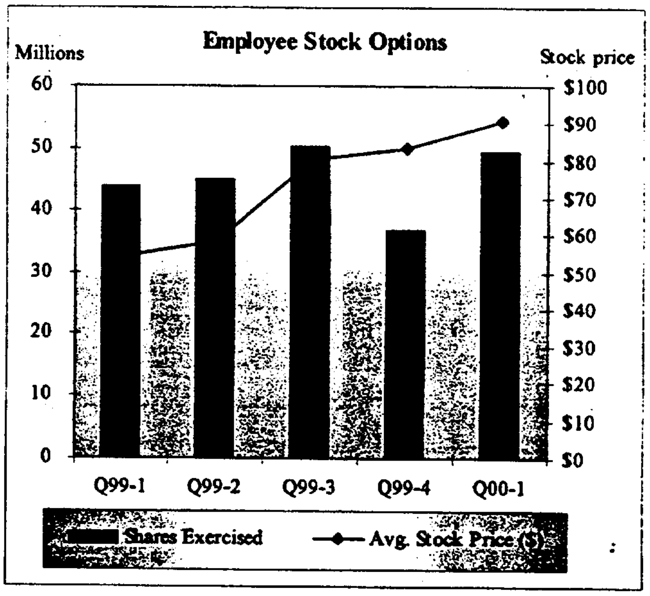
- MS repurchased 12.1 million shares during Q00-1, spending a total of $1.03 billion (average price of $85.30 per share). A total of 722 million shares have been repurchased life-to-date at an average price of $17.47 per share.

PUT WARRANTS

- At quarter end, 163 million put options were outstanding, with strikes ranging from $64 to $73 and maturities from six months to thirty-six months. The weighted average strike price is $69.91. During Q00-1, MS took in additional premiums of $288 million. Life-to-date program proceeds are now $1,866 million, of which $382 million represents put options that have expired or been closed out. Total put warrant authorization is 200 million puts, with a maximum maturity of three years. This program has enhanced the buyback program by reducing the life-to-date stock buyback cost per share by $2.58, or 14.8%, from $17.47 to $14.89.

STOCK OPTION GRANTS AND EXERCISES

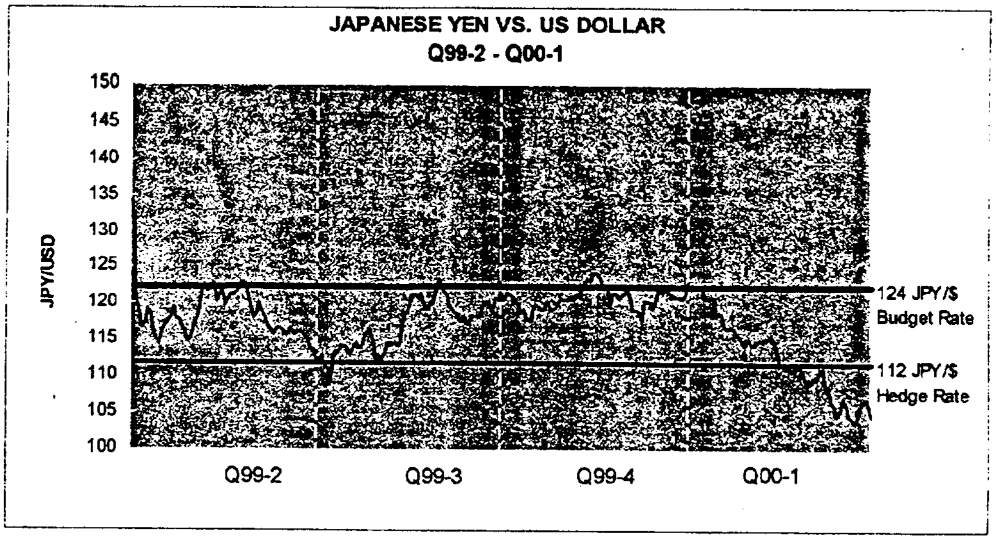
- In Q00-1, the number of stock option exercises was 19,632, an increase of 34% over the same period in Q99-1. The number of shares exercised was 49.2 million, a 12% increase from Q99-1.
- During Q00-1, 26,661 stock option grants were issued, totaling 47 million shares. The annual grant was priced at $85.8125, the closing price on July 31, 1999.
- Cumulative outstanding options on September 30, 1999, were 753 million with an average price of $22.03 per share, . Authorized but unissued options totaled 1.7 million.



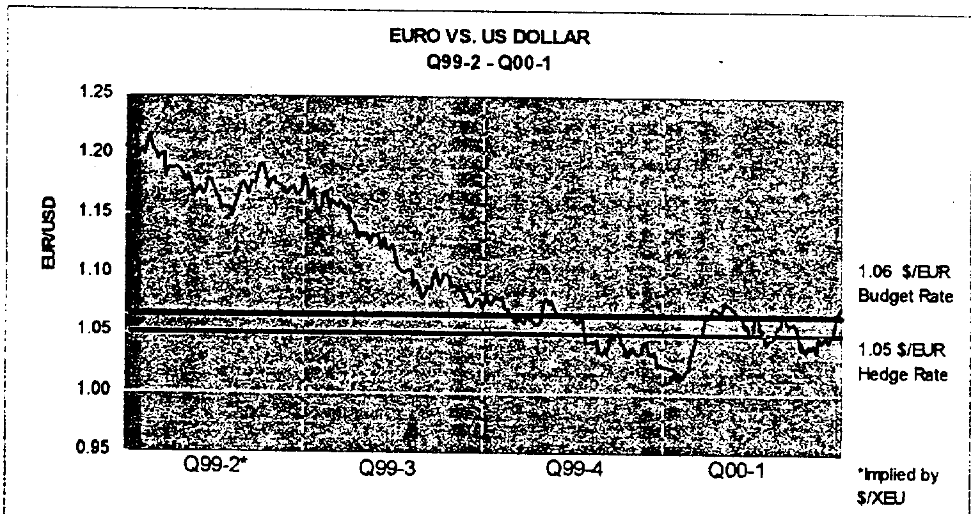
EMPLOYEE STOCK PURCHASE PLAN

- Under the ESPP program, a total of 280,350 shares for the period ended June 30, 1999 were issued to 7,023 international employees at a purchase price of $59.93 per share. Domestic ESPP is reported in even numbered quarters.

FOREIGN EXCHANGE HEDGING



- The U.S. dollar remained strong versus the Euro during Q00-1, but appears to have hit its peak. MS expects the Euro to gain for the next several quarters against the U.S. dollar as the European economy begins to strengthen and gain momentum. The U.S. dollar weakened considerably (13%) versus the Japanese yen during the same period on expectations of the Japanese economy recovering. MS expects some of this Japanese yen strength to ease in the coming quarters.
- The Q00-1 foreign exchange net revenue hedges delivered a net gain of $13 million. ($12 million in net premium spent versus $25 million in settlement).
- Treasury has a continuing program of actively hedging MS's exposure to foreign currency denominated cash flows on a short-term rolling 30-day basis. This program is measured against a 50/50 benchmark of completely hedged (via forwards) and completely unhedged positions. The Q00-1 gain/loss versus this benchmark was a gain of $1.6 million.
- The Treasury Emerging Markets Hedge Program earned a return during Q00-1 of $1.2 million. This program mitigates risk in those countries where Microsoft bills its customers in US Dollars, but is indirectly exposed due to the inability of customers to manage their foreign exchange risk in the event of large devaluations.
- Treasury hedges the revaluation of our account receivable balance on a quarterly basis. We spent $1.8 million in option premium to hedge Q00-1. All options expired out of the money.

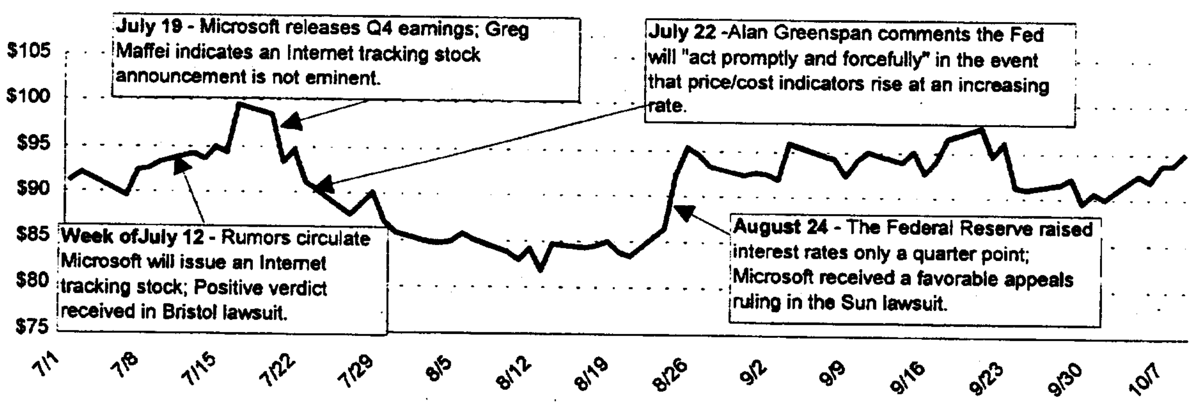


INVESTOR RELATIONS

MARKET OVERVIEW

- The DJIA performed quite strongly at times during the quarter, hitting an all-time high of more than 11,300 in August. However, the highs were not sustainable given cautionary comments about potential inflation from Fed Chairman Alan Greenspan, stronger than expected U.S. employment reports, and interest rate concerns. The DJIA closed the quarter down 7% to 10,336, as investors remained hesitant to commit to heavy buying before the Federal Reserve Open Market Committee meeting on October 5, and upon worries of a significantly weakening dollar/yen exchange rate.
- Major indices were mixed in the September quarter. While the Nasdaq Composite was up 2%, the S&P 500 and the DJIA were both down 7%. Microsoft competitors' results were mixed in the September quarter as well. Sun and Oracle led the way with 36% and 21% stock price growth, respectively. While Microsoft stock price was down 1%, AOL, IBM, and Novell experienced stock price declines of 7%, 8%, and 23%, respectively.
- The PC industry delivered mixed signals during the quarter. IDC released a revised PC unit shipment growth rate estimate of nearly 25% for the September quarter attributing the increase to robust global consumer demand for ever-cheaper PCs, healthy growth in Asian markets and the strong U.S. economy. A Merrill Lynch PC industry warning released in August, and the Taiwan earthquake in September that raised questions about PC parts shortages and higher prices, tempered the positive news.
- MSFT ended the quarter $0.625 below where it started. Rumors of an Internet tracking stock, quarterly earnings release anticipation, and a positive verdict in the Bristol antitrust lawsuit contributed to the rise to $100 3/4 in intra-day trading in mid-July. However, U.S. wage cost information and fears of interest rate increases kept MSFT down until late August, when Microsoft received a favorable appeals court ruling in the Sun case and the Federal Reserve raised interest rates only a quarter point taking an unexpectedly neutral stance.

MICROSOFT COMMON STOCK



WALL STREET ANALYST COVERAGE

Rating	Analysts
Strong Buy	12
Buy	13
Hold	2

Source: First Call

- Doug Crook, Prudential Securities, raised his recommendation from Hold to Buy, after downgrading in April on Q99-3 earnings. Reasons cited for the upgrade included strength in the platforms and server business, rumors of a tracking stock, and increasing levels of unearned revenue.

- First Call consensus estimates for Q00-2 and FY00 are $0.39 and $1.56, representing 8% and 12% year over year growth, respectively.

- Top analyst ratings were unchanged: Rick Sherlund, Goldman Sachs - Recommended List/Strong Buy; Mary Meeker, Morgan Stanley - Buy; and Michael Kwatinetz, CS First Boston - Strong Buy.

SHAREHOLDER ACTIVITY

Institution (June Rank)	Investment Style	Turnover Rate	Change Since June 99	September 99 Position
1 Fidelity Management & Research Co. (1)	Growth	Medium	7,400,000	158,900,000
2 Barclays Global Investors, N.A. (2)	Index	Low	(101,000)	144,899,000
3 State Street Bank and Tr. Co. Boston (5)	Index	Low	10,813,000	81,713,000
4 The Vanguard Group (4)	Index	Low	4,385,000	75,885,000
5 Deutsche Asset Management (3)	Index	Low	(6,100,000)	68,900,000
6 Janus Capital Corporation (6)	Growth	High	(11,419,000)	50,781,000
7 Alliance Capital Management L.P. (7)	Growth	Medium	1,780,000	43,880,000
8 Putnam Investment Management. (11)	Value	Medium	10,791,000	43,591,000
9 American Century Investment Mgmt. (10)	Growth	High	6,256,000	40,897,000
10 TIAA-CREF Investment Management Inc. (8)	Index	Low	1,507,000	40,155,000
11 The Northern Trust Company (20)	Growth	Low	11,079,000	32,010,000
12 Mellon Bank, N.A. (12)	Index	Low	500,000	30,500,000
13 Smith Barney Investment Advisers. (15)	Value	Low	4,866,000	30,456,000
14 Massachusetts Financial Services Co. (9)	Growth	Medium	(4,705,000)	30,018,000
15 J.P. Morgan Investment Management (19)	Value	Medium	6,294,000	27,894,000

- Officer and director ownership fell 3% in the quarter to 26% overall ownership. U.S. institutions compensated for 2% of the officer & director sell-off growing to 44%, and retail shareholders picked up the remaining 1% ending at 28% overall ownership.

- Fidelity Management & Research Co., our top institutional holder, added 5% to their position during the quarter after two straight previous quarters of lightening their position. The Northern Trust Company added 53% to their position to place them as our 11th top institutional holder up from 20th, and Putnam Investment Management added 33% during the quarter to bring their total holdings to 43.6 million shares.

- Janus Capital Corporation continued their sell-off by lightening their holdings 18% in the quarter, and by 18 million shares since the beginning of the year.

INVESTOR RELATIONS SIGNIFICANT EVENTS

- The 1999 Annual Report was mailed to 2.8 million shareholders in early October. The online version is posted on our Investor Relations Web site (www.microsoft.com/msft) and features Bill's letter in 11 languages, income statements presented in the languages, currencies, and accounting conventions of 6 major countries, and includes a variety of financial analysis tools.

- Microsoft is again offering all shareholders the opportunity to vote their proxy online. All votes will be tallied by the November 10th Shareholder Meeting.

- Investor Relations hosted its Annual Financial Analyst Meeting for 200 financial analyst and press attendees. Presentations were made by Jeff Raikes, Steve Ballmer, Bob Herbold, Brad Chase, Greg Maffei, and Bill Gates.

- Investor Relations and MS executives presented at five Wall Street Analyst conferences during September and October - the official beginning of the conference season. Greg Maffei presented at Goldman Sachs Communacopia Conference; Bob McDowell keynoted the Salomon Smith Barney Technology Industry Conference; Jeff Raikes presented at the Bank of America Securities Growth Conference and the Volpe Brown Whelan 1999 Internet & Communications Conference; and Joachim Kempin spoke at the S.G. Cowen 27th Annual Technology Conference.

Industry Watch

INDUSTRY HIGHLIGHTS

(PRICES AS OF NOVEMBER 2, 1999)

ORACLE ($53)

- Oracle's net income rose to $237 million, or 16 cents a share, in the August quarter, from $195 million, or 13 cents, a year earlier, matching average analysts estimates, but below the "whisper" estimate of 19 cents. Revenue rose 13 percent to $2.0 billion. Revenue forecasts were as high as $2.1 billion. Oracle was expected by some analysts to post higher earnings from its cost-cutting efforts, which are expected to reduce expenses by $1 billion in 18 months. Oracle said its August quarter revenue from its database software sales rose only 8 percent to $443 million, and its application software sales rose 11 percent to $109 million.
- Oracle plans to create a new company that will sell $199 network computers, which will use the Linux operating system, Netscape's Navigator Web browser, and an Intel microprocessor. The new company is expected to be created shortly and is likely to sell shares in an initial stock offering.
- Oracle released a technology called "Portal-to-Go," first introduced as "Project Panama" in March. Portal-to-Go will allow users access Web-based applications through the Palm VII handheld computing device and through cell phones.
- Oracle developed a standard structure for packaging corporate information into portlet components, which are an extension of older technologies and can be assembled using an Oracle development tool called WebDB. Oracle expects next year to make complete programs based on the portlet technology, but also hopes other software and information suppliers will make products based on the technology. Oracle isn't widely known for setting broad technology standards, and analysts said the announcement seems at least partly a response to comparable technology from rivals.
- Oracle entered into a new strategic partnership with Hewlett-Packard. Under the new agreement, H-P and Oracle will "virtually" integrate their sales forces to share sales leads and other customer data as they co-market Oracle's software and services for managing sales and interactions with customers. While H-P and Oracle will maintain separate customer tracking and management systems, they will store new sales leads in a database that both companies' salespeople can access freely. Oracle also agreed to bolster its efforts to tune its database, customer-management and human-resource software to run on H-P's computer servers. Until now, Oracle's primary supplier of servers for software development has been Sun.
- Oracle will offer a new outsourcing service for small and medium-sized businesses that do not want to handle their computing needs in-house. The Oracle Business Online offering will provide a small-business user with a secure Web site address from which to use various Oracle. A key component in this strategy is the release of the company's Application Server, a suite of software services that is intended to sit between a client and a back-end database system. Though some industry observers have noted that the definition of an application server remains elusive.
- Oracle announced a new initiative to encourage Internet service providers (ISPs) to host applications from Oracle and its independent software vendor (ISV) partners. The center of the iHost initiative is the Oracle Internet Platform Hosting Edition, a product suite that includes the Oracle8i database management system (DBMS), Oracle Application Server, Oracle Enterprise Manager, and other products.

SUN MICROSYSTEMS ($103 11/16)

- Sun reported results for the September quarter of $0.33 per share, $0.02 per share higher than average analysts estimates. Revenue for the quarter was $3.12 billion, up 25 percent compared with same quarter in the prior year. Net income was $275 million, an increase of 39 percent from the previous year results (excluding acquisition-related charges).
- Sun said it will unveil the new Solaris 8 OS, the new edition of Sun's version of Unix, in February.

- Sun announced a 2-for-1 stock split. The split would take effect for shareholders of record as of Nov. 11 and would be paid on Dec. 7.
- The Sun-Netscape alliance is adding new features to e-commerce software aimed at letting businesses buy goods from their suppliers online. The partnership is shipping its BuyerXpert software, which creates online purchase orders and invoices. In addition to BuyerXpert, the alliance's procurement software suite includes two existing products: Custom NetCenter, which lets businesses create portal sites for buying and selling goods, and TradingXpert, which lets companies exchange purchasing information via the Web. With the products, the partnership is trying to grab a piece of the online procurement software market by bundling a mix of new and existing products. The market for online procurement software reached $147 million in 1998 and is expected to grow to $5.3 billion by 2003, according to a recent IDC study. The alliance is aiming its procurement software at two customers: large corporations that can run the services themselves, and service providers--such as telecommunications companies--that would host the services for small and medium-size businesses.
- Sun will acquire Forte Software for $540 million to expand Sun's network computing software. Forte has a strong position in the market for distributed application development and enterprise application integration software, which are hoped to complement Sun's Java platform and other network computing technologies.
- Sun bought Star Division, a maker of a software suite similar to Microsoft Office. Sun is positioning itself to leverage the trend toward Web-hosted services by delivering applications to the desktop and as well as handheld devices through StarPortal next year. Sun is taking tactical aim at Dell, IBM, H-P, SGI and Compaq on the hardware front and Microsoft, Citrix, SCO and Applixware on the software front. In regard to Linux, the purchase of StarDivision will further extend the use of StarOffice, which is bundled with the leading Linux distributors including Red Hat, Caldera and SuSE. While this will help the Linux user base grow, the licensing of StarOffice under the Sun Community Source License (SCSL) is problematic to open-source purists due to intellectual property constraints. Among the factors against Sun succeeding with this endeavor is that it does not have a solid reputation when it comes to software initiatives.
- Alan Baratz, president of Sun's recently formed Software Products and Platforms division, plans to take a position as a managing director at a private equity capital firm. The former head of Sun's Java software division took over his current role on July 1. Sun created the Software Products and Platform division to better compliment its Solaris software consumer and embedded and Java software groups with its alliance with AOL.
- The Sun-Netscape Alliance announced that it had signed a multimillion dollar deal with KLM Royal Dutch Airlines. KLM will use Alliance software to automate its procurement processes for staff, suppliers and partners. The goal is to enable the KLM staff to make purchases online, and to streamline the airline's purchasing via "e-procurement" over the Internet.
- As a key part of its stand-alone marketing, the Alliance launched the iPlanet brand name and logo for all of its products. The Alliance still faces numerous hurdles. The acquired product lines partially overlap, particularly between Sun's NetDynamics and the Netscape Application Server. The Alliance's organizational structure is difficult to explain to customers and might be difficult to maintain in practice. The Alliance's new product road map is a step toward providing support for e-commerce initiatives, but there are still weak spots in the product story.
- The Sun-Netscape Alliance will upgrade the Netscape Application Server (NAS) without a Linux port. The pending NAS 4.0 release marks the product's last major upgrade before it is fused with Sun's NetDynamics next year.
- Sun announced that it is ending a joint effort with IBM to develop a Java-based operating system for so-called network computers.

IBM ($94 13/16)

- IBM reported only 5 percent revenue growth for the September quarter and warned of earnings weakness through year end, which raised concerns about a Y2K-related slowdown in the technology sector. Excluding special items, IBM's income of $1.69 billion, or 90 cents a share, was in line with analysts' expectations for the quarter. But its $21.1 billion in revenue, up from $20.1 billion a year earlier, was significantly below analysts estimates. Computer-hardware sales, which had been expected to grow modestly, instead fell by 1 percent. IBM warned that its December quarter profit may be 15 to 20 cents a share below the year-earlier period, coming up as much as 29 cents below analysts' estimates of $1.33 a share. IBM also warned of continued Y2K effects into next year.

- IBM announced that it is moving CFO Douglas L. Maine to run a new interactive sales-and-support team. John Joyce, who currently heads IBM's sales force in Asia, will take over the CFO post.
- IBM said it will work with Cisco to enable application service providers to build and test hosted applications offerings, where as software will reside on centralized mainframe-class computers to be farmed out to individual users on demand. In the emerging application service provider business model, companies can rent access to such software over phone lines.
- IBM said that one of its Thinkpad series of laptops will be certified "compatible" with Red Hat Linux. IBM will set up a Web page for the Thinkpad 600E that will include "how-to" documents for getting Linux up and running on the 600E and other Linux-related news. However, the announcement does not include the release of software drivers that will allow the 600E's internal modem to work with Linux. On a similar note, Dell plans to offer the option of choosing the Linux operating system over Windows 95, 98 or NT for its Dimension desktop PCs and Inspiron notebook computer line. Motorola announced it will work with Linux-based platforms to develop an array of products embedded in smaller computing devices such as the Palm personal digital assistants.
- IBM is releasing a new Web site aimed at developers including news, resources, and advice needed to build better software. The site, called DeveloperWorks, provides information on the Java programming language, the XML Web standard, as well as the open-source Linux operating system. The site also plans to focus on the software infrastructure needed for building e-commerce sites, and Unicode, which helps developers build software using languages other than English.
- IBM will ship a new version of the advanced edition of WebSphere, along with upgrades to the application server's development tools. WebSphere Application Server 3.0, Advanced Edition, supports Java servlets, Java Server Pages, Extensible Markup Language and Enterprise JavaBeans. IBM has integrated its VisualAge for Java 3.0 development tool and WebSphere Studio 3.0, a visual layout tool for building Web pages with Java Server Pages, JavaScript, HTML and DHTML. A WebSphere Performance Pack is also available for the upgraded server.

NOVELL ($19 1/16)

- Novell announced a service called digitalme (www.digitalme.com) that works as a personal data repository, allowing users to create the equivalent of online identity cards that can be exchanged with friends and Web sites. The offering attempts to compete with MS Passport.
- Novell launched a set of services targeted at reducing network downtime. Novell is building application software on top of its NetWare operating system and Novell Directory Services (NDS). In the past, the company has suffered from a shortage of application development for its software, but Novell hopes that by supporting various Internet standards it can make up some lost ground. Novell will ship its NetWare Cluster Services, which uses the company's NDS and allows a system to move its software processes to a back-up system if problems surface in the "failover." process. The new service can support a "cluster" of eight server machines. The company also announced plans to add IBM to its list of systems companies that plan to sell a server-based appliance with Novell's Internet Caching System, a technology that allows frequently used Web pages to be stored closer to a Web surfer, thereby increasing the speed of downloads.
- Novell plans to distribute NetVision Synchronicity that integrates user account information found in messaging and collaboration software such as Lotus Notes, Microsoft Exchange, and Windows NT, as well as its own NetWare.
- Novell announced it has sold $300 million worth of NetWare 5.0 operating system upgrades in its first year of sales and has 80 million users of its operating system.
- Novell posted 20 percent sales growth for the July quarter. Net income rose to $49 million, or 14 cents a share, in the July quarter, from $27 million, or 7 cents, in the year-ago period. Profit in the latest quarter fell in line with analysts' estimates of 13 cents a share. The company's service, education, and consulting business increased 43 percent from a year ago. NetWare server software sales were up 27 percent to $175 million and directory-enabled applications grew 34 percent to $75 million.
- Novell announced directory-enabled NetWare Cluster Services for NetWare 5. NetWare Cluster Services is a highly scalable, extremely manageable clustering solution for Intel-based servers that maximizes network uptime and allows

businesses to provide their customers with reliable access to network resources like file, print, e-mail/collaboration or Web applications. Through integration with Novell Directory Services (NDS), NetWare Cluster Services also simplifies and lowers the cost of network management by providing a single point of administration, allowing live upgrades and maintenance, and supporting shared storage between servers in a cluster.

AOL ($97 1/8)

- AOL reported revenue of $1.47 billion for the September quarter, up 47 percent over the comparable quarter of the prior year. Operating income of $265 million was up 244% compared to a year ago. EPS was $0.15, above average analysts estimates of $0.13. Revenue growth was solid across all segments - online services up 38 percent to $995 million; advertising and commerce up 100 percent to $350 million, and enterprise solutions up 21 percent to $122 million. AOL added a net 1.1 million subscribers in the quarter growing to 18.7 million subscribers, while the CompuServe 2000 service added a net 378,000 subscribers growing to 2.2 million subscribers.
- AOL announced a joint venture with Gateway 2000. AOL will invest $800 million in Gateway and in return, AOL will be loaded on every Gateway PC sold.
- AOL's new version 5.0 was launched during the quarter and includes new features such as "You've got pictures," which was developed in association with Eastman Kodak. The service allows AOL users get pictures developed and e-mailed to their AOL account. Other features include an online calendar, which has since been adopted by 1.9 million members. AOL 5.0 was downloaded 3.6 million times during the 2 weeks after its launch by AOL users.
- AOL Search is a service AOL offers in an attempt to keep its users from going to competitors for Web searches and services. The search service is not on the main AOL.com page, but expects to launch AOL Search soon on AOL.com. It lets subscribers search for both Web content and its proprietary offerings, which currently can be located through keywords. AOL also has made some primarily cosmetic changes to AOL.com, part of a larger effort involving posting new features that will coincide with the launch of AOL 5.0. AOL.com will include a calendar service, its "You've Got Pictures" online photo section.
- Netscape cofounder Marc Andreessen is stepping aside as chief technology officer of AOL. Former Sun Microsystems chief strategy officer William Raduchel, will take over the role. Andreessen, who joined AOL in February after the acquisition of Netscape, will stay on as a part-time "strategic adviser" focusing on emerging technologies and investments.
- AOL has released a new version of its Instant Messaging software with such features as stock tickers and graphics transfers.
- AOL Europe, the joint venture between AOL and Germany's Bertelsmann AG, launched a subscription-free Internet service in Britain. AOL is trying to compete with Britain's Freeserve Plc and 200 smaller Internet competitors with its new service, Netscape Online. The company hopes to make up lost ground after being wrong footed when Freeserve began offering Internet access with no monthly free in Britain. In just four months, Freeserve won over one million registered users and has displaced AOL Europe as Britain's biggest Internet service provider.
- AOL is investing $10 million for a 4% stake in Radiant Systems Inc., a company that makes "point of sale" terminals. These increasingly sophisticated touch-screen computers are used in many gas stations and restaurants, among other places. The agreement is the latest in the "AOL Anywhere" strategy to extend its reach beyond personal computers into an emerging class of appliance-like devices such as TV set-top boxes, handheld computers and mobile telephones.

OTHER

- 3Com plans to sell shares of its Palm Computing subsidiary, reducing its presence in the consumer handheld computing market. The company plans an initial public offering of stock in the Palm division by the end of this year or early next year. 3Com will sell 20 percent of the Palm venture's shares in the initial IPO, with 3Com owning the other 80 percent. Within six months, the company will transfer the remaining share stake to 3Com's shareholders.
- Corel is cutting costs and trying to refocus on its marketing strategy. It plans to spend much less to attract new office-software customers and is

concentrating more on selling upgrades to existing users. Corel WordPerfect installed base includes 50 million users. Analysts say the stock's comeback at least partly reflects speculation about a possible takeover, as well as Corel's adapting its WordPerfect software to run with the Linux operating system. After two years of heavy losses, Corel reported a profit of $9.2 million, or 14 cents a share, in its May quarter.

Appendix

NOTES TO CONSOLIDATED MANAGEMENT REPORTS

- The consolidated management P&L is based on functional responsibility and prepared in accordance with Microsoft accounting policies (MAP). These results exclude the impact of certain adjustments and reclassifications required by generally accepted accounting principles (GAAP) for external reporting, non-operating items, and income taxes. Significant differences between MAP and GAAP results are described in the bullets following.
- Revenue under MAP is generally recognized "as billed". Under GAAP, net revenue includes adjustments for certain billed, but unearned revenue, such as a portion of operating system revenue that will be recognized over the product life cycle. Conversely, certain revenue that is earned but not yet billed, such as unreported OEM and select revenue, is also recognized for external purposes.
- Interactive Media Joint Venture expenses represent Microsoft's share of joint venture operating loss. These product development costs are reflected as non-operating expenses for GAAP purposes.
- For external reporting purposes, all product marketing related activities are classified as a sales and marketing expense. For internal reporting purposes, product marketing departments and related marketing expenses are included in product development.
- For external reporting, the amounts received from customers for the product support services (PSS), consulting (MSC), and MCP/MCSP certification and training are reclassified as revenue. Direct costs of these activities are reclassified to cost of revenue from sales and marketing.

GENERAL & ADMINISTRATIVE

REPORTING DEFINITIONS

- General and administrative (G&A) costs include functional corporate cost centers that support MS on a worldwide basis such as general human resources, facilities, finance, legal services, IT project development and infrastructure. Costs such as recruiting, employee benefits, employee services, IT infrastructure and facilities costs are distributed to domestic product, sales, and administrative groups.
- For internal management reports, net G&A costs are allocated to the channels and product groups as part of corporate allocations.
- Distributions are costs where typically a G&A group controls the unit cost and the receiving business unit drives unit consumption. For example, human resources and administrative services manages the benefit costs per person, but employees and their covered dependents drive total benefit costs. Distributions are based on a standard rate per domestic headcount, except recruiting costs which are distributed to product sales and administrative groups based on the number of new hires.

COST CATEGORIES

- ITG costs include application development, regional support, and distributed infrastructure costs. These costs are driven primarily by demand from supported organizations for new technology and tools, support of existing systems, and sales increased demands on the corporate WAN and telecommunications network.
- Human resources costs are driven primarily by employee headcount. Allocated expenses include employee development, payroll, and stock administration. Distributed HR costs include recruiting and domestic employee benefits such as health insurance, 401(k) match, and health club dues.
- Employee services group provides administrative support including building services, library services, mail, food and beverage, administrative procurement, travel services, and copy centers. These costs are driven by user demand and are indirectly correlated to headcount growth.
- Real estate and facilities costs include allocated functional costs related to facilities planning and development that are driven primarily by growth in domestic headcount and distributed infra-structure costs such as depreciation, rent, utilities, and maintenance which are driven by the number of employees and contingent staff using MS facilities.
- Finance, legal, and executive costs are corporate functional groups supporting MS on a worldwide basis.

COST OF REVENUE - DEFINITIONS

- Cost of revenue includes product costs, royalties, pipe and channel costs, and the cost of obsolete and scrapped inventory as described below. The cost of product engineering, configuration and testing prior to release are included as well as the activities of purchasing, manufacturing, and assembling finished goods. In addition, the activities of supply chain management, customer operations, licensing/contract administration, program management, and all the associated costs of IT systems and support are part of cost of revenue.

PRODUCT COSTS

- Standard product costs represent both the standard material cost for media, manuals, packaging, hardware and collateral per a bill of materials (BOM) for each product as well as labor and overhead expenses incurred in the procurement and assembly of physical product.
- Other costs include expenses for hardware tooling, prep charges incurred to establish the manufacturing process for a product, cancellation fees, blueline scrap, and recost impacts.
- Purchasing variances include material purchase price variances (PPV), turnkey PPV, purchase discounts, expediting or change order charges with turnkey vendors, and freight-in and duty/customs expenses incurred to ship raw materials to the location of final assembly or packaging.
- Manufacturing variances represent manufacturing costs incurred in the internal or external assembly of product which are not included in the standard product cost. This includes operating expenses to manage turnkey vendors, manufacturing absorption variances, material usage variances, BOM variances and variances related to outsourcing packaged product.
- Program costs and variances represent the material costs of Select Welcome and Upgrade kits as well as any product costs incurred for programs such as MSDN, TechNet or Courseware not included in Standard Product Cost. Cost recovery programs such as MSP (Solution Provider) are charged to marketing operations.

ROYALTIES

- Royalties include payments to third parties for the right to use intellectual property in MS products.
- The Royalty P&L line item includes both third party royalty payments and the payment or amortization of license fees.

BUSINESS OPERATIONS

- Business operations represent all of the operating expenses incurred by an individual organization or by a worldwide organization in direct support of the various revenue-generating business streams of MS. These operations include primarily customer operations (order processing, billing, and collection), supply chain management, program management, worldwide licensing, and project management.
- Distribution represents internal and external costs of picking and packing MS products, including operating expenses of the distribution department, storage costs of finished goods and shipping supplies
- Central services represent all of the operating expenses incurred by centralized organizations that provide supporting functions across all pipes and business streams. These include OBS expenses, hardware operating expenses, operations management and planning, supply base management, and product information and release services.
- Online telecom consists of network costs for Internet connectivity and network access for MSN Subscribers as well as internal expenses for the MSN Network and online operations groups.
- Online data center captures all facilities, maintenance, operational support and staffing of the online data center including MS internal data center operations people and infrastructure costs, and external contracts for facilities and maintenance costs.
- Online processing is comprised of credit card processing fees, Internet advertising tracking and reporting costs, and financial operations people and infrastructure expenses for the MSN and online operations groups.