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Q88-1

# Microsoft

FINANCE AND ADMINISTRATION REPORT  
FOR QUARTER ENDED SEPTEMBER 30, 1987  
BOARD OF DIRECTORS  
OCTOBER 31, 1987

NET REVENUES SOAR TO NEW HEIGHTS!!!

Month	Net Revenue
July	~\$50 M
August	~\$75 M
September	\$102.6 M

Steve Gray

Windows 2.0 • Word 4.0 • The New White Mouse

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FINANCE

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**RESULTS OF OPERATIONS**  
Compared With Prior Year

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**RESULTS OF OPERATIONS COMPARED WITH PRIOR YEAR**

**Consolidated**

Consolidated statements of income for the three months ended September 30, 1987 and 1986 are presented below (in thousands, except net income per share):

	1987		1986		Growth Percentage
Net revenues	\$102,636	100.0%	\$66,780	100.0%	53.7
Cost of revenues	21,625	21.1	13,217	19.8	63.6
Gross profit	81,011	78.9	53,563	80.2	51.2
Operating expenses	48,701	47.4	27,958	41.9	74.2
Income from operations	32,310	31.5	25,605	38.3	26.2
Non-operating income	3,200	3.1	1,779	2.7	79.9
Stock option bonus expense	(3,031)	(3.0)	—	—	—
Income before income taxes	32,479	31.6	27,384	41.0	18.6
Provision for income taxes	11,220	10.9	11,560	17.3	(2.9)
NET INCOME	<u>\$21,259</u>	<u>20.7%</u>	<u>\$15,824</u>	<u>23.7%</u>	34.3
Average shares outstanding	<u>55,536</u>		<u>55,050</u>		
NET INCOME PER SHARE	<u>\$0.38</u>		<u>\$0.29</u>		31.0

Net revenues for the first quarter of fiscal year 1988 (Q88-1) increased 53.7% to \$102.6 million from \$66.8 million for the corresponding period of the prior year (Q87-1). The current quarter was a record revenue quarter for the Company, surpassing the \$99.8 million recorded in the preceding quarter (Q87-4). As can be seen from the following breakdown of net revenues by Channel of Distribution and Commodity, all channels experienced period-to-period growth, as did all commodities except Languages. In terms of trend, of most significance is the increased importance of worldwide retail (led by International Retail) and the increased importance of the Applications and Hardware product groups. Worldwide retail net revenue grew 68.3% to \$62.5 million (60.8% of total net revenue) from \$37.1 million (55.6% of total net revenue) for Q87-1. This 68.3% growth was a combination of 45.1% growth in US Sales and Marketing Division (USSMD) and an impressive 98.8% growth in International Retail. In terms of commodities, Applications net revenue grew 80.2% to \$40.3 million (39.3% of total net revenue) for Q88-1 from \$22.4 million (33.5% to total net revenue) for Q87-1 while Hardware grew 76.7% to \$9.7 million (9.4% of total net revenue) from \$5.5 million (8.2% of total net revenue).

Channel of Distribution	Q88-1		Q87-1		Growth Percentage
USSMD	\$ 30,609	29.8%	\$21,092	31.6%	45.1
International Retail	31,842	31.0	16,020	24.0	98.8
Worldwide Retail	62,451	60.8	37,112	55.6	68.3
Domestic OEM	21,866	21.3	16,915	25.3	29.3
International OEM	14,389	14.0	11,316	16.9	27.2
Worldwide OEM	36,255	35.3	28,231	42.2	28.4
Press	1,809	1.8	1,437	2.2	25.9
CD ROM	251	0.2	-	-	-
Product Support	1,392	1.4	-	-	-
MS Systems Journal	478	0.5	-	-	-
CD Consumer	-	-	-	-	-
Total	\$102,636	100.0%	\$66,780	100.0%	53.7

Commodity	Q88-1		Q87-1		Growth Percentage
Books	\$ 2,165	2.1%	\$ 1,716	2.6%	26.2
Hardware	9,675	9.4	5,475	8.2	76.7
CD Consumer	-	-	-	-	-
MS Systems Journal	478	0.5	-	-	-
Languages	9,641	9.4	10,600	15.9	(9.0)
Network	348	0.3	-	-	-
CD ROM	460	0.5	-	-	-
Systems	37,272	36.3	26,616	39.8	40.0
Applications	40,312	39.3	22,373	33.5	80.2
Xenix	2,783	2.2	-	-	-
Total	\$102,636	100.0%	\$66,780	100.0%	53.7

In terms of revenue generation, the Company's leading products for the quarter (compared with prior year for the first time ever) were as follows:

Q88-1	Q87-1		Q88-1		Q87-1	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	DOS/GW Basic	1,406,441	\$24,871	755,408	\$14,605
2	8	Mac Word	62,124	9,851	21,307	2,030
3	2	Microsoft Mouse	89,955	8,832	47,940	5,195
4	3	PC Word	37,683	8,202	28,556	5,057
5	5	Mac Excel	35,470	6,347	21,665	4,253
6	6	Windows (includes ISV Kits)	246,812	4,945	197,829	3,391
7	4	PC Multiplan	68,698	4,717	78,534	4,608
8	7	C Compiler (DOS)	9,956	2,468	17,519	3,039
9	9	Xenix	25,694	2,240	13,086	1,799
10	10	PC Chart	10,132	1,721	11,428	1,553
11	-	Mac Works	11,603	1,618	-	-
12	-	Macro Assembler (DOS)	16,651	1,271	20,633	840
13	11	Fortran (DOS)	6,819	1,269	8,650	1,344
14	13	QuickBasic (DOS)	21,836	1,181	16,880	1,026
15	-	PC Project	4,853	1,052	3,497	670
-	12	Flight Simulator (PC and Mac)	23,282	555	54,584	1,309
-	14	Mac Word Update	22,896	944	17,373	1,001
-	15	Cobol (DOS)	1,842	533	2,869	891
				\$82,617		\$52,618
		Percent of net revenues		80.5%		78.8%

Cost of revenues for Q88-1 was 21.1% of net revenues compared with 19.8% for Q87-1. The most significant factor accounting for the increase in cost of revenues as a percentage of net revenues is the shift in revenue mix to a greater contribution from worldwide retail as previously noted.

Operating expenses grew 74.2% from period-to-period (from \$28.0 million to \$48.7 million). This growth in operating expenses exceeds the growth in net revenues (53.7%) and, as such, operating expenses as a percentage of net revenues increased from 41.9% to 47.4%. Payroll and payroll taxes increased 61.7% to \$16.7 million (34.3% of total operating expenses) from \$10.3 million (37.0% of total operating expenses). This increase tracks closely with the 55.5% growth in operating headcount (from 1,148 at the end of Q87-1 to 1,785 at the end of Q88-1). Third-party product development expense grew 228.6% to \$3.2 million from \$1.0 million. Extensive use of freelancers and amortization of intellectual property rights acquired in the Forethought acquisition account for the increase. Public relations and trade shows expense increased 333.2% to \$2.7 million from \$627,000. A substantial portion of this increase results from the \$1.3 million spent on the Fall Rollout (aka MSU). This program (administered by USSMD's channel marketing) consisted of product demos to dealers and national accounts in eight major US cities. Supplies and equipment expense increased 87.4% to \$3.5 million from \$1.9 million. The majority of this increase relates to the installation of networking capabilities, including the network infrastructure (cable) and individual PC connections (consisting of a card, transceiver, and minor cable). As a practice, we categorically network connect all development machines. The expense items identified above (payroll, third-party product development, public relations and trade shows, and supplies and equipment) account for \$12.3 million of the total increase in operating expenses of \$20.7 million. The remainder of the increase is divided among many expense items and, in general, results from an overall increase in the size of the operation.

Non-operating income for Q88-1 was \$3.2 million compared with \$1.8 million for Q87-1. Non-operating income for the current quarter consists of investment income of \$2.3 million, foreign currency transaction gains of \$1.2 million, and miscellaneous expense of \$300,000. Non-operating income for Q87-1 consists of investment income of \$1.6 million and miscellaneous income of \$200,000. The growth in investment income is primarily attributed to a larger investment portfolio resulting from funds from operations. The foreign currency transaction gains are non-recurring and result from intercompany borrowings.

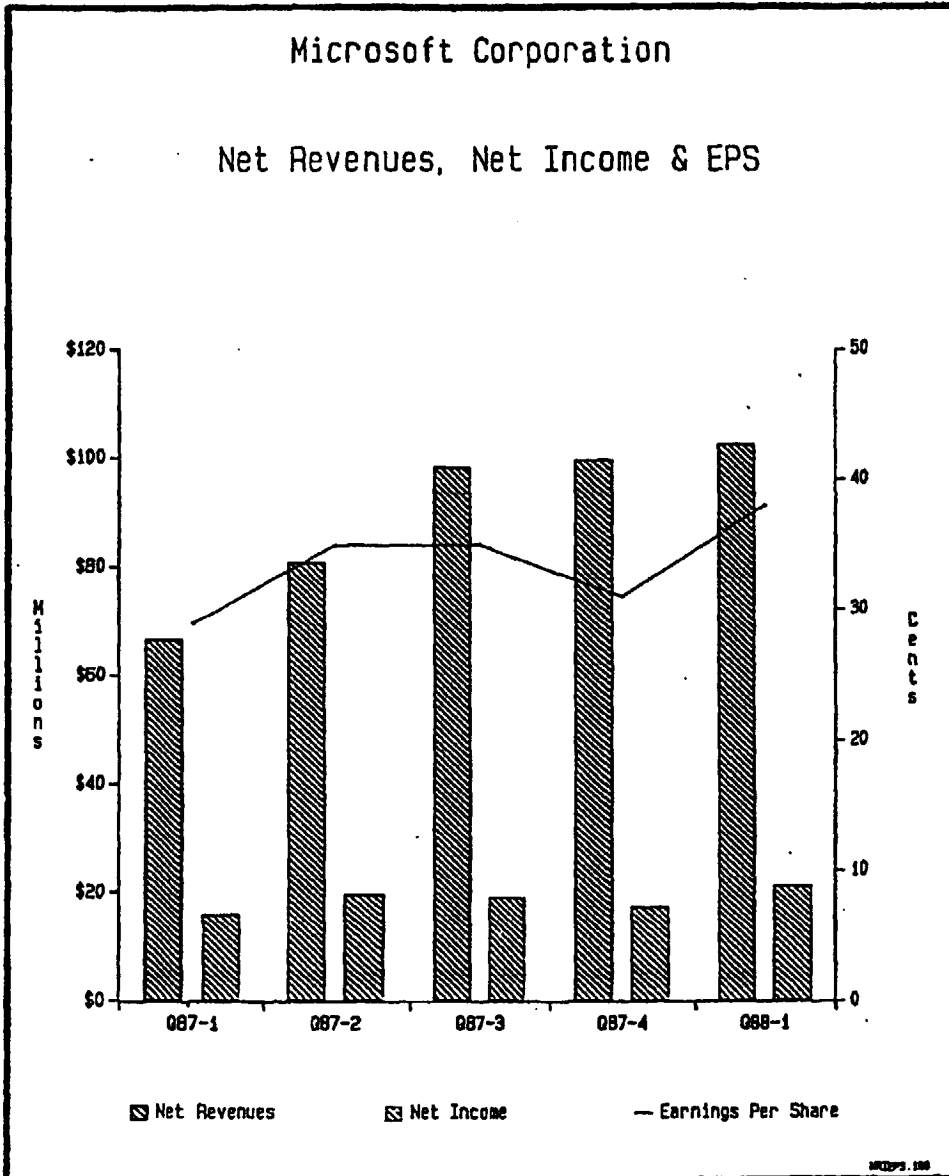
Stock option bonus expense of \$3.0 million is the result of the Company's program regarding incentive stock options under which, if the employees elect to participate, they are paid a bonus in exchange for taking certain actions that result in a tax benefit to the Company. Under current accounting rules, the Company reports the gross benefit under the program as a contribution to capital, whereas the bonus (\$3.0 million) net of directly related taxes (\$1.0 million) is charged against income, thereby reducing net income by \$2.0 million. Of the stock bonus expense total, only \$231,000, was actually paid out while the other \$2.8 million was simply accrued. Accounting rules require that this expense be recognized ratably over the vesting period of the related options as opposed to being recognized when paid.

The effective tax rates for Q88-1 and Q87-1 were 34.5% and 42.2%, respectively. This decrease in the effective tax rate results from the Tax Reform Act of 1986 which lowered the top corporate tax rate from 46% to 34%.

Net income for Q88-1 was \$21.3 million compared with \$15.8 million for Q87-1. Net income as a percentage of net revenues decreased from 23.7% to 20.7%. Had the stock option bonus program discussed above not been adopted, net income for Q88-1 would have been \$23.3 million, 22.7% of net revenues. Both cost of revenues and operating expenses grew at a faster rate than net revenues. This situation, offset somewhat by a reduction in the effective tax rate, resulted in a slight deterioration of our net profit margin.

# Microsoft Corporation

## Net Revenues, Net Income & EPS



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**Channel Reporting**

The contribution on a channel of distribution basis to net revenues and income from operations for Q88-1 and Q87-1 was as follows (amounts in thousands):

Net Revenues	Q88-1		Q87-1		Growth Percentage
	Amount	Percentage	Amount	Percentage	
USSMD	\$ 30,609	29.8%	\$21,092	31.6%	45.1
International Retail	<u>31,842</u>	<u>31.0</u>	<u>16,020</u>	<u>24.0</u>	98.8
Worldwide Retail	<u>62,451</u>	<u>60.8</u>	<u>37,112</u>	<u>55.6</u>	68.3
Domestic OEM	21,866	21.3	16,915	25.3	29.3
International OEM	<u>14,389</u>	<u>14.0</u>	<u>11,316</u>	<u>16.9</u>	27.2
Worldwide OEM	<u>36,255</u>	<u>35.3</u>	<u>28,231</u>	<u>42.2</u>	28.4
Press	1,809	1.8	1,437	2.2	25.9
CD ROM	251	0.2	-	-	-
Product Support	1,392	1.4	-	-	-
MS Systems Journal	478	0.5	-	-	-
CD Consumer	-	-	-	-	-
<b>Total</b>	<b><u>\$102,636</u></b>	<b><u>100.0%</u></b>	<b><u>\$66,780</u></b>	<b><u>100.0%</u></b>	<b>53.7</b>

Burdened Operating Income (Loss)	Percentage			Percentage			Growth
	Total	Revenue	Revenue	Total	Revenue	Revenue	
US Sales	\$ 2,666	8.2	8.7	\$ 5,971	23.3	28.3	(55.4)
International Retail	<u>7,910</u>	<u>24.5</u>	<u>24.8</u>	<u>3,326</u>	<u>13.0</u>	<u>20.8</u>	137.8
Worldwide Retail	<u>10,576</u>	<u>32.7</u>	<u>16.9</u>	<u>9,297</u>	<u>36.3</u>	<u>25.1</u>	13.8
Domestic OEM	14,243	44.1	65.1	10,761	42.0	63.6	32.4
International OEM	<u>1,259</u>	<u>25.5</u>	<u>57.4</u>	<u>6,618</u>	<u>25.9</u>	<u>58.5</u>	24.8
Worldwide OEM	<u>22,502</u>	<u>69.6</u>	<u>62.1</u>	<u>17,379</u>	<u>67.9</u>	<u>61.6</u>	29.5
Press	10	-	0.6	(450)	(1.8)	(31.3)	102.2
CD ROM	(398)	(1.2)	(158.6)	(485)	(1.9)	-	17.9
Product Support	(135)	(0.4)	(9.7)	-	-	-	-
MS Systems Journal	(100)	(0.3)	(20.8)	-	-	-	-
CD Consumer	(125)	(0.4)	-	-	-	-	-
Unallocated	<u>(20)</u>	<u>-</u>	<u>-</u>	<u>(18)</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>Total</b>	<b><u>\$32,310</u></b>	<b><u>100.0</u></b>	<b><u>31.5</u></b>	<b><u>\$25,605</u></b>	<b><u>100.0</u></b>	<b><u>38.3</u></b>	<b><u>26.2</u></b>

**Commodity Reporting**

The contribution on a commodity basis to net revenues and income from operations for Q88-1 and Q87-1 follows (amounts in thousands):

Net Revenues	Q88-1		Q87-1		Growth Percentages
Books	\$ 2,165	2.1%	\$ 1,716	2.6%	26.2
Hardware	9,675	9.4	5,475	8.2	76.7
CD Consumer	-	-	-	-	-
MS Systems Journal	478	0.5	-	-	-
Languages	9,641	9.4	10,600	15.9	(9.0)
Network	348	0.3	-	-	-
CD ROM	460	0.5	-	-	-
Systems	37,272	36.3	26,616	39.8	40.0
Applications	40,312	39.3	22,373	33.5	80.2
Xenix	2,285	2.2	-	-	-
Total	\$102,636	100.0%	\$66,780	100.0%	53.7

Burdened Operating Income (Loss)	Percentage			Percentage			
	Total	Revenue	Growth	Total	Revenue	Growth	
Languages	\$ 84	0.3	3.9	\$ (476)	(1.9)	(27.7)	117.6
Hardware	802	2.5	8.3	888	3.5	16.2	(9.7)
CD Consumer	(124)	(0.4)	-	(118)	(0.5)	-	(5.1)
MS Systems Journal	(99)	(0.3)	(20.6)	-	-	-	-
Languages	1,373	4.2	14.2	4,730	18.5	44.6	(71.0)
Network	(365)	(1.1)	(104.9)	-	-	-	-
CD ROM	(694)	(2.2)	(130.9)	(485)	(1.9)	-	(43.1)
Systems	22,482	69.6	60.3	16,191	63.2	60.8	38.9
Applications	8,231	25.5	20.4	4,895	19.1	21.9	68.2
Xenix	658	2.0	28.8	-	-	-	-
Unallocated	(38)	(0.1)	-	(20)	-	-	-
Total	\$32,310	100.0	31.5	\$25,605	100.0	38.3	26.2



**RESULTS OF OPERATIONS**  
Compared With Plan

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**RESULTS OF OPERATIONS COMPARED WITH PLAN**

**Consolidated**

A consolidated statement of income for the three months ended September 30, 1987, compared with plan, follows (in thousands, except net income per share):

	Actual		Plan		Variance Percentage
Net revenues	\$102,636	100.0%	\$84,420	100.0%	21.6
Cost of revenues	21,625	21.1	18,900	22.4	14.4
Gross profit	81,011	78.9	65,520	77.6	23.6
Operating expenses	48,701	47.4	51,017	60.4	(4.5)
Income from operations	32,310	31.5	14,503	17.2	122.8
Non-operating income	3,200	3.1	2,062	2.5	55.2
Stock option bonus expense	(3,031)	(3.0)	(3,000)	(3.4)	910.3
Income before income taxes	32,479	31.6	16,265	19.3	99.7
Provision for income taxes	11,220	10.9	4,672	5.8	130.3
<b>NET INCOME</b>	<b>21,259</b>	<b>20.7%</b>	<b>11,593</b>	<b>13.5%</b>	<b>86.6</b>
Average shares outstanding	55,536		55,400		
<b>NET INCOME PER SHARE</b>	<b>\$0.38</b>		<b>\$0.21</b>		<b>\$1.0</b>

Net revenues for the first quarter of fiscal year 1988 at \$102.6 million were 21.6% above plan of \$84.4 million. The current quarter was a record revenue quarter for the Company, the eighth in a row. As can be seen from the following breakdown of net revenues by Channel of Distribution, significant favorable revenue variances occurred in International OEM (63.9%), Domestic OEM (43.2%), and International Retail (39.2%), whereas shortfalls occurred in Product Support (49.1%), MS Systems Journal (27.4%), and USSMD (5.2%). Combined international net revenues at \$46.2 million accounted for 45.0% of total net revenues compared with a budget of only 37.5%.

Channel of Distribution	Actual		Plan		Variance Percentage
US Sales	\$ 30,609	29.8	\$32,290	38.2%	(5.2)
International Retail	31,842	31.0	22,874	27.1	39.2
Worldwide Retail	62,451	60.8	55,164	65.3	13.2
Domestic OEM	21,866	21.3	15,271	18.1	43.2
International OEM	14,389	14.0	8,777	10.4	63.9
Worldwide OEM	36,255	35.3	24,048	28.5	50.8
Press	1,809	1.8	1,565	1.9	15.6
CD ROM	251	0.2	250	0.3	4.0
Product Support	1,392	1.4	2,735	3.2	(49.1)
MS Systems Journal	478	0.5	658	0.8	(27.4)
CD Consumer	--	--	--	--	--
Total	\$102,636	100.0%	\$84,420	100.0%	21.6



From a commodity standpoint, as shown below, Systems (49.6%) and Applications (14.8) accounted for \$17.5 million or 96.3% of the total revenue variance.

Commodity	Actual		Plan		Variance Percentage
Books	\$ 2,165	2.1%	\$ 1,754	2.1%	23.4
Hardware	9,675	9.4	9,729	11.5	(0.6)
CD Consumer	-	-	-	-	-
MS Systems Journal	478	0.5	658	0.8	27.5
Languages	9,641	9.4	9,568	11.3	0.8
Network	348	0.3	263	0.3	32.3
CD ROM	460	0.5	631	0.8	(27.1)
Systems	37,272	36.3	24,907	29.5	49.6
Applications	40,312	39.3	35,128	41.6	14.8
Xcix	2,285	2.2	1,782	2.1	28.2
Total	\$102,636	100.0%	\$84,420	100.0%	21.6

In terms of revenue generation, the Company's leading products for the quarter (compared with plan) were as follows:

Actual	Plan		Actual		Plan	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	DOS/GW Basic	1,406,441	\$24,871	1,128,842	\$18,873
2	4	Mac Word	62,124	9,851	35,968	6,564
3	3	Microsoft Mouse	89,955	8,832	104,948	8,960
4	2	PC Word	37,683	8,202	47,394	9,851
5	6	Mac Excel	35,470	6,347	23,011	4,640
6	7	Windows (includes ISV Kits)	246,812	4,945	104,891	3,761
7	5	PC Multiplan	68,698	4,717	38,923	4,705
8	8	C Compiler (DOS)	9,956	2,468	11,901	2,772
9	11	Xenix	25,694	2,240	17,328	1,566
10	10	PC Chart	10,132	1,721	13,549	1,923
11	9	Mac Works	11,603	1,618	14,142	2,106
12	13	Macro Assembler (DOS)	16,651	1,271	19,191	1,118
13	12	Fortran (DOS)	6,819	1,269	6,364	1,427
14	14	QuickBasic (DOS)	21,836	1,181	20,000	1,051
15	-	PC Project	4,653	1,052	4,643	1,004
				\$80,585		\$70,321
Percent of net revenues				78.5%		83.3%

Actual cost of revenues was 21.1% of net revenues compared with a plan of 22.4%. Product costs (material, labor, and overhead) as a percentage of net revenues were 13.4% compared with a plan of 14.6%. This favorable situation resulted because of a shift in revenue mix to a lesser contribution from worldwide retail (60.8% of total net revenues compared with a plan of 65.3%). All other items included in cost of revenues (inventory valuation adjustments, royalties, distribution costs, duty and other) were right in line with plan as a percentage of net revenues.

Operating expenses at \$48.7 million were 4.5% below plan of \$51.0 million and as a percentage of net revenues were 47.4% compared with plan of 60.4%. A combined \$3.1 million under-spending in the areas of public relations and trade shows, advertising, and marketing, offset by a net overrun of \$800,000 in all other items, produced the \$2.3 million favorable variance in operating expenses. Public relations and trade shows expense was actually over budget by \$876,000 as a result of the \$1.3 million spent on the Fall Rollout (aka MSU). This program (administered by USSMD channel marketing) consisted of product demos to dealers and national accounts in eight major US cities. The Fall Rollout as an activity was not specifically included in the budget. USSMD channel marketing did reach agreement with the various product marketers, whereby the product marketers "funded" the event by agreeing not to spend other budgeted monies in advertising and marketing, which experienced favorable variance of \$2.4 million and

\$1.6 million respectively. Advertising and marketing were further affected by the slippage of introduction dates for several key products and the termination of our relationship with k/d/p.

Non-operating income for the quarter was \$3.2 million compared with a plan of \$2.1 million. Actual non-operating income consists of investment income of \$2.3 million, foreign currency transaction gains of \$1.2 million, and miscellaneous expense of \$300,000, whereas plan non-operating income consists entirely of investment income. The variance in investment income results from a larger than anticipated portfolio, an unanticipated increase in interest rates, and increased participation in higher yielding instruments such as increasing rate notes. During the quarter, we recognized unbudgeted, non-recurring foreign currency transaction gains of \$1.2 million resulting from intercompany borrowings. Included in the miscellaneous expense of \$300,000 is an equity loss of \$100,000 resulting from our joint venture participation in EIKON.

Stock option bonus expense of \$3.0 million is the result of the Company's program regarding incentive stock options under which, if the employees elect to participate, they are paid a bonus in exchange for taking certain actions that result in a tax benefit to the Company. Under current accounting rules, the Company reports the gross benefit under the program as a contribution to capital, whereas the bonus (\$3.0 million), net of directly related taxes (\$1.0 million), is charged against income, thereby reducing net income by \$2.0 million. Of the stock option bonus expense total, only \$231,000 was actually paid out while the other \$2.8 million was simply accrued. Accounting rules require that this expense be recognized ratably over the vesting period of the related options as opposed to being recognized when paid.

The effective tax rate for the quarter was 34.5% compared with a plan of 30.0%. Our accounting policy is to provide US tax expense on undistributed earnings of subsidiaries operating in countries with tax rates lower than those in the US and to recognize US tax benefit on undistributed earnings of subsidiaries operating in countries with tax rates higher than those in the US. Accordingly, regardless of where we generate pre-tax income, our effective tax rate should be close to the US federal statutory rate of 34%. State income taxes will drive our effective rate above 34%, whereas tax credits (Foreign Sales Corporation and research and experimentation) and tax exempt non-operating income will drive our effective rate below 34%.

Net income for the quarter was \$21.3 million compared with a plan of \$11.4 million, and as a percentage of net revenues was 20.7% compared with a plan of 13.5%. Had the stock bonus program discussed above not been adopted, net income would have been \$23.3 million, 22.7% of net revenues. Additional revenues of \$18.2 million generated additional net income of \$9.9 million (54.2% incremental net income margin). This illustrates the relationship between variable costs and non-variable costs. Cost of revenues and income taxes are variable, whereas the majority of our operating expenses are non-variable.

### Channel Reporting

The contribution (actual and plan) on a channel of distribution basis to net revenues and income from operations for Q88-1 was as follows (amounts in thousands):

Net Revenues	Actual		Plan		Variance
		Percentage		Percentage	Percentage
USSMD	\$ 30,609	29.8	\$32,290	38.2%	(5.2)
International Retail	31,842	31.0	22,874	27.1	39.2
Worldwide Retail	62,451	60.8	55,164	65.3	13.2
Domestic OEM	21,866	21.3	15,271	18.1	43.2
International OEM	14,389	14.0	8,777	10.4	63.9
Worldwide OEM	36,255	35.3	24,048	28.5	50.8
Press	1,809	1.8	1,565	1.9	15.6
CD ROM	251	0.2	250	0.3	4.0
Product Support	1,392	1.4	2,735	3.2	(49.1)
MS Systems Journal	478	0.5	658	0.8	(27.4)
CD Consumer	—	—	—	—	—
Total	\$102,636	100.0%	\$84,420	100.0%	21.6

Burdened Operating Income (Loss)	Percentage			Total	Percentage		Variance
	Total Revenue				Total Revenue		
USSMD	\$ 2,666	8.2	8.7	\$ 2,209	15.2	6.8	20.7
International Retail	7,910	24.5	24.8	1,204	8.3	5.3	557.0
Worldwide Retail	10,576	32.7	16.9	3,413	23.5	6.2	209.9
Domestic OEM	14,243	44.1	65.1	7,855	54.1	51.4	81.3
International OEM	8,259	25.5	57.4	2,692	18.6	30.7	206.7
Worldwide OEM	22,502	69.6	62.1	10,548	72.7	43.7	113.3
Press	10	—	0.6	37	0.3	2.5	(73.0)
CD ROM	(398)	(1.2)	(158.6)	(191)	(1.3)	(76.4)	(108.4)
Product Support	(135)	(0.4)	(9.7)	1,005	6.9	36.7	(113.4)
MS Systems Journal	(100)	(0.3)	(20.8)	137	0.9	20.8	(173.0)
CD Consumer	(125)	(0.4)	—	(390)	(2.7)	—	67.9
Unallocated	(20)	—	—	(56)	(0.3)	—	—
Total	\$32,310	100.0	31.5	\$14,503	100.0	17.2	122.8

**USSMD**

The condensed burdened operating income statement for USSMD for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$30,609	100.0%	\$32,290	100.0%	\$(1,681)
Cost of revenues	8,338	27.2	9,351	29.0	1,013
Operating expenses	11,019	36.0	12,524	38.8	1,505
Allocations	8,586	28.1	8,206	25.4	(380)
Burdened operating income	\$2,666	8.7%	\$2,209	6.8%	\$457

USSMD net revenues by commodity were as follows (in thousands):

	Actual		Plan		Variance
Books	\$ 306	1.0%	\$ 195	0.6%	\$ 111
Hardware	8,811	28.5	6,836	21.2	(3,025)
Languages	4,951	16.2	6,279	19.4	(1,328)
CD ROM	101	0.3	75	0.2	26
Systems	983	3.2	1,656	5.1	(673)
Xenix	-	-	-	-	-
Applications	21,487	70.2	18,583	57.6	2,904
Discounts and rebates	(1,030)	(3.4)	(1,324)	(4.1)	304
	\$30,609	100.0%	\$32,290	100.0%	\$(1,681)

Net revenues for Q88-1 at \$30.6 million were 5.2% below a plan of \$32.3 million. In terms of revenue generation, the division's ten leading products (compared with plan) for the quarter were as follows:

Q88-1	Q87-4		Actual		Plan	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	-	Mac Word	55,995	\$ 8,478	30,995	\$ 5,387
2	2	Mac Excel	25,968	4,631	17,252	3,135
3	3	Microsoft Mouse	37,506	3,333	66,144	5,948
4	1	PC Word	18,310	2,537	26,463	4,168
5	6	Mac Works	8,572	1,159	10,571	1,466
6	4	C Compiler (DOS)	4,541	988	8,000	1,728
7	5	Windows (includes ISV Kits)	15,223	965	31,330	1,656
8	10	Macro Assembler (DOS)	12,728	948	10,720	772
9	7	Fortran (DOS)	4,426	780	4,700	1,015
10	8	QuickBasic (DOS)	15,025	743	14,878	707
				\$24,562		\$25,982
		Percentage of net revenues		80.2%		80.5%

Strong sales of the Macintosh computer continued to create a brisk demand for Mac-based software. One analyst estimated that Apple shipped approximately 176,000 Macintoshes during the quarter, more than double last year's summer quarter. This demand has helped push Mac Word to the No. 1 position with \$8.5 million (a 57.4% increase over a planned \$5.4 million). Mac Excel remained No. 2 with sales at 47.7% over plan. PC Word slipped from the No. 1 position to No. 4 due to the delay in the release of version 4.0 and significant dealer and distributor returns of version 3.1. During Q88-1, returns of PC Word version 3.10 and 3.11 totaled 7,173 units (\$1.2 million in credits issued). Dealers and distributors returning Word typically reordered Word version 4.0.



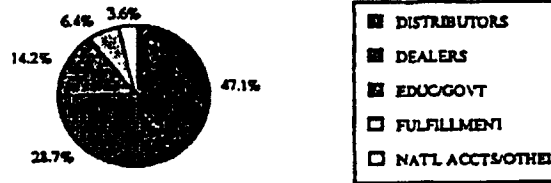
Of total USSMD Applications revenue dollars, the following shows the percentage contributed by operating system by quarter:

Quarter	PC	Mac	Other
Q88-1	26.3	72.5	1.2
Q87-4	52.8	47.0	.2
Q87-3	39.5	60.0	.5
Q87-2	46.1	53.3	.6
Q87-1	49.4	49.4	1.2

Despite a major emphasis placed on promoting and selling PC-based products, Mac Apps out sold PC Apps at a ratio of 2.8 to 1. PC Apps revenues decreased 45.4% from \$10.4 million in the prior quarter to \$5.7 million in Q88-1. This drop can partially be contributed to a shortfall in PC Word sales. PC Word's contribution to total USSMD Applications revenue dropped from 35.5% in Q87-4 to 12.9% in Q88-1. Sales of Chart and Project remained consistent in relation to previous quarters, despite new version releases, and did not contribute significantly to the overall decrease in PC environment sales.

During Q88-1, sales to distributors (\$15.0 million) and dealers (\$9.1 million) as a percentage of gross revenues decreased to 75.8% from 81.5% for Q87-4. Fulfillment sales were \$2.0 million for Q88-1, an increase of \$300,000 from \$1.7 million in Q87-4. Fulfillment shipped approximately 57,200 units during Q88-1; 9,150 units of Word upgrades (\$488,000) and 3,470 units of Chart upgrades (\$231,000).

USSMD Q88-1: SALES BY CUSTOMER TYPE



Sales to distributors (in thousands):

	Q88-1	Q87-4	Q87-3	Q87-2	Q87-1
Micro D	\$ 5,226	\$ 5,386	\$ 6,389	\$ 6,582	\$ 2,859
Softsel	3,061	4,260	3,262	2,919	2,492
Ingram	3,017	4,163	5,022	5,305	3,664
First Software	1,801	2,500	519	608	35
Gates Distributing	1,653	2,022	2,525	2,631	1,567
Micro United	241	489	105	361	735
	<u>\$14,999</u>	<u>\$18,820</u>	<u>\$17,822</u>	<u>\$18,406</u>	<u>\$10,852</u>
Percentage of gross revenues	<u>47.1%</u>	<u>53.1%</u>	<u>52.1%</u>	<u>56.6%</u>	<u>50.0%</u>

At the close of Q88-1, USSMD carried a \$16.8 million backlog, a significant increase over a \$4.7 million backlog in Q87-4. A breakdown of the backlog by product follows:

	Backlog	
	Units	Revenue (in thousands)
PC Word 4.0	24,614	\$ 4,279
Windows Excel (unreleased)	14,936	3,909
Mac Word 3.01	10,000	2,029
Mouse, Serial	22,220	1,829
PC Works (unreleased)	15,217	1,488
Mouse, Bus	5,810	465
Other	43,624	2,792
	<u>136,421</u>	<u>\$16,796</u>

During Q88-1, USSMD began the Dealer Enterprise Campaign which consists of a combination of increased marketing funds, special pricing, and rebates (based on sell-through) for dealers and distributors who commit to a minimum purchase of PC Word, Mac Word, and Windows Excel. Dealers and distributors participating in the program have committed to minimum purchases of \$16.7 million of these three application products. Marketing funds totaling \$2.1 million will be offered to participants, and accrue as shipments occur. The campaign is funded by contributions from the Applications marketing budget. Shipments have been scheduled through the end of Q88-2, creating the unusually high backlog at the end of Q88-1. During September, the first month of the Dealer Enterprise Campaign, \$5.0 million (30%) of the minimum commitment have shipped.

In Q88-1, Hardware released the New White Mouse in a variety of mouse and software combinations for both Bus and Serial versions. Actual hardware revenues were 44.3% below a plan of \$6.8 million. These revenues decreased 41.9% from \$6.6 million in the prior quarter to \$3.8 million in Q88-1 and were the result of delayed product releases. Mach 20, scheduled to be released in Q88-1, was also delayed and should be released early in November. At quarter end, there was a \$2.3 million backlog of Mouse orders. Serial Mouse was 79.7% of the total Mouse backlog, with orders of \$1.8 million (22,220 units). This large backlog was caused by delayed releases, raw material shortages and quality problems with the Smart Mouse Adaptor cable.

Language revenues for Q88-1 of \$5.0 million decreased 28.9% compared to \$7.0 million in the prior quarter. Actual revenues were 21.1% below a plan of \$6.3 million. Delayed releases of C Compiler 5.0 and Quick C were partially responsible for the revenue decrease. Revenues for C Compiler, the No. 1 selling Language product, decreased 59.4% from \$2.4 million in the prior quarter to \$988,000 in Q88-1. C Compiler sales were \$740,000 under plan. Unreleased Quick C versions had been forecast to provide an additional \$613,000 in Q88-1. Version 5 of MASM was released in Q88-1 and produced revenues of \$948,000 against a plan of \$772,000.

Cost of revenues of \$8.3 million was 10.8% below a planned \$9.4 million. As a percentage of net revenues, cost of revenues was 27.2%, against a planned 29.0%. This is a direct result of sales mix, with lower than planned sales of PC Word and Mouse products, both of which have relatively higher product costs.

Operating expenses at \$11.0 million were 12% under a planned \$12.5 million, and as a percentage of net revenues were 36.0% against a planned 38.8%. An analysis of operating expense categories shows a knowingly created overrun in public relations and trade shows (\$971,000). This variance was due primarily to the recognition of expenses (\$1.3 million) relating to the Fall Rollout (also known as Microsoft University) whose multi-city presentation occurred in late September. Expenses relating to Microsoft's participation at MacWorld-Boston and P.C. Expo along with public relations work for the Windows Tool

Kit also contributed to the variance.

There was a significant favorable variance in the advertising and marketing category as actual expenditures of \$2.0 million were under a planned \$4.9 million. This large variance can be explained by several factors. During Q88-1, much of the advertising and promotional effort was focused on the Fall Rollout, and also on preparation for Works Days, slated to occur in October. As of September 30th, there were approximately \$584,000 of prepaid Works Days advertising that will be recognized as an expense in Q88-2. Delayed product introductions and the termination of our relationship with k/d/p also inhibited spending for advertising and marketing.

The Fall Dealer Enterprise Campaign also contributed to the favorable advertising and marketing variance for the USSMD channel. This campaign requires contributions of planned advertising and other promotional funds from Application marketing's budget to pay for the increased marketing funds earned by participating dealers and distributors. The end result of the program should be lower than planned advertising and marketing expenditures and higher than planned marketing fund and incentive expenditures.

Payroll and employee fringe expenses produced an unfavorable variance of \$425,000. The National Sales meeting was held during Q88-1 at an approximate cost of \$400,000. The budgeted cost of the meeting was spread evenly over the year in the USSMD conference and seminar budget, a subset of the payroll and employee fringe expense classification. Thus, the variance created by the National Sales meeting should turn around during subsequent quarters. The total variance in this area during Q88-1 was an unfavorable \$272,000. Retail incentive bonuses, another component of USSMD payroll, accounted for an unfavorable variance of \$239,000. Unbudgeted payments relating to the Associate Sales Representative program and the Spring Word War generated the variance.

Allocations to USSMD were \$8.6 million against a planned \$8.2 million. Allocations to Domestic OEM for predetermined marketing benefit resulted in a favorable variance of \$295,000. Applications development allocations of \$3.2 million exceeded plan by \$505,000 due to an overrun in development costs (primarily due to the acquisition of Forethought).

In summary, burdened operating income of \$2.7 million (8.7% of net revenues), against a planned \$2.2 million (6.8% of net revenues) produced a favorable variance of \$500,000 despite an unfavorable net revenue variance of \$1.7 million. A lower than planned ratio of cost of revenues to net revenues (27.2% vs. a planned 29.0%), and a net favorable variance in operating expenses (essentially advertising and marketing) produced this positive burdened operating income variance.

### International Retail

The condensed burdened operating income statement for International Retail for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$31,842	100.0%	\$22,874	100.0%	\$8,968
Cost of revenues	9,719	30.5	6,482	28.3	(3,237)
Operating expenses	7,489	23.5	8,524	37.3	1,035
Allocations	6,724	21.2	6,664	29.1	(60)
Burdened operating income	\$ 7,910	24.8%	\$ 1,204	5.3%	\$6,706

International Retail activities are primarily those of wholly owned subsidiaries. Translation of foreign currency denominated financial statements into U.S. dollars affects comparisons to plan by increasing actual amounts if the U.S. dollar is weaker or decreasing actual amounts if the U.S. dollar is stronger than planned. During Q88-1 the U.S. dollar was slightly weaker than planned in relation to the Australian dollar, British pound, Canadian dollar and Irish pound. It was slightly stronger than or about the same as planned in relation to the other currencies listed below. Actual (weekly average) and planned exchange rates for Q88-1 are as follows:

Currency	U.S. dollars per unit of Foreign Currency	
	Actual Rate	Planned Rate
Australian Dollar	.7129	.6918
British Pound	1.6164	1.5825
Canadian Dollar	.7564	.7476
Deutsch Mark	.5443	.5545
Dutch Guilder	.4834	.4907
French Franc	.1632	.1633
Irish Pound	1.4354	1.4498
Italian Lira	.00075	.00077
Japanese Yen	.00682	.00713
Swedish Krona	.1557	.1587

International Retail net revenues comprised 31.0% of the Company's total Q88-1 net revenues. Actual and planned Q88-1 retail net revenues of each consolidating unit are as follows (in thousands):

	Actual		Plan		Variance
<b>EUROPE</b>					
MS LTD (England)	\$3,209	10.1%	\$ 1,803	7.9%	\$1,406
MS AB (Sweden)	1,894	5.9	1,284	5.6	610
MS GmbH (Germany)	7,662	24.1	6,045	26.4	1,617
MS SARL (France)	6,803	21.4	4,604	20.2	2,199
MS BV (Netherlands)	1,193	3.7	988	4.3	205
MS SPA (Italy)	896	2.8	620	2.7	276
MS SRL (Spain)	225	0.7	228	1.0	(3)
Other Europe	303	1.0	—	—	303
	<u>22,185</u>	<u>69.7</u>	<u>15,572</u>	<u>68.1</u>	<u>6,613</u>
<b>ICON</b>					
MS INC (Canada)	2,377	7.5	1,707	7.5	670
MS PTY (Australia)	2,066	6.5	1,583	6.9	483
Mexico	115	0.3	471	2.1	(356)
Latin America	219	0.7	916	4.0	(697)
India	68	0.2	135	0.6	(67)
Other ICON	488	1.5	58	0.2	430
	<u>5,333</u>	<u>16.7</u>	<u>4,870</u>	<u>21.3</u>	<u>463</u>
<b>EAR EAST</b>					
MS KK	3,462	10.9	2,437	10.7	1,025
Korea (MS SA)	1	—	123	0.5	(122)
ASEA	657	2.1	93	0.4	564
Other Far East	330	1.0	—	—	330
	<u>4,450</u>	<u>14.0</u>	<u>2,653</u>	<u>11.6</u>	<u>1,797</u>
Discounts and rebates	(126)	(0.4)	(221)	(1.0)	95
Total	<u>\$31,842</u>	<u>100.0%</u>	<u>\$22,874</u>	<u>100.0%</u>	<u>\$8,968</u>

International Retail net revenues for Q88-1 of \$31.8 million were 39.2% over a planned \$22.9 million despite a small unfavorable exchange rate variance of \$144,000 or 1.6%. Localized product sales of \$17.6 million comprised 55.3% of International Retail Q88-1 net revenues (up from 51.2% for Q87-4). A summary of revenues by commodity sold by the International Retail channel follows (in thousands):

	Actual		Plan		Variance
	\$	%	\$	%	\$
Books	54	0.2%	-	-	54
Hardware	5,814	18.3	3,088	13.5	2,726
Languages	3,809	12.0	2,640	11.5	1,169
CD ROM	18	-	-	-	18
Systems	4,331	13.6	2,301	10.1	2,030
Applications	17,939	56.3	15,066	65.9	2,873
Xenix	3	-	-	-	3
Discounts and rebates	(126)	(0.4)	(221)	(1.0)	95
	<u>\$31,842</u>	<u>100.0%</u>	<u>\$22,874</u>	<u>100.0%</u>	<u>\$8,968</u>

International Retail Hardware revenues in Q88-1 were 18.3% of the channel's net revenues rather than 13.5% as planned. Serial and Bus Mouse sales of \$2.7 million each accounted for 93.4% of the Hardware sold through the channel in Q88-1.

Sales of C-Compiler (\$1.4 million), QuickBasic (\$431,000) and Fortran (\$423,000) comprised 60.4% of the International Retail Languages revenues in Q88-1 and exceeded planned sales of these products totalling \$1.7 million by \$622,000 or 37.0%.

International Retail Systems revenues were also a greater portion of the channel's net revenues in Q88-1 at 13.6% compared with plan of 10.1%. Packaged DOS (\$2.7 million) and localized Windows (\$1.2 million) were the top selling Systems products in Q88-1 and were almost twice planned sales for these products.

Applications revenues accounted for only 56.3% of the channel's net revenues in Q88-1 compared with plan of 65.9%. The four top-selling Applications products for International Retail in Q88-1 were (in thousands):

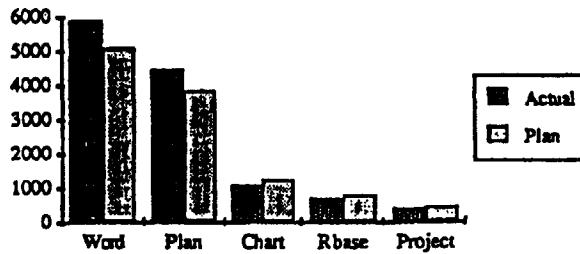
	Actual	Plan	Variance
PC Word German	\$1,970	\$1,715	\$255
PC Multiplan Japanese	1,735	1,716	19
PC Word French	1,530	948	582
PC Multiplan French	903	959	(56)

The table below shows the percentages of International Retail Applications revenues derived from PC, Mac and other system based products in Q88-1 and in each quarter of FY87:

	PC Based	Mac Based	Other
Q88-1	72.6%	24.3%	3.0%
Q87-4	78.1	18.8	3.1
Q87-3	73.2	20.6	6.2
Q87-2	74.4	20.9	4.7
Q87-1	71.7	25.1	3.2

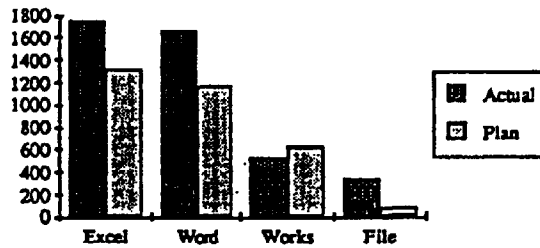
Actual and planned sales of major PC Applications product families sold by International Retail in Q88-1 are shown below in thousands of dollars:

PC APPLICATIONS SALES  
THROUGH INTERNATIONAL RETAIL



A comparison of actual and planned sales of major Mac Applications product families sold by International Retail in Q88-1 in thousands of dollars is shown below:

MAC APPLICATIONS SALES  
THROUGH INTERNATIONAL RETAIL



Cost of International Retail revenues was 30.5% of net revenues for Q88-1 compared with a plan of 28.3% due to lower than planned gross margins on Hardware, Languages and Systems sales and the shift in product mix to include more Hardware (as a percent of total) and less Applications (as a percent of total) than planned. Actual and planned gross margin percentages for Q88-1 of these four principal commodities sold through the International Retail channel were:

	Gross Margin	
	Actual	Plan
Hardware	60.2%	61.3%
Languages	81.0	85.2
Systems	79.0	83.2
Applications	83.6	83.4

Actual International Retail operating expenses in Q88-1 were \$7.5 million or 12.1% less than plan of \$8.5 million. Planned expenses for incentive programs, trade shows, advertising and marketing totalled \$2.8 million, but actual expenses for these activities were only \$1.9 million. Delayed activities at MS LTD, MS GmbH and MS SARL account for two-thirds of the favorable variance in this area. MS LTD will incur expenses for Softeach and PC Excel and other product launches in Q88-2. MS GmbH deferred a planned advertising campaign in Der Spiegel and will report expenses for the Systems Fair scheduled for October 1987 in Q88-2. MS SARL will incur expenses for the Tour de France also scheduled for October 1987 in Q88-2 as well.

In Q88-1, actual expenses allocated to the International Retail channel were about the same as planned allocations of \$6.7 million. Allocations from Applications Development in excess of plan by \$485,000 (primarily due to the Forethought acquisition) were offset by allocations from International R&D (localization) which were lower than plan by \$401,000.

Burdened operating income of the International Retail channel in Q88-1 of \$7.9 million or 24.8% of net revenues was over six times plan of \$1.2 million or only 5.3% of net revenues. This \$6.7 million favorable variance in burdened operating income is a direct result of the \$9.0 million variance in net revenues.

**Domestic OEM**

The condensed burdened operating income statement for Domestic OEM for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$21,866	100.0%	\$15,271	100.0%	\$6,595
Cost of revenues	1,637	7.5	1,335	8.7	(302)
Operating expenses	1,282	5.9	1,689	11.1	407
Allocations	4,704	21.5	4,392	28.8	(312)
Burdened operating income	<u>\$14,243</u>	<u>65.1%</u>	<u>\$ 7,855</u>	<u>51.4%</u>	<u>\$6,388</u>

Domestic OEM net revenues by commodity were as follows (in thousands):

	Actual		Plan		Variance
Books	\$ 1	0%	\$ -	-	\$ 1
Hardware	227	1.0	5	-	222
Languages	621	2.8	448	2.9	173
Networks	275	1.3	155	1.0	120
CD ROM	93	0.4	261	1.7	(168)
Systems	17,927	82.0	11,439	75.0	6,488
Applications	1,193	5.5	1,859	12.2	(666)
Xenix	1,422	7.0	1,104	7.2	425
Total	<u>\$21,866</u>	<u>100.0%</u>	<u>\$15,271</u>	<u>100.0%</u>	<u>\$6,595</u>
Licensing	\$18,312	83.7%	\$11,474	75.1%	\$6,838
Packaged Product	3,554	16.3	3,797	24.9	(243)
Total	<u>\$21,866</u>	<u>100.0%</u>	<u>\$15,271</u>	<u>100.0%</u>	<u>\$6,595</u>

Significant Domestic OEM customers, by commodity, for Q88-1 were (in thousands):

	Languages	Systems	Applications	Xenix	Other*	Total Actual	Total Plan
Zenith	\$ 91	\$ 2,669	\$(144)	\$ 18	\$ 45	\$ 2,679	\$1,616
Compaq	-	1,785	-	-	-	1,785	806
AT&T	2	1,447	(89)	-	138	1,498	806
Tandy	82	524	184	68	-	858	1,719
SCO	33	-	28	705	4	770	498
Tandem	-	728	-	-	-	728	765
DEC	29	60	264	-	343	696	682
Commodore	276	463	-	-	(44)	695	540
Wang	1	306	146	129	25	637	331
IBM	1	589	-	-	(15)	575	659
Wysc	-	530	-	-	-	530	421
NCR	-	442	-	-	1	443	310
AST	-	277	-	-	123	400	210
T.I.	4	132	-	223	32	391	310
Cordata	-	92	-	-	276	368	210
Convergent	25	263	164	-	(114)	348	301
Kaypro	-	312	-	-	-	312	355
Altos	3	-	24	198	73	298	336
Alloy	-	279	-	-	-	279	-
Thompson	-	-	-	-	250	250	-
GAAP Adjustment	-	2,400	-	-	-	2,400	-
UPB Allocations	13	1,243	48	34	(1,338)	-	-
Other Customers	51	3,386	568	154	767	4,926	4,159
Total	<u>\$621</u>	<u>\$17,927</u>	<u>\$1,193</u>	<u>\$1,529</u>	<u>\$ 596</u>	<u>\$21,866</u>	<u>\$15,271</u>

\*includes UPB.  
\*\*customer not specifically forecasted.





Domestic OEM enjoyed a very strong quarter with licensing revenues up 59.6% over plan. Almost all of the key customers exceeded expectations as a result of favorable market conditions for PC's and compatibles, both domestically and abroad.

Tandem's purchase of \$112,500 in Bus Mice and Renaissance's purchase of \$87,000 in Mouse Chips were the main factors behind the \$222,000 favorable variance in the Hardware commodity.

Commodore's Amiga 500 is selling well in Europe (a total of 81,000 units were reported) and contributed a \$228,000 favorable variance to the Languages commodity (Basic Interpreter). Convergent Technologies and DEC also exceeded plan by \$32,000 (Basic Interpreter royalties) and \$29,000 (packaged C Compiler), respectively. These were partially offset by the late filing of IBM's royalty report which will delay recognition of \$93,000 into Q88-2, resulting in a net \$173,000 favorable variance for the commodity.

Previously unreported royalties from AT&T and Hewlett Packard accounted for \$48,000 additional revenue in the Networks commodity. The remainder of the \$120,000 favorable variance was the result of an overall higher than anticipated volume. Significant customers were 3 Com (\$63,000), Ungermann Bass (\$59,000) and DEC (\$22,000). The unfavorable \$168,000 variance in the CD ROM commodity was due to the late availability of packaged Bookshelf for shipment to Amdek.

The Systems commodity benefited from the overall favorable market conditions. Some of the more significant variances were Zenith (\$1.4 million), Compaq (\$742,000) and AT&T (\$655,000). Both Zenith and Compaq had record manufacturing quarters with 113,000 and 86,000 machines, respectively. The AT&T variance resulted from their "fire sale" of 8088-based machines to their employees. One point worth noting is that next quarter's revenue from AT&T will be at half the normal royalty rate. This is due to provisions in the agreement which allow such reduction in the quarter subsequent to one in which their revenue exceeds \$1 million. The GAAP Adjustment and UPB allocations, as shown in the customer table, were the other significant contributors to the \$6.5 million variance for the commodity.

The GAAP Adjustment (\$2.4 million) reflects an overall higher accrual for earned but unreported royalties in Q88-1 than was accrued at the end of Q87-4 (accounting for \$2 million), combined with a net decrease in deferred revenue related to billings prior to product acceptance (accounting for the remaining \$400,000). UPB (\$1.3 million) was the result of minimum commitment billings exceeding the amounts reclassified to product specific revenue as royalty reports are received. This figure, compared with a planned \$300,000, produced a favorable variance of \$1.0 million.

Applications experienced a revenue shortfall of \$666,000 due to shortfalls by Tandy (\$780,000), Zenith (\$314,000) and AT&T (\$165,000). The Tandy shortfall was due to the delay in shipping PC Works (\$225,000) and PC Excel (\$172,000) coupled with lower than forecasted sales of packaged product in Tandy stores. A downward price adjustment for Zenith Word sales to the U.S. Government was the key factor behind its variance. The AT&T variance resulted from its adjustment of previously reported Multiplan and Word royalties. These were partially offset by favorable variances from Kyocera (\$344,000 - Access), Convergent Technologies (\$153,000 - Multiplan) and DEC (\$122,000 - packaged Chart, Word and Multiplan). During the quarter, a dispute with Kyocera over its packaged Access agreement was settled, creating \$344,000 in unplanned revenue. Sales in excess of plan generated the Convergent and DEC variances.

SCO and T.I. reported greater than anticipated Xenix royalties, contributing \$265,000 and \$109,000, respectively, to the \$425,000 overall variance for that commodity.

Actual cost of revenues was negatively impacted in terms of real dollars (\$1.6 million versus plan of \$1.3

million) by the earlier than planned shipment of packaged Windows 386 to Compaq (\$297,000) and higher than expected royalty and second sourcing (support) expense related to the increased Xenix revenues. These factors were partially offset by the overall lower than planned level of packaged product sales. This, combined with the lower mix of packaged product to total channel revenue, explains the positive percentage variance (7.5% versus 8.7%).

Operating expenses were favorably impacted by lower than planned headcount (resulting from a departmental reorganization) and Corpcom related expenses (\$289,000-marketing and public relations). Allocated expenses were negatively impacted by the same factors. The departmental reorganization, which caused the favorable headcount variance, resulted in the cancellation of a planned \$140,000 expense allocation out to other channels. The amount of Corpcom related expenses that are charged to Domestic OEM is determined at the beginning of the fiscal year. The \$295,000 negative impact of the Corpcom allocation brought the net Corpcom related charges in line with the predetermined amount. Added together, operating expenses and allocations differed from plan by only \$95,000.

In summary, burdened operating income of \$14.2 million (65.1% of net revenues) against a planned \$7.9 million (51.4% of net revenues) produced a favorable variance of \$6.4 million. This positive effect resulted from a significant increase in net revenues (59.6%) without corresponding relative increases in expenses (2.8%). Accordingly, 97.2% of the additional revenue flowed through to the operating income line for the channel.

**International OEM**

The condensed burdened operating income statement for International OEM for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$14,389	100.0%	\$8,777	100.0%	\$5,612
Cost of revenues	405	2.8	173	2.0	(232)
Operating expenses	2,868	19.9	2,596	29.6	(272)
Allocations	2,857	19.9	3,315	37.7	458
Burdened operating income	\$ 8,259	57.4%	\$2,693	30.7%	\$5,566

International OEM net revenues by commodity were as follows (in thousands):

	Actual		Plan		Variance
Hardware	\$ -	-%	\$ -	-%	\$ -
Languages	403	2.8	418	4.7	(15)
Networks	72	0.5	85	1.0	(14)
CD ROM	-	-	16	0.2	(16)
Systems	12,775	88.8	7,526	85.7	5,249
Applications	394	2.7	269	3.1	125
Xenix	745	5.2	462	5.3	283
Total	\$14,389	100.0%	\$8,777	100.0%	\$5,612

The contribution (actual and plan) to International OEM net revenues by consolidating unit for Q88-1 follows (in thousands):

	Actual		Plan		Variance
<b>EUROPE</b>					
MS LTD	\$ 1,136	7.9%	\$ 517	5.9%	\$ 619
MS AB	1,013	7.0	370	4.2	643
MS GmbH	431	3.0	201	2.3	230
MS SARL	896	6.2	1,144	13.0	(248)
MS BV	344	2.4	67	0.8	277
MS SPA	1,662	11.6	1,126	12.8	536
	5,482	38.1	3,425	39.0	2,057
<b>ICON</b>					
MS INC (Canada)	25	0.2	-	-	25
MS PTY	95	0.7	-	-	95
Mexico	25	0.2	-	-	25
Latin America	9	0.1	-	-	9
India	55	0.4	-	-	55
Other ICON	86	0.5	-	-	86
	295	2.1	-	-	295
<b>EAR EAST</b>					
MS KK	2,516	17.5	2,471	28.1	45
Korea (MS SA)	2,073	14.4	1,560	17.8	513
ASEA	3,823	26.6	1,321	15.1	2,502
	8,412	58.5	5,352	61.0	3,060
<b>GAAP</b>					
Total	200	1.3	-	-	200
	\$14,389	100.0%	\$8,777	100.0%	\$5,612

Significant International OEM customers, by commodity, for Q88-1 were (in thousands):

	Languages	Systems	Applications	Xenix	Other	Total Actual		Total Plan	
Multitech	\$ -	\$ 436	\$ -	\$ -	\$1,240	\$1,676	11.6%	\$ 270	3.1%
Olivetti	12	1,406	-	541	(383)	1,576	11.0	1,040	11.8
Mitac	-	185	-	-	722	907	6.3	207	2.4
Daewoo	-	642	-	-	211	853	5.9	680	7.7
Ericsson	-	504	-	-	321	825	5.7	321	3.7
Matsushita	-	(58)	-	-	878	820	5.7	835	9.5
Bull S.A.	-	595	326	-	(158)	763	5.3	506	5.8
Samsung	-	72	-	-	428	500	3.5	250	2.8
Epson	99	329	-	-	-	428	3.0	91	1.0
Sony	-	25	-	-	375	400	2.8	-	-
Siemens	5	209	-	85	16	315	2.2	178	2.0
Trigem	-	50	-	-	250	300	2.1	300	3.4
Apricot	-	117	-	22	148	287	2.0	287	3.3
Research Machines	-	-	-	-	283	283	2.0	-	-
Tulip	1	151	-	-	108	260	1.8	5	0.1
Copson	-	305	-	-	(67)	238	1.7	157	1.8
Hitachi	2	1,525	-	-	(1,527)	-	-	-	-
Sanyo	-	375	-	-	(375)	-	-	-	-
GAAP Adjustment	-	200	-	-	-	200	1.4	-	-
UPB Allocations	-	1,500	-	-	(1,500)	-	-	-	-
Other Customers	284	4,207	68	97	(898)	3,758	26.0	3,650	41.6
Total	\$403	\$12,775	\$394	\$745	\$ 72	\$14,589	100.0%	\$8,777	100.0%

\*includes UPB:

\*\*customer not specifically forecasted.

As with Domestic OEM, International OEM also benefited from favorable market conditions, generating net revenues in excess of plan by \$5.6 million (63.9%). Almost all of the key customers exceeded expectations.

The Languages commodity was negatively impacted by no revenue reported for Apricot (plan was \$112,000 - C Compiler and GW-Basic Compiler) and Toshiba (plan was \$243,000 - Cobol and MASM). The plan included an agreement with Apricot which has not yet materialized. Toshiba has yet to report any royalties under its agreement. This was partially offset by revenue reported but not planned for Kyocera (\$144,000 - Basic Interpreter), Fujitsu Espana (\$108,000 - Cobol and Fortran) and Epson (\$99,000 - Basic Interpreter) resulting in a net unfavorable variance of \$15,000 for the commodity.

The Networks commodity incurred an unfavorable variance as a result of a number of insignificant volume variances. The CD ROM commodity shortfall was due to a lack of licensing revenue from various customers for the MS-DOS Extensions to CD ROM product.

The overall market conditions primarily benefited the Systems commodity. Significant variances were generated by Hitachi (\$1.3 million - MS-DOS) Sanyo (\$375,000 - MS-DOS), Ericsson (\$343,000 - MS-DOS and Windows) and Olivetti (\$302,000 - MS-DOS and Windows). The Hitachi variance was the result of its submission of late royalty reports for the two prior quarters in addition to the current quarter report. The other customers reported higher than plan royalties. Two customers which reported significantly lower than anticipated royalties were Toshiba (\$807,000 - MS-DOS) and Matsushita Electric (\$227,000 - MS-DOS). The Matsushita variance was the result of a correction of previously reported royalties. The GAAP adjustment and UPB allocations, as shown in the customer table, contributed \$200,000 and \$2.0 million, respectively, to the total commodity variance.

The GAAP Adjustment (\$200,000) reflects an overall higher accrual for earned but unreported royalties in Q88-1 than was accrued at the end of Q87-4 (accounting for a positive \$700,000), partially offset by a net

increase in deferred revenue related to billings prior to product acceptance (accounting for a negative \$500,000). UPB (\$1.5 million) was the result of minimum commitment billings exceeding the amounts reclassified to product specific revenue as royalty reports are received. This figure, compared with a planned negative \$500,000, produced a favorable variance of \$2.0 million.

Bull S.A. reported greater than planned Word royalties which generated a \$179,000 variance in the Applications commodity. This was partially offset by negative variances from IBM Japan (\$53,000 - Multiplan and Chart) and Apricot (\$44,000 - Write and Multiplan). IBM's report was not received before the end of the quarter, but will contribute \$80,000 to Q88-2. The planned agreement with Apricot has not yet materialized. The net variance for the commodity was \$125,000.

The Xenix commodity incurred a positive variance of \$283,000, primarily the result of Olivetti's reporting \$501,000 over the \$40,000 plan. This excess is not expected to continue into future quarters. Mitsubishi and Fujitsu reported \$138,000 and \$130,000 less than plan, respectively. This greater than anticipated Xenix activity resulted in related royalty and second sourcing (support) expenses in excess of plan, accounting for the negative \$232,000 cost of revenues variance.

The excess of actual revenues over plan accounted for the unfavorable \$272,000 variance in operating expenses. Commission expense incurred a negative \$104,000 impact as a result of MS SA's (Korea) sales exceeding the plan by \$513,000 (at a commission rate of 20%). Bad debt expense, provided at three percent of revenue, also exceeded plan by \$157,000 as a direct result of the higher revenue level.

International OEM was positively impacted in the expense allocation area by \$458,000. Contributing factors were the favorable effect of a change in methodology for allocating CD ROM development costs (\$181,000), combined with Systems Development (\$141,000) and International R&D (\$106,000) pools being under plan. The CD ROM development costs are allocated to the various channels based upon their planned relative percentage of total CD ROM commodity revenue. Subsequent to finalization of the plan for FY'88, revenue generated by the EIKON joint venture was determined to belong to the CD ROM channel instead of International OEM, as originally envisioned. As a result, International OEM channel receives less CD ROM commodity revenue and less allocation of CD ROM development costs than planned, while the opposite occurs in the CD ROM channel.

In summary, burdened operating income of \$8.3 million (57.4% of net revenues) against a planned \$2.7 million (30.7% of net revenues) produced a favorable variance of \$5.6 million. This positive effect results from a significant increase in net revenues (63.9%) without corresponding relative increases in expenses (0.8%) since very few variable costs are associated with licensing revenue. Accordingly, 99.2% of the additional revenue flowed through to the channel's operating income line.

**Press**

The condensed burdened operating income statement for Press for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$1,809	100.0%	\$ 1,565	100.0%	\$ 244
Cost of revenues	822	45.4	626	40.0	196
Operating expenses	304	16.8	282	18.0	22
Allocations	673	37.2	620	39.6	53
Burdened operating income	\$ 10	0.6%	\$ 37	2.4%	\$ (27)

	Actual		Plan	
	Revenue (in thousands)	Percent	Revenue (in thousands)	Percent
MS DOS books (27 titles)	\$1,386	76.6%	\$1,112	71.0%
General books (30 titles)	191	10.6	372	23.8
Mac books (20 titles)	128	7.1	81	5.2
Foreign publishers	104	5.7	0	0.0
	<u>\$1,809</u>	<u>100.0%</u>	<u>\$1,565</u>	<u>100.0%</u>

In terms of revenue generation, exclusive of foreign publishing revenues, the division's leading titles (compared with plan) for the quarter were as follows:

	Actual		Plan	
	Units	Revenue (in thousands)	Units	Revenue (in thousands)
Running MS DOS, 2nd Ed	38,497	\$ 431	40,700	\$ 461
Norton's Programmer's Guide	36,022	193	13,000	134
Supercharging MS DOS	15,677	175	14,750	144
Word Processing Power, 2nd Ed	10,313	101	3,075	32
Excel In Business	4,958	59	2,850	34
MS QuickBasic	5,334	57	2,350	23
Proficient C	5,930	55	2,650	31
Appleworks	3,997	38	6,500	64
Pursuit of Growth	3,633	32	6,500	60
Flying Flight Simulator	5,405	27	10,000	51
		<u>\$1,168</u>		<u>\$1,034</u>
Percent of net revenues		<u>64.6%</u>		<u>66.1%</u>

Press net revenues of \$1.8 million exceeded plan by \$244,000, creating a favorable variance of 15.6%. Contributing to this positive variance was \$104,000 in unbudgeted revenue from foreign publishers. This foreign revenue represents sales of translated Microsoft Press titles for the six month period ending June 30, 1987. The balance of the variance was primarily due to higher than anticipated sales of the top four selling titles. These titles, excluding foreign publisher sales, contributed \$900,000 (49.8%) of revenue, as compared to plan of \$771,000 (49.3%). The remaining 73 titles produced \$805,000 compared to plan of \$794,000. Only two titles, forecast to generate revenue of \$56,000 remained unpublished.

Actual cost of revenues was 45.4% of net revenues compared with a plan of 40.0%. Product costs (material, labor and overhead) as a percentage of net revenues were 17.9% compared with a plan of 15.8%. Product costs for several titles were higher than anticipated which resulted in this unfavorable variance. All other items included in costs of revenues (inventory valuations adjustments, royalties, distribution costs and other) totaled 27.5% of net revenues compared with a plan of 24.2%. This variance is due to higher than anticipated distribution fees, an unbudgeted inventory adjustment resulting from changes in standard cost,

and higher than anticipated freight costs.

Operating expenses at \$304,000 were slightly higher than plan of \$282,000 but were lower as a percentage of revenue (16.8% compared to plan of 18.0%). The only significant favorable variance was recorded in advertising (\$22,000).

Allocations to the Press channel were \$673,000 against plan of \$620,000. The unfavorable variance was a result of higher than anticipated book development expenses.

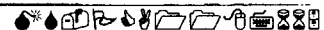
In summary, Press' burdened operating income of \$10,000 resulted in a shortfall of \$27,000 against a planned operating income of \$37,000. This variance can be attributed to the unfavorable ratio of cost of revenues to net revenues (45.4% versus a planned 40.0%) and the unfavorable variance in allocated book development expenses.

**CD ROM**

The condensed burdened operating income statement for CD ROM for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$ 251	100.0%	\$ 250	100.0%	\$ 1
Cost of revenues	-	-	-	-	-
Operating expenses	193	76.9	251	100.4	58
Allocations	456	181.7	190	76.0	(266)
Burdened operating loss	<u>\$(398)</u>	<u>(158.6)%</u>	<u>\$191</u>	<u>(76.4)%</u>	<u>\$(207)</u>

The CD ROM channel receives credit for revenue generated by Beta Partner Agreements and the EIKON joint venture. Revenues of \$251,000 were generated by the Beta Partner Agreements for the development of customized CD ROM applications with US West (\$125,000) and Triatex (\$125,000). The favorable \$58,000 variance in operating expenses was primarily due to payroll, recruiting and travel & entertainment expenses below planned levels. The negative \$266,000 variance in allocated expenses resulted from the CD ROM Development pool exceeding plan combined with the unfavorable effect of a change in methodology for allocating CD ROM development costs. The CD ROM development costs are allocated to the various channels based upon their planned relative percentage of total CD ROM commodity revenue. Subsequent to finalization of the plan for FY'88, revenue generated by the EIKON joint venture was determined to belong to the CD ROM channel instead of International OEM, as originally envisioned. As a result, CD ROM channel receives more CD ROM commodity revenue and more allocation of CD ROM development costs than planned, while the opposite occurs in the International OEM channel. The net effect was a burdened operating loss of \$398,000 compared with a planned loss of \$191,000.





Product Support Services (PSS)

The condensed burdened operating income statement for PSS for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$ 1,392	100.0%	\$2,735	100.0%	\$(1,343)
Cost of revenues	592	42.5	747	27.3	155
Operating expenses	2,096	150.6	2,230	81.5	134
Allocations	(1,161)	(83.4)	(1,247)	(45.5)	(86)
Burdened operating loss	\$ (135)	(9.7)%	\$1,005	36.7%	\$ (1,140)

PSS net revenues by commodity were as follows (in thousands):

	Actual		Plan		Variance
Hardware	\$ -	-%	\$ 5	0.2%	\$ (5)
Languages	49	3.5	85	3.1	(36)
Network	1	0.1	22	0.8	(21)
CD ROM	1	0.1	33	1.2	(32)
Systems	1,322	95.0	2,068	75.6	(746)
Applications	11	0.8	306	11.2	(295)
Xenix	8	0.5	216	7.9	(208)
	\$1,392	100.0%	\$2,735	100.0%	\$(1,343)

The Product Support Services (PSS) channel generates revenue through Microsoft University (MSU), which provides training seminars on a wide range of Microsoft products, and through its on-line technical assistance subscription service (DIAL).

The negative variance in net revenues (\$1.3 million) is primarily due to OS/2 SDK seminar attendance running significantly below planned levels (\$741,000 versus \$2 million). DIAL subscription sales are also below plan, but at a more modest level. The favorable \$155,000 variance in cost of revenues is also associated with the low OS/2 seminar attendance. Additionally, one of the planned seminars did not materialize.

The favorable operating expense variance of \$134,000 was principally the result of travel & entertainment and facilities expenses being under plan by \$60,000 and \$89,000, respectively. Expenses incurred by the channel are allocated to US Sales and Domestic OEM based upon perceived benefit received. The negative \$86,000 variance in allocated expenses is the result of operating expenses being under plan, consequently, fewer dollars were available for allocation to the other channels.

The negative variances in revenue and allocated expenses were only partially offset by the impact of the favorable cost of revenues and operating expenses, resulting in a burdened operating loss of \$135,000 which is \$1.1 million, or 103.2% under plan.

**MS Systems Journal**

The condensed burdened operating income statement for MS Systems Journal channel for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$ 478	100.0%	\$ 658	100.0%	\$ (180)
Cost of revenues	109	22.7	186	28.3	77
Operating expenses	177	36.9	143	21.7	(34)
Allocations	292	61.2	192	29.2	(100)
Burdened operating income	\$ (100)	(20.8)%	\$ 137	20.8%	\$ (237)

Total MS Systems Journal net revenue was \$180,000 below plan of \$658,000. This was primarily a result of timing differences in the anticipated collection of subscription payments from subscribers. (Systems Journal is on a cash basis for reporting revenues). Both issues published during the quarter, July/August and September/October were distributed later than anticipated which negatively impacted the collection of revenue. The subscriber list continued to grow during the quarter and reached a total of just over 33,000 by the end of the quarter.

Actual cost of revenues at \$109,000 was 22.7% of net revenues compared against a plan of \$186,000 (28.3%). This favorable variance was a result of lower than anticipated printing costs of the September issue, also costs for the July issue were incurred and expensed in FY 87.

Operating expenses at \$177,000 were higher than plan of \$143,000. The most significant variances related directly to mailing and marketing expenses of a special promotional piece and totaled \$32,000.

Allocations to the Systems Journal channel were \$292,000 against a planned \$192,000. MS Systems Journal development costs allocated to the Systems Journal channel were \$284,000 against a planned \$180,000. Overruns in administrative services (\$50,000), supplies (\$23,000), marketing (\$19,000), postage (\$17,000) and third-party product development (\$15,000) were slightly offset by positive variances in professional fees (\$13,000) and rent and utilities (\$9,000).

In summary, the burdened operating loss of \$100,000 against a planned burdened operating income of \$137,000 produced an unfavorable variance of \$237,000. This variance was primarily due to lower revenues and greater than anticipated allocation of development expenses.

**Commodity Reporting**

The contribution (actual and plan) on a commodity basis to net revenues and income from operations for Q88-1 follows (amounts in thousands):

Net Revenues	Actual		Plan		Variance
		Percentage		Percentage	Percentage
Books	\$ 2,165	2.1%	\$ 1,754	2.1%	23.4
Hardware	9,675	9.4	9,729	11.5	(0.6)
CD Consumer	-	-	-	-	-
MS Systems Journal	478	0.5	658	0.8	(27.5)
Languages	9,641	9.4	9,568	11.3	0.8
Network	348	0.3	263	0.3	32.3
CD ROM	460	0.5	631	0.8	(27.1)
Systems	37,272	36.3	24,907	29.5	49.6
Applications	40,312	39.3	35,128	41.6	14.8
Xenix	2,285	2.2	1,782	2.1	28.2
Total	<u>\$102,636</u>	<u>100.0%</u>	<u>\$84,420</u>	<u>100.0%</u>	21.6

Burdened Operating Income (Loss)	Percentage Total Revenue Variance			Percentage Total Revenue			
Books	\$ 84	0.3	3.9	32	0.2	1.8	162.5
Hardware	802	2.5	8.3	668	4.6	6.9	20.1
CD Consumer	(124)	(0.4)	-	(390)	(2.7)	-	68.2
MS Systems Journal	(100)	(0.3)	(20.8)	137	0.9	20.8	(173.0)
Languages	1,373	4.2	14.2	1,041	7.2	10.9	31.9
Network	(365)	(1.1)	(104.9)	(530)	(3.8)	(209.2)	33.6
CD ROM	(694)	(2.2)	(150.8)	(561)	(3.9)	(88.9)	(23.7)
Systems	22,482	69.6	60.3	10,758	74.2	43.2	109.0
Applications	8,231	25.5	20.4	3,097	21.4	8.8	165.8
Xenix	658	2.0	28.8	273	1.9	15.4	141.0
Unallocated	(37)	(0.1)	-	(2)	-	-	-
Total	<u>\$32,310</u>	<u>100.0</u>	<u>31.5</u>	<u>\$14,503</u>	<u>100.0</u>	<u>17.2</u>	<u>122.8</u>

**Books**

The condensed burdened operating income statement for Books for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$2,165	100.0%	\$1,754	100.0%	\$ 411
Cost of revenues	965	44.5	695	39.6	(270)
Operating expenses	926	42.8	837	47.7	(89)
Allocations	190	8.8	190	10.8	0
Burdened operating income	\$ 84	3.9%	\$ 32	1.8%	\$ 52

Books revenues by channel of distribution were as follows (in thousands):

	Actual		Plan		Variance
USSMD	\$ 306	14.2%	\$ 195	11.1%	\$ 111
Domestic OEM	1	0.0	-	-	1
International Retail	54	2.5	-	-	54
Press	1,816	83.9	1,565	89.2	251
Discounts and rebates	(12)	(0.6)	(6)	(0.3)	(6)
	\$2,165	100.0%	\$1,754	100.0%	\$ 411

Net revenues for Q88-1 at \$2.2 million were 23.4% above plan of \$1.8 million. All channels recorded positive variances from plan. The USSMD channel was the percentage leader with sales of \$306,000 against a plan of \$195,000, a 56.9% increase. The Press channel also exceeded plan with \$1.8 million against a plan of \$1.6 million. Contributing to the favorable variance in the Press channel was \$104,000 in unbudgeted revenue from foreign publishers. This foreign publishers revenue represents sales of translated Microsoft Press titles for the six-month period ending June 30, 1987. Revenue from the remaining channels was unbudgeted. The hottest selling title continued to be *Running MS DOS, 2nd Edition*, which, with sales of \$559,000 contributed 25.8% of the total book revenue during the quarter. In the US Sales channel, sales of companion disks to five titles earned revenue of \$52,000.

Actual cost of revenues was 44.5% of net revenues compared with a plan of 39.6%. Product costs (material, labor and overhead) as a percentage of net revenues were 17.6% compared with a plan of 15.8%. Product costs for several titles were higher than anticipated which resulted in this unfavorable variance. All other items included in costs of revenues (inventory valuation adjustments, royalties, distribution costs and other) totaled 26.9% of net revenues compared with a plan of 23.8%. This variance is due to higher than anticipated distribution fees, an unbudgeted inventory adjustment resulting from changes in standard costs, and higher than anticipated freight costs.

Operating expenses totaled \$926,000 against plan of \$837,000 but, as a percentage of revenues were 42.8% compared to a plan of 47.7%. Notable unfavorable variances were seen in third-party product development (\$42,000), travel and entertainment (\$23,000) and supplies and equipment (\$16,000). These variances were slightly offset by a positive variance in advertising (\$22,000). A factor in the third-party product development variance was higher than anticipated expenses in the development of the *Technical Reference Encyclopedia*. Allocations to the Book commodity were in line with plan of \$190,000, but were a smaller percentage of net revenues at 8.8% compared to a planned 10.8%.

In summary, burdened operating income of \$84,000 exceeded plan of \$32,000 by \$52,000. A fairly significant favorable variance in revenues (\$411,000) was all but eaten up by overruns in cost of revenues (\$270,000) and operating expenses (\$89,000).

**Hardware**

The condensed burdened operating income statement for Hardware for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$ 9,675	100.0%	\$ 9,729	100.0%	\$ (54)
Cost of revenues	4,976	51.4	4,729	48.6	(247)
Operating expenses	1,011	10.5	1,371	14.1	360
Allocations	2,886	29.8	2,961	30.4	75
Burdened operating income	\$ 802	8.3%	\$ 668	6.9%	\$ 134

Hardware revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
USSMD	\$3,811	39.4%	\$6,836	70.3%	\$ (3,025)
International Retail	5,814	60.1	3,088	31.7	2,726
Domestic OEM	227	2.3	5	0.1	222
International OEM	-	-	-	-	-
Product Support Services	-	-	5	0.1	(5)
Discounts and rebates	(1,777)	(1.8)	(205)	(2.1)	28
	\$9,675	100.0%	\$9,729	100.0%	\$ (54)

In terms of revenue generation, Hardware's leading products (compared with plan) for the quarter were as follows (dollars in thousands):

	Actual		Plan		Variance
	Units	Dollars	Units	Dollars	
Bus Mouse	37,748	\$3,569	28,439	\$2,816	\$ 753
Serial Mouse	31,870	3,614	20,369	2,241	1,373
White (New) Mouse	20,119	1,637	42,561	3,860	(2,223)
Import Mouse	218	12	13,579	43	(31)
Subtotal Mice	89,955	8,832	104,948	8,960	(128)
Mach 20	-	-	4,181	966	(966)
Mach 10	518	99	-	-	99
EasyCAD	7,585	376	-	-	376
Other - net of discounts	-	368	-	(197)	565
		\$9,675		\$9,729	\$ (54)

Several new hardware products were announced during Q88-1. The new MS White Mouse was introduced in a variety of mouse and software combinations for both Bus and Serial versions. Shipment of the new mouse was limited due to pending release of bundled software, availability of certain raw materials, and quality problems relating to the Smart Mouse Adapter cable. This contributed to a backlog of 28,030 mice totaling \$2.3 million at the end of Q88-1. Also announced during Q88-1 was the Mach 20 Performance Enhancement System. This did not begin shipping during Q88-1, as originally forecasted, resulting in an unfavorable variance of \$966,000. Shipment of the Mach 20 is currently expected to start during the last week of October. EasyCAD is a computer aided drafting program that Microsoft began marketing both separately and with mice. A special promotional offer was made to existing MS Mouse owners allowing them to purchase EasyCAD for \$50. In conjunction with this offer, a royalty of \$26.64 per unit was paid to Evolution Computing, the developers of EasyCAD, which totaled approximately \$200,000 for Q88-1. While USSMD were \$3.0 million below forecast, this shortfall was nearly offset by International Retail sales which were \$2.7 above plan.

Cost of revenues totaling \$5.0 million were \$247,000 above plan. As a percentage of sales, cost of revenues were 51.4% versus a plan of 48.6%. Product costs (material, labor and overhead) as a percentage

of net revenues were 37.8% compared with a plan of 40.6%. All other items included in cost of revenues (inventory valuation adjustments, royalties, distribution costs, and other) as a percentage of net revenues were 13.6% compared with a plan of 8.0%. This is primarily due to royalties and initial tooling charges for the new mice. The \$200,000 EasyCAD royalty payments noted above were not forecast and resulted in a 2.2% variance. An additional 2.5% unfavorable variance was due to tooling charges of a \$239,000.

Hardware operating expenses during Q88-1 were \$1.0 million against a planned \$1.4 million (10.4% of net revenues compared to a budgeted 14.1%). Notable favorable variances occurred in hardware advertising expenditures where actuals of \$173,000 were under a planned \$372,000 by \$199,000. Marketing expenses also were under plan with actuals of \$114,000 against a planned \$333,000. These favorable variances were due to delays in the introduction of new Mouse versions and Mach 20. However, public relations and trade show expenditures of \$176,000 were \$87,000 over a planned \$89,000. Of the actual Q88-1 public relations and trade show expenses, \$100,000 related to Hardware's participation in the Fall Rollout (also known as Microsoft University).

Allocations to Hardware were \$75,000 under a planned \$3 million. The allocation of International Retail's expenses produced most of this favorable variance with actuals of \$768,000 against a budgeted \$824,000. This was due to a lower than planned allocation cost pool within International Retail.

Q88-1 burdened operating income for Hardware was \$802,000 against a planned \$668,000 resulting in a favorable variance of \$134,000. Net revenues at \$54,000 under plan, and an unfavorable ratio of cost of sales to net revenues (51.4% against a planned 48.6%), both unfavorably effected Q88-1 results. However, favorable variances in operating expenses (primarily advertising and marketing) and allocations combined to produce this positive income result.

**Languages**

The condensed burdened operating income statement for Languages for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$9,641	100.0%	\$9,568	100.0%	\$ 73
Cost of revenues	2,223	23.1	1,849	19.3	(374)
Operating expenses	2,928	30.4	3,530	36.9	602
Allocations	3,117	32.3	3,148	32.9	31
Burdened operating income	\$1,373	14.2%	\$1,041	10.9%	\$ 332

Languages revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
USSMD	\$4,951	51.4%	\$6,279	65.6%	\$ (1,328)
International Retail	3,809	39.5	2,640	27.6	1,169
Domestic OEM	621	6.4	449	4.7	172
International OEM	403	4.2	418	4.4	(15)
Product Support	49	0.5	85	0.9	(36)
Discounts and rebates	(192)	(2.0)	(303)	(3.2)	111
	\$9,641	100.0%	\$9,568	100.0%	\$ 73

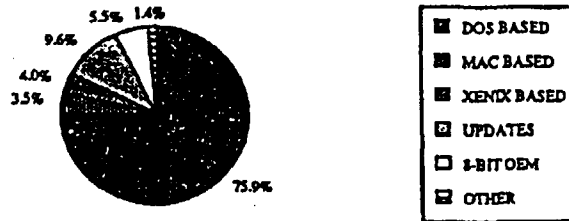
Net revenues for Q88-1 at \$9.6 million were \$73,000 above plan. In comparison to the prior quarter, revenues decreased 24.3% from \$12.7 million in Q87-4. OEM license and package product activity decreased by 57.6% and 18.3%, respectively. In terms of revenue generation, the commodity's leading products (compared with plan) for the quarter were as follows:

Q88-1	Q87-4		Actual		Plan	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	C Compiler (DOS)	9,956	\$ 2,468	11,901	\$ 2,772
2	4	Macro Assembler	16,651	1,271	19,191	1,118
3	2	Fortran (DOS)	6,819	1,269	6,364	1,427
4	3	QuickBasic (DOS)	21,836	1,181	20,000	1,051
5	5	Cobol	1,842	533	13,615	768
				\$ 6,722		\$ 7,136
Percentage of net revenues				69.7%		74.6%

The top 5 Language products have remained relatively consistent throughout the last several quarters. As usual, C Compiler is in the No. 1 position generating 25.6% of total net revenues. Macro Assembler advanced to the No. 2 position with the release of version 5.0 in late August. Cobol narrowly out-sold Basic (8-Bit OEM) to remain in the No. 5 position.

The unfavorable USSMD variance of \$1.3 million was due primarily to the delayed release of C Compiler version 5.0 and Quick C as originally forecasted. Despite these delays, International Retail sales of C Compiler exceeded plan by \$508,000. Combined with favorable Language Update sales of \$237,000, these two factors account for the majority of \$1.1 million favorable variance of International Retail sales.

**LANGUAGE REVENUE BY OPERATING ENVIRONMENT**



The Language commodity's product sales mix by operating environment has remained fairly consistent over the last several quarters. DOS-based sales decreased slightly from 78.3% in the previous quarter to 75.9% in Q88-1. Despite a significant drop in total OEM sales, 8-Bit OEM sales as a percentage of total Language commodity sales has increased from 2.2% to 5.5% in Q88-1.

Cost of revenues totaling \$2.2 million were 20.2% above a plan of \$1.8 million. As a percentage of sales, cost of revenues was 23.1% against a planned 19.3%. Product costs (material, labor and overhead) as a percentage of net revenues were 17.1% compared with a plan of 14.0%. This variance is the result of channel mix (more International Retail with higher product cost) and product mix. All other items included in cost of revenues (inventory valuation adjustments, royalties, distribution costs, and other) as a percentage of net revenues were 6.0% compared with a plan of 5.3%.

Operating expenses during Q88-1 for the Languages commodity were \$2.9 million against a planned \$3.5 million, creating a \$600,000 favorable variance. As a percentage of net revenues, these operating expenses were 30.4% as compared to a plan of 36.9%. Lower than planned third-party product development expenditures resulted in underspending of \$338,000. Planned expenditures for purchased code were deferred to subsequent quarters, some of which are currently planned for Q88-2. Marketing expenditures were also under a planned \$431,000 by \$282,000, a variance caused primarily by product slippage (Quick C and C version 5). QB-4 was also released relatively late in the quarter before any significant marketing expenditures could be incurred. Languages participation in the Fall Rollout (also known as Microsoft University) was limited to \$25,000.

Allocations to the Languages commodity totaled \$3.1 million, resulting in a variance of only \$31,000. Of note was a \$44,000 positive variance resulting from lower than planned International Retail allocations. Other allocation variances were insignificant.

Burdened operating income for Languages was \$1.4 million compared to a plan of \$1.0 million. Net revenues approximated plan (actuals of \$9.64 million against a planned \$9.57 million), while cost of revenues as a percentage of net revenues was 23.1% versus a plan of 19.3%. The most significant factor contributing to the positive Languages income variance was the favorable variance in operating expenses (\$2.9 million against a planned \$3.5 million).



**Networks**

The condensed burdened operating income statement for Networks for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$348	100.0%	\$263	100.0%	\$ 85
Cost of revenues	-	-	6	2.3	6
Operating expenses	578	166.1	670	254.8	92
Allocations	135	38.8	137	52.1	2
Burdened operating loss	<u>\$365</u>	<u>(104.9)%</u>	<u>\$550</u>	<u>(209.2)%</u>	<u>\$185</u>

Networks net revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
Domestic OEM	\$275	79.0%	\$155	58.9%	\$120
International OEM	72	20.7	86	32.7	(14)
Product Support	1	0.3	22	8.4	(21)
	<u>\$348</u>	<u>100.0%</u>	<u>\$263</u>	<u>100.0%</u>	<u>\$ 85</u>

Networks revenue exceeded plan by \$85,000 as a net result of a favorable volume variance from Domestic OEM (23,100 units versus 12,200 units, or \$120,000) and an unfavorable variance from International OEM (3,600 units versus 5,200 units, or \$14,000). The Domestic OEM figure includes \$48,000 in previously unreported revenue from AT&T and Hewlett Packard. Other significant customers were 3 Com (\$63,000), Ungermann Bass (\$59,000) and DEC (\$22,000).

No cost of revenues was recorded since all of the revenue was royalty related. The positive operating expense variance was due to actual advertising and trade show expenses below plan. Allocations from the support and sales groups at \$135,000, varied by only \$2,000 from plan.

The positive results in all categories yielded a burdened operating loss of \$365,000 compared with a plan burdened operating loss of \$550,000. Networks is planned to incur burdened operating losses of between \$500,000 and \$600,000 each quarter of FY '88.

**CD ROM**

The condensed burdened operating income statement for CD ROM for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$460	100.0%	\$ 631	100.0%	\$(171)
Cost of revenues	83	18.0	86	13.6	3
Operating expenses	765	166.3	728	115.4	(37)
Allocations	306	66.5	378	59.9	72
Burdened operating loss	<u>\$(694)</u>	<u>(150.8)%</u>	<u>\$(561)</u>	<u>(88.9)%</u>	<u>\$(133)</u>

CD ROM net revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
USSMD	\$101	22.0%	\$ 75	11.9%	\$ 26
International Retail	18	3.9	-	-	18
Domestic OEM	93	20.2	261	41.4	(168)
International OEM	-	-	16	2.5	(16)
CD ROM	251	54.6	250	39.6	1
Product Support	1	0.2	33	5.2	(32)
Discounts and rebates	(4)	(0.9)	(4)	(0.6)	-
	<u>\$460</u>	<u>100.0%</u>	<u>\$631</u>	<u>100.0%</u>	<u>\$(171)</u>

The CD ROM channel handles the Beta Partner Agreements and the EIKON joint venture. Domestic OEM receives credit for sales of Bookshelf to Amdek, while retail Bookshelf is distributed through both US Sales and International Retail. MS-DOS Extensions are marketed by both Domestic OEM and International OEM.

In terms of revenue generation, the CD ROM commodity leading products (compared with plan) for the quarter were as follows:

Current Quarter	Prior Quarter		Actual		Plan	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	-	Beta Partner Agreements	2	\$251	2	\$250
2	-	Bookshelf	1,714	206	3,500	336
3	-	MS-DOS Extensions	100	1	6,500	16
				<u>\$458</u>		<u>\$602</u>
		Percent of net revenues		<u>99.6%</u>		<u>95.4%</u>

CD ROM revenues were under plan by \$171,000. Contributing factors were the delay in the availability of packaged Bookshelf for the Domestic OEM channel (Amdek shortfall of \$174,000), lower than anticipated MS-DOS Extensions licensing revenue from the International OEM channel (\$16,000) and fewer CD ROM related Product Support seminars (\$32,000), partially offset by higher volume sales of Bookshelf through the U.S. Sales (\$26,000) and International Retail (\$18,000) channels. The CD ROM channel revenue was right on plan with \$251,000 associated with the Beta Partner agreements for the development of custom CD ROM applications for US West and Trintex.

The lower volume of packaged product sales did create a favorable \$29,000 variance in direct costs, but this was essentially negated by an unfavorable impact in "other" costs, resulting in the net favorable cost of revenues variance of only \$3,000. Employee recruiting expenses were \$36,000 below plan, but this was offset by excess supplies & equipment (\$34,000) and facilities (\$32,000) expenses, with the net result of an unfavorable operating expense of \$37,000. The favorable \$72,000 allocations variance was primarily due to a lower allocation from the International OEM channel.

As a result of the revenue shortfall, CD ROM commodity incurred a burdened operating loss of \$694,000 compared with a planned loss of \$561,000.

**Systems**

The condensed burdened operating income statement for Systems for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$37,272	100.0%	\$24,907	100.0%	\$12,365
Cost of revenues	3,143	8.4	2,267	9.1	(876)
Operating expenses	5,126	13.8	5,629	22.6	503
Allocations	6,521	17.5	6,253	25.1	(268)
Burdened operating income	\$22,482	60.3%	\$10,758	43.2%	\$11,724

Systems net revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
USSMD	\$ 983	2.6%	\$ 1,656	6.7%	(673)
International Retail	4,331	11.6	2,301	9.2	2,030
Domestic OEM	17,927	48.1	11,439	45.9	6,488
International OEM	12,775	34.3	7,526	30.2	5,249
Product Support	1,322	3.5	2,068	8.3	(746)
Discounts and rebates	(66)	(0.1)	(83)	(0.3)	17
	\$37,272	100.0%	\$24,907	100.0%	\$12,365

In terms of revenue generation, the Systems commodity leading products (compared with plan) for the quarter were as follows:

Current Quarter	Prior Quarter		Actual		Plan	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	MS-DOS/GW-Basic	1,406,441	\$24,871	1,128,842	\$18,873
2	2	Windows (includes ISV Kits)	246,812	4,945	104,891	3,761
3	-	Windows 386	27,265	423	1,550	81
				\$30,239		\$22,715
Percent of net revenues*				81.1%		91.2%

\*GAAP and UPB, as quantified on the following page, account for a majority of the remainder of Systems revenue.

Table of significant Domestic OEM Systems customers, by product (in thousands):

	MS-DOS		Windows/Windows 386		Other		Total	
	\$	%	\$	%	\$	%	\$	%
Zenith	\$2,292	18.5%	\$ 377	19.8%	\$ -	-%	\$2,669	14.9%
Compaq	1,375	11.1	395*	20.7	15*	0.4	1,785	10.0
AT&T	850	6.9	594	31.1	3	0.1	1,447	8.1
Tandon	673	5.4	55	2.9	-	-	728	4.1
Patterson Labs	607*	4.9	-	-	-	-	607	3.4
IBM	340	2.7	250	13.1	-	-	590	3.3
Wyc	530	4.3	-	-	-	-	530	3.0
Teody	514	4.2	10*	0.5	-	-	524	2.9
Commodore	463	3.7	-	-	-	-	463	2.6
NCR	440	3.6	-	-	2*	0.1	442	2.5
Kaypro	312	2.5	-	-	-	-	312	1.7
Wang	226	1.8	71*	3.7	9*	0.2	306	1.7
PC's Ltd.	281*	2.3	-	-	-	-	281	1.6
Alloy	279	2.3	-	-	-	-	279	1.6
AST Research	277	2.2	-	-	-	-	277	1.5
Convergent	263	2.1	-	-	-	-	263	1.5
GAAP Adjustment	-	-	-	-	2,400	65.8	2,400	13.4
UPB Allocations	-	-	-	-	1,243	34.1	1,243	6.9
Other Customers	2,650	21.5	155	8.2	(78)*	(0.7)	2,781	15.3
Total	\$12,372	100.0%	\$1,907	100.0%	\$3,648	100.0%	\$17,927	100.0%
Licensing	\$10,457	84.5%	\$1,381	72.4%	\$ 5	0.1%	\$11,843	66.1%
Packaged Product	1,915	15.5	526	27.6	-	-	2,441	13.6
GAAP and UPB	-	-	-	-	3,643	99.9	3,643	20.3
Total	\$12,372	100.0%	\$1,907	100.0%	\$3,648	100.0%	\$17,927	100.0%
Plan	\$10,231		\$ 849		\$ 359		\$11,439	

\*Primarily packaged product

Table of significant International OEM Systems customers, by product (in thousands):

	MS-DOS		Windows/Windows 386		Other		Total	
	\$	%	\$	%	\$	%	\$	%
Hitachi	\$1,522	15.4%	\$ 3	0.3%	\$ -	-%	\$ 1,525	11.9%
Olivetti	844	8.5	562	47.5	-	-	1,406	11.0
Daewoo	642	6.5	-	-	-	-	642	5.0
Bull S.A.	585	5.9	9	0.8	-	-	594	4.6
Toshiba	564	5.7	-	-	-	-	564	4.4
Ericsson	302	3.1	202	17.0	-	-	504	3.9
Multitech	436	4.4	-	-	-	-	436	3.4
Gold Star	412	4.2	-	-	-	-	412	3.2
Sanyo	375	3.8	-	-	-	-	375	2.9
Epson	329	3.3	-	-	-	-	329	2.6
Copam	305	3.1	-	-	-	-	305	2.4
Tulip	130	1.3	123	10.4	-	-	253	2.0
GAAP Adjustment	-	-	-	-	200	11.8	200	1.6
UPB Allocations	-	-	-	-	1,500	88.2	1,500	11.7
Other Customers	3,445	34.8	285	24.0	-	-	3,730	29.4
Total	\$9,891	100.0%	\$1,184	100.0%	\$1,700	100.0%	\$12,775	100.0%
Plan	\$7,796		\$ 258		\$ (468)		\$ 7,526	

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The Systems commodity benefited most from the overall favorable PC market conditions. Net revenues were \$37.3 million, \$12.4 million or 50% over the planned \$24.9 million. The Domestic OEM channel contributed \$6.5 million toward the variance, primarily due to positive volume variances from MS-DOS (\$2.1 million), Windows (\$644,000) and Windows 386 (\$342,000). This was combined with the \$2.4 million GAAP Adjustment and a \$1 million favorable UPB variance which is credited to Systems. The International OEM channel contributed another \$5.2 million, also due to favorable volume variances from MS-DOS (\$2.1 million) and Windows (\$900,000), coupled with a \$2 million favorable UPB variance and the \$200,000 GAAP Adjustment. International Retail sold 291% of its planned packaged MS-DOS volume, thus generating an additional \$1.7 million in revenue variance. These positive factors were partially offset by negative volume variance from US Sales (Windows - \$657,000) and Product Support which was \$746,000 below plan as a result of lower than expected OS/2 seminar revenue.

The unfavorable cost of revenues resulted from the higher level of packaged MS-DOS, Windows and Windows 386 sales, although the greater mix of high-margin licensing revenue kept the overall cost of revenues below plan on a percent of revenue basis (8.4% versus 9.1%). Operating expenses were positively impacted by lower advertising and third-party product development costs (\$755,000), partially offset by an unfavorable variance in public relations and trade shows (\$227,000). Allocations from International OEM at \$2.4 million, compared with a planned \$2.1 million, produced an unfavorable variance of \$268,000 or 12.7%. This allocation variance results because direct expenses of the International OEM sales force were over budget by 10.5%.

The strong revenue performance and favorable operating expense variance, offset only slightly by the negative impact of cost of revenues and allocations, resulted in a burdened operating income of \$22.5 million, 109% over plan.

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**Applications**

The condensed burdened operating income statement for Applications for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$40,312	100.0%	\$35,128	100.0%	\$5,184
Cost of revenues	9,405	23.3	8,552	24.3	(853)
Operating expenses	9,505	23.6	9,940	28.3	435
Allocations	13,171	32.7	13,539	38.6	368
Burdened operating income	\$ 8,231	20.4%	\$ 3,097	8.8%	\$5,134

Applications net revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
USSMD	\$21,487	53.3%	\$18,583	52.9%	\$2,904
International Retail	17,939	44.5	15,066	42.9	2,873
Domestic OEM	1,193	3.0	1,858	5.3	(665)
International OEM	394	1.0	269	0.7	125
Product Support Sales	11	-	306	0.9	(295)
Discounts and rebates	(712)	(1.8)	(954)	(2.7)	242
	<u>\$40,312</u>	<u>100.0%</u>	<u>\$35,128</u>	<u>100.0%</u>	<u>\$5,184</u>

Net revenues for Q88-1 at \$40.3 million were 14.8% above plan of \$35.1 million. The current quarter, once again, was a record revenue quarter for this product group, surpassing the \$37.3 million recorded in the preceding quarter. In terms of revenue generation, the unit's ten leading products (compared with plan) for the quarter were as follows:

This Qtr	Prior Qtr		Actual		Plan	
			Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	8	Mac Word	62,124	\$ 9,851	35,968	\$ 6,564
2	1	PC Word	37,683	8,202	47,394	9,851
3	2	Mac Excel	35,470	6,347	23,011	4,640
4	3	PC Multiplan	68,698	4,717	38,923	4,705
5	4	PC Chart	10,132	1,721	13,549	1,923
6	5	Mac Works	11,603	1,618	14,142	2,106
7	6	PC Project	4,653	1,052	4,643	1,004
8	7	Mac Word Update	22,896	944	-	-
9	10	Learning DOS	28,400	688	21,588	507
10	-	RBase IBM	2,495	673	2,528	780
				<u>\$35,813</u>		<u>\$32,080</u>
		Percentage of net revenues		<u>88.8%</u>		<u>91.3%</u>

Mac Word moved to the No. 1 position from the prior quarter's No. 8 position with \$9.9 million in sales, a 50.1% increase over the plan of \$6.6 million. Higher than planned sales for both Mac Word and Mac Excel can be partially attributed to strong sales of the Macintosh computer. One financial analyst estimates that Apple shipped about 176,000 Macintoshes during the quarter, more than double last year's summer quarter.

International Retail out-stripped USSMD on PC Word at a ratio of 2 to 1, totaling 65.1% of the \$8.2 million for all PC Word sales. This was a direct result of delaying PC Word 4.0 in order to clear the USSMD channel of PC Word 3.11 as well as high domestic returns of PC Word during the quarter. In Q88-1, Microsoft KK released PC Multiplan 3.5 resulting in very strong sales. With \$1.7 million in sales, Japanese Multiplan comprised 36.9% of total PC Multiplan revenues.

The following table shows PC Applications versus Mac Applications by channel for Q88-1 (in thousands):

	USSMD		International Retail		Worldwide OEM		Total Q88-1		Total Q87-4
PC Apps	\$ 5,709	14.0%	\$12,804	31.4%	\$1,014	2.5%	\$19,527	47.9%	64.8%
Mac Apps	15,909	39.0	4,355	10.6	-	-	20,264	49.6	32.4
Other	61	0.1	777	1.9	180	0.4	1,015	2.5	2.8
	<u>\$21,681</u>	<u>53.1%</u>	<u>\$17,931</u>	<u>43.9%</u>	<u>\$1,194</u>	<u>2.9%</u>	<u>40,806</u>	<u>100.0%</u>	<u>100.0%</u>
Discounts and other							(494)		
Net revenue							<u>\$40,312</u>		

USSMD of PC Apps down-turned sharply, decreasing 45.4% from \$10.4 million in the prior quarter to \$5.7 million in Q88-1. In contrast to emphasis placed on promoting and selling PC based products, Mac Apps outsold PC Apps 2.8 to 1 in the USSMD channel. Conversely, in the International Retail channel, PC Apps outsold Mac Apps by a ratio of 2.9 to 1.

Cost of revenues of \$9.4 million was 10.0% over a planned \$8.6 million. The prime factor in this variance was the higher than anticipated overall net revenues. As a percentage of net revenues, cost of revenues was 23.3% against a planned 24.3%. Royalty expense, a component of cost of revenues, was \$932,000 (2.3% of net revenues) against a planned \$1.1 million (3.1% of net revenues). The decrease in royalty expense is primarily a result of decreased shipments of royalty bearing products. Shown below is an analysis of Applications royalty expense for Q88-1 (in thousands):

Product	Revenue	Royalty	Percent
Word	\$18,997	\$161	0.8
Works	1,618	258	15.9
Project	1,052	153	14.5
RBase	673	149	22.1
Flight Simulator	555	115	19.7
Other	585	96	16.4
	<u>\$23,480</u>	<u>\$932</u>	

Operating expenses totaled \$9.5 million against a planned \$9.9 million. As a percentage of net revenues, actual operating expenses were 23.6% against a planned 28.3%. The most significant unfavorable variance for the commodity was in the public relations and trade show area where actuals of \$1.5 million exceeded plan by \$850,000 (see the following discussion on advertising and marketing expenses). Other significant unfavorable variances appeared in the payroll and fringe area where actual expenditures of \$2 million overran a planned \$1.5 million by \$500,000. A major contributing factor to this cost overrun was severance payments made in connection with the Forethought acquisition. A smaller part of the variance came from payments to summer interns. Another unfavorable variance of \$184,000 occurred in the marketing fund and incentive programs, and is also discussed by the following advertising and marketing comments.

Advertising and marketing expenses of \$2.3 million against a planned \$4.7 million produced a favorable variance of \$2.4 million. These lower than planned expenditures were due to several factors. During Q88-1, much of the Applications advertising and marketing efforts centered around the Fall Rollout (also known as Microsoft University), which produced the unfavorable variance in the public relations and trade show area. This quasi-unbudgeted event, planned and administered by Channel Marketing, included visits to eight major U.S. cities. Microsoft dealers and selected national accounts were given training and hands-on exposure to products such as Word, PC Works and PC Excel. Microsoft University (MSU) was funded by a contribution of budgeted Applications advertising and marketing funds. Of a total MSU budget of \$1.3 million, Applications contributed \$950,000.

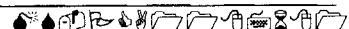
As noted in the USSMD channel discussion of operating expenses, on September 30th, there was \$584,000 of deferred Works Days advertising expenses. These expenses will be recognized in Q88-2, when the event occurs. This also contributed to the lower than planned Applications advertising and marketing expenditures. Advertising and marketing expense levels were further affected by the slippage of introduction dates for several key products and the termination of our relationship with k/d/p.

As promotional efforts move toward such programs as the recently completed Spring Word War and the upcoming Fall Dealer Enterprise Campaign, as well as Works Days, more and more of the product marketing budget is committed to the marketing funds and other costs associated with these new channel related programs. This shift deemphasizes the more common print and media advertising efforts. These marketing funds and incentive programs are co-operative in nature and illustrate our increasing reliance on dealers to create marketing programs appropriate for their markets.

Allocations to Applications of \$13.2 million were \$300,000 under a planned \$13.5 million. Most of this positive variance can be traced to the unexpectedly low allocation from the International Retail channel where actuals of \$4.0 million were under a planned \$4.3 million by \$300,000. This was due to lower than planned operating expenses for Q88-1 in International Retail.

PowerPoint, the product acquired from Forethought, generated revenues of \$357,000 on sales of 1,960 units. Product costs, at \$9.33 per unit, were \$18,000. Total operating expenses for the graphics business unit for the quarter were \$992,000. This figure includes amortization of intellectual property rights of \$670,000 and severance payments of \$143,000.

In summary, Application's burdened operating income of \$8.2 million against a planned \$3.1 million produced a favorable variance of \$5.1 million. A \$5.2 million favorable net revenue variance did the trick as cost and expenses showed little variation from plan.





Xenix

The condensed burdened operating income statement for Xenix for Q88-1 follows (in thousands):

	Actual		Plan		Variance
Net revenues	\$2,285	100.0%	\$1,782	100.0%	\$503
Cost of revenues	707	30.9	530	29.7	(177)
Operating expenses	521	22.8	597	33.5	76
Allocations	392	17.5	382	21.4	(10)
Burdened operating income	\$ 658	28.8%	\$ 273	15.4%	\$385

Xenix net revenues by channel were as follows (in thousands):

	Actual		Plan		Variance
International Retail	\$ 3	0.1%	\$ -	-%	\$ 3
Domestic OEM	1,529	66.9	1,104	62.0	425
International OEM	745	32.6	462	25.9	283
Product Support	8	0.4	216	12.1	(208)
	\$2,285	100.0%	\$1,782	100.0%	\$503

Table of significant OEM Customers (in thousands):

	Actual		Plan		Variance
<b>DOMESTIC OEM</b>					
SCO	\$ 705	46.1%	\$ 440	39.8%	\$265
T.I.	223	14.6	115	10.4	108
Altos	198	12.9	228	20.7	(30)
Wang	129	8.4	107	9.7	22
Tandy	68	4.4	153	13.9	(85)
Lanier	60	3.9	-	-	60
Intel	51	3.3	60	5.4	(9)
Other	94	6.4	1	0.1	93
Total	\$1,529	100.0%	\$1,104	100.0%	\$425
<b>INTERNATIONAL OEM</b>					
Olivetti	\$541	72.6%	\$ 40	8.7%	\$501
Siemens	85	11.4	100	21.6	(15)
Fujitsu	30	4.0	160	34.6	(130)
Apricot	22	3.0	-	-	22
Other	67	9.0	162	35.1	(95)
Total	\$745	100.0%	\$462	100.0%	\$283

The Domestic OEM channel generated a \$425,000 favorable revenue variance, primarily due to greater than anticipated revenues from SCO (\$265,000) and T.I.(\$109,000). International OEM contributed an additional net \$283,000 positive variance (Olivetti positive \$501,000, Mitsubishi negative \$138,000 and Fujitsu negative \$130,000). The Olivetti variance is not expected to continue into future quarters. The customer is revising its Xenix strategy and will be utilizing SCO's version. The net effect should be a shift of related Xenix revenue from International OEM to Domestic OEM as SCO's volume increases. The Product Support channel shortfall resulted from fewer Xenix related courses taught than planned.

The excess in cost of revenues represents increased royalties and second sourcing (support) costs associated with the increase in revenue. Lower advertising/marketing and third-party product development expenses accounted for \$43,000 and \$32,000, respectively, of the \$76,000 favorable operating expense variance. The unfavorable allocations variance is the result of numerous insignificant amounts.

The positive effects of recorded revenue and favorable operating expense activity outweighed the negative impact in cost of revenues and allocations, producing a net operating income of \$658,000, 141% over plan.

### Allocations

The cost pools being allocated consist of support and development activities. The following schedule is a summary of each cost pool compared to plan for Q88-1 (in thousands):

	<u>Actual</u>	<u>Plan</u>	<u>Variance</u>	<u>Variance Percentage</u>
Corporate Administration	\$4,627	\$4,402	\$ (225)	(5.1)
Corpcom Overhead	1,057	1,009	(48)	(4.8)
Executive Support	186	332	146	44.0
Legal Support	519	425	(94)	(22.1)
Book Development	612	555	(57)	(10.3)
Hardware Development	481	435	(46)	(10.6)
CD Consumer Development	95	355	260	73.2
MS Journal Development	260	154	(106)	(68.8)
Language Development	1,780	1,788	8	0.4
Network Development	570	550	(20)	(3.6)
CD ROM Development	537	389	(148)	(38.0)
Systems Development	3,610	3,783	173	4.6
Applications Development	4,216	3,108	(1,108)	(35.6)
User Education	2,010	2,205	195	8.8
Xenix Development	446	491	45	9.2
International R&D	2,249	2,767	518	18.7

The support groups (Corporate Administration, Corpcom, Executive and Legal) are allocated to the sales and development groups based on perceived level of support. Individual commodity development costs are allocated to the sales channels based on who sells the developed products. For example, USSMD is budgeted to generate 59.9% of all revenue from language products. Accordingly, US Sales is allocated 59.9% of all language development costs. The following is an analysis of the significant variances between actual and plan for Q88-1 for the various support and development activities.

**Corporate Administration** - Corporate Administration's overall actual operating expenses were very close to plan with an unfavorable variance of only 5.1%. The unfavorable variance was composed of the following:

Payroll and payroll taxes	(121,000)
Employee fringes	298,000
Professional fees	161,000
Maintenance and repair	179,000
Supplies and equipment	(219,000)
Postage and freight	(176,000)
Rent and utilities	(217,000)
Depreciation and amortization	(174,000)
Taxes, licenses, settlements & insurance	(109,000)
Other insignificant items	153,000
	<u>(225,000)</u>

None of the variance items within the above categories are of a long-term nature or are significant enough to elaborate on.

**Corpcom Overhead** - The \$48,000 negative variance is primarily attributable to \$107,000 of unplanned public relations/trade shows activity. There is an additional \$76,000 unfavorable variance in professional fees for freelancers who aid in developing marketing materials. These negative variances are partially offset by positive variances in recruiting (\$60,000) and payroll (\$50,000).

**Executive Support** - The favorable variance of \$146,000 in this area is due primarily to the Board of Director's insurance planned at \$125,000. The insurance was planned but was not actually purchased. The remaining variances in the executive support area are of a noise level variety.

Legal Support - The \$94,000 unfavorable variance is primarily due to a planning oversight regarding the amortization of capitalized legal fees for trademarks.

Book Development - The \$57,000 unfavorable variance can primarily be attributed to third-party product development. Some of the significant titles in development are: Inventors at Work, Computer Library/Dream Machines, MS-DOS Technical Reference Encyclopedia, The Pursuit of Growth, Programming Windows, Soviet High-Tech Espionage, Working With Word, MS-DOS Encyclopedia, Programmer's Guide to PC & PS/2 Video Systems, Put MS Works to Work, and Inside MS OS-2.

Hardware Development - Third-party product development costs on the new mouse and the Mach 20 enhancement board are the primary elements in the \$46,000 unfavorable variance in Hardware.

CD Interactive Development - The \$260,000 favorable variance is comprised primarily of a \$199,000 favorable variance in third-party product development as activity in this area is lagging planned levels.

MS Systems Journal Development - The \$106,000 unfavorable variance is due to travel and entertainment (\$24,000 unfavorable variance) primarily due to contractor (Lazarus) billings for trips prior to July which were not received or paid until Q88-1. Administrative services had a \$42,000 unfavorable variance relating to payments for the systems journal management fee. Finally, supplies and equipment shows a \$26,000 unfavorable variance related to the purchase of furniture and supplies for the new facility in New York City.

Languages Development - The overall variance for Languages is less than 1%, and there are no mentionable variances.

Networks Development - The overall variance for Networks is less than 4%, and there are no significant variances.

CD ROM Development - The \$148,000 unfavorable variance is comprised primarily of a \$58,000 unfavorable variance in third-party product development. The excess expenditures are related to the current quarter release of Bookshelf. The remaining variances are relatively insignificant.

Systems Development - Systems shows an overall favorable variance of \$173,000. This is comprised primarily of \$111,000 of favorable variance in third-party product development and a \$86,000 favorable variance in market research. The plan for these areas is based upon the amount expected to be disbursed over the year. The yearly budget was then allocated ratably over the year, and the actual expenses are yet to be incurred.

Applications Development - The \$1,108,000 unfavorable variance in Applications is due primarily to the acquisition of Forethought. Forethought's total operating expenses (which were not planned) for Q88-1 were \$992,000. Most of this related to the amortization of the intellectual property rights acquired from Forethought (\$670,000). The remaining variance in Applications can be attributed to the product marketing unit (\$205,000) and the testing unit (\$118,000). The development unit had an overall positive variance of \$208,000.

User Education - The \$195,000 favorable variance is due primarily to two areas, employee recruiting (\$33,000) and third-party product development (\$99,000). Recruiting costs are planned ratably over the year and this quarter is typically slow for recruiting. The variance in third-party product development results from a lower than anticipated use of freelancers.

Xenix Development - A \$45,000 overall favorable variance is almost entirely due to third-party product development (\$32,000) activity being less than expected.

International Research & Development - A \$518,000 overall favorable variance is fueled primarily by the \$563,000 favorable variance in third-party product development (localization). This positive variance experience is not expected to continue throughout in the year as project activity increases compared with plan that was spread evenly throughout the year.

**RESULTS OF OPERATIONS**  
Compared With Competition

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**RESULTS OF OPERATIONS COMPARED WITH COMPETITION**

Consolidated statements of income for Microsoft, Lotus, and Ashton-Tate are presented below. The first set is for the three months ended September 30, 1987 (July 31, 1987 for Ashton-Tate). The second set is for the twelve months ended September 30, 1987 (July 31, 1987 for Ashton-Tate). Amounts are in thousands, except net income per share.

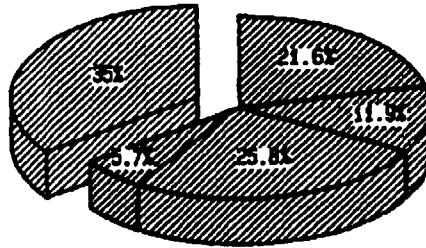
	Microsoft		Lotus		Ashton-Tate	
Net revenues	\$102,636	100.0%	\$101,199	100.0%	\$63,575	100.0%
Costs and expenses:						
Cost of revenues	21,625	21.1	16,753	16.6	11,140	17.5
Research and development	14,603	14.2	15,234	15.0	6,584	10.4
Sales and marketing	28,766	28.0	31,551	31.2	15,146	23.8
General and administrative	5,332	5.2	12,218	12.1	13,555	21.3
Total costs and expenses	70,326	68.5	75,756	74.9	46,425	73.0
Income from operations	32,310	31.5	25,443	25.1	17,150	27.0
Non-operating income	3,200	3.1	1,885	1.9	939	1.4
Stock option bonus expense	(3,021)	(3.0)	—	—	—	—
Income before income taxes	32,479	31.6	27,328	27.0	18,089	28.4
Provision for income taxes	11,220	10.9	8,198	8.1	7,951	12.5
<b>NET INCOME</b>	<b>\$ 21,259</b>	<b>20.7%</b>	<b>\$ 19,130</b>	<b>18.9%</b>	<b>\$ 10,136</b>	<b>15.9%</b>
Average shares outstanding	55,536		45,969		25,177	
<b>NET INCOME PER SHARE</b>	<b>\$ 0.38</b>		<b>\$ 0.42</b>		<b>\$ 0.40</b>	

	Microsoft		Lotus		Ashton-Tate	
Net revenues	\$381,746	100.0%	\$361,799	100.0%	\$244,425	100.0%
Costs and expenses:						
Cost of revenues	82,262	21.6	64,093	17.7	39,249	16.0
Research and development	45,608	11.9	54,303	15.0	23,746	9.7
Sales and marketing	98,428	25.8	113,166	31.3	58,725	24.0
General and administrative	21,856	5.7	44,494	12.3	54,893	22.5
Total costs and expenses	248,154	65.0	276,056	76.3	176,613	72.2
Income from operations	133,592	35.0	85,743	23.7	67,812	27.8
Non-operating income	10,059	2.6	5,880	1.6	2,762	1.1
Stock option bonus expense	(17,218)	(4.5)	—	—	—	—
Income before income taxes	126,433	33.1	91,623	25.3	70,574	28.9
Provision for income taxes	49,120	12.8	26,924	7.4	32,879	13.5
<b>NET INCOME</b>	<b>\$ 77,313</b>	<b>20.3%</b>	<b>\$ 64,699</b>	<b>17.9%</b>	<b>\$ 37,695</b>	<b>15.4%</b>
Average shares outstanding	55,391		45,334		24,703	
<b>NET INCOME PER SHARE</b>	<b>\$ 1.40</b>		<b>\$ 1.44</b>		<b>\$ 1.53</b>	

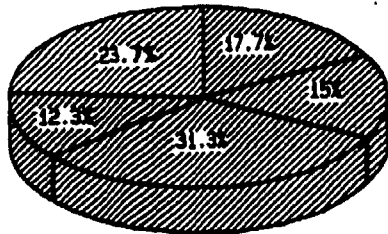
# Summary Of Operations

Trailing Twelve Months

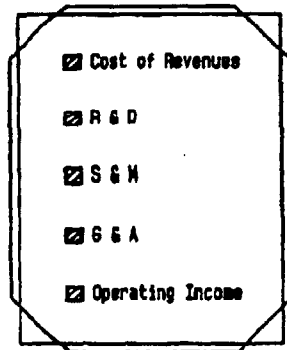
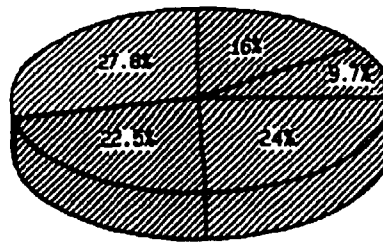
Microsoft



Lotus



Ashton-Tate



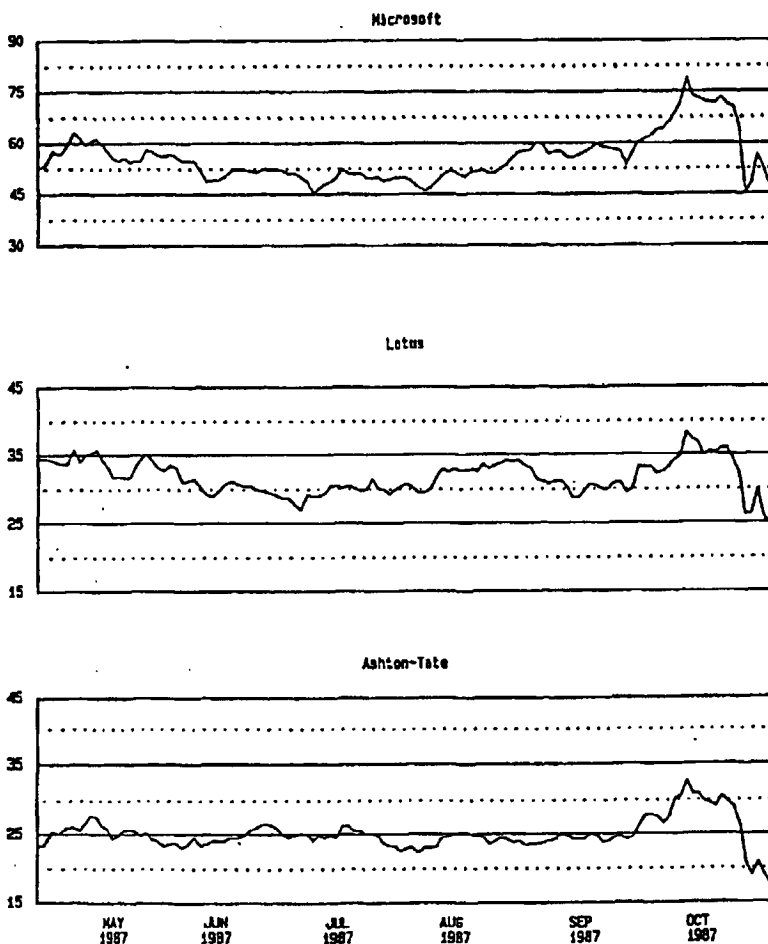
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Selected market statistics as of October 23, 1987 for these three companies are presented below.

	Microsoft	Lotus	Ashton-Tate
Closing Stock Price	\$48.25	\$25.00	\$17.75
365-Day High	\$79.25	\$38.50	\$33.00
365-Day Low	\$13.75	\$7.625	\$9.125
Common Shares Outstanding (estimate in thousands)	52,985	42,300	24,600
Market Value (in millions)	\$2,557	\$1,058	\$437
Latest Twelve Months EPS	\$1.40	\$1.44	\$1.53
Price/Earnings Ratio	34.5x	17.4x	11.6x
Price/Revenues Ratio	6.7x	2.9x	1.8x



## Microsoft, Lotus, and Ashton-Tate Comparative Closing Prices



THRU 10/23/87



# FINANCIAL CONDITION

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**FINANCIAL CONDITION**

Consolidated balance sheets as of September 30, 1987 and June 30, 1987 are presented below (in thousands).

	September 30 <u>1987</u>	June 30 <u>1987</u>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and short-term investments	\$152,053	\$132,484
Accounts receivables - net	55,835	55,131
Inventories	23,005	16,555
Other	<u>14,860</u>	<u>8,832</u>
Total current assets	245,753	213,002
Property, plant and equipment - net	78,078	70,010
Intellectual property rights - net	11,392	-
Other assets	<u>8,279</u>	<u>4,742</u>
<b>TOTAL</b>	<b><u>\$343,502</u></b>	<b><u>\$287,754</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 21,880	\$ 16,513
Customer deposits and deferred revenue	9,856	6,289
Royalties and commissions payable	4,063	4,013
Accrued compensation and employee benefits	7,636	5,127
Notes payable	3,381	5,172
Income taxes payable	17,904	2,217
Other	<u>12,562</u>	<u>7,313</u>
Total current liabilities	77,282	46,644
Long-term liabilities	<u>4,024</u>	<u>2,005</u>
<b>Stockholders' equity:</b>		
Common stock	53	53
Paid-in capital	79,137	76,811
Retained earnings	182,365	161,106
Translation adjustment	<u>641</u>	<u>1,135</u>
Total stockholders' equity	262,196	239,105
<b>TOTAL</b>	<b><u>\$343,502</u></b>	<b><u>\$287,754</u></b>



Consolidated statements of changes in financial position for the three months ended September 30, 1987 and 1986 are presented below (in thousands).

	1987	1986
<b>WORKING CAPITAL PROVIDED:</b>		
Operations:		
Net income	\$21,259	\$ 15,824
Depreciation and amortization	<u>3,164</u>	<u>1,511</u>
Total from operations	24,423	17,335
Common stock issued	1,913	1,518
Income tax benefit related to stock option plans	413	-
Long-term liabilities	<u>2,019</u>	<u>54</u>
Total working capital provided	<u>28,768</u>	<u>18,907</u>
<b>WORKING CAPITAL USED:</b>		
Additions to property, plant and equipment - net	10,562	8,582
Acquisition of intellectual property rights	12,062	-
Translation adjustment	494	(30)
Other	<u>3,537</u>	<u>1,403</u>
Total working capital used	<u>26,655</u>	<u>9,955</u>
<b>INCREASE IN WORKING CAPITAL</b>	<b>2,113</b>	<b>8,952</b>
<b>WORKING CAPITAL, Beginning of Period</b>	<b>166,358</b>	<b>118,452</b>
<b>WORKING CAPITAL, End of Period</b>	<b><u>\$168,471</u></b>	<b><u>\$127,404</u></b>
<b>CHANGES IN ELEMENTS OF WORKING CAPITAL:</b>		
Current assets - increase (decrease):		
Cash and short-term investments	\$19,569	\$16,122
Accounts receivables - net	704	5,373
Inventories	6,450	2,713
Other	6,028	2,482
Current liabilities - (increase) decrease	<u>(30,638)</u>	<u>(17,738)</u>
<b>INCREASE IN WORKING CAPITAL</b>	<b><u>\$ 2,113</u></b>	<b><u>\$ 8,952</u></b>

Overview

Microsoft's financial health continued to strengthen even further during the first quarter of FY88. Except for working capital, the key measures of financial strength registered impressive gains (see table below) ranging from 9.7% to 19.4%. Working capital increased only \$2.1 million or 1.3% because most all of the newly generated working capital (\$28.8 million) was expended to acquire Forethought and to add more property, plant and equipment. Thus, in absolute terms, current assets grew only \$2.1 million more than current liabilities, however, percentage-wise, current liabilities grew more than four times as much as current assets. The primary contributor to the \$30.6 million growth in current liabilities was the \$15.6 million accrual for income taxes, none of which was paid during the quarter. Consequently, the current and quick (acid) ratios declined to 3.2 and 2.8, respectively, from 4.6 and 4.2, respectively. Additionally, despite the significant outlay of cash during the quarter, cash and short-term investments grew \$19.6 million, or 14.8%. Lastly, nearly all of the \$23.1 million growth in stockholders' equity can be attributed to the \$21.3 million of net income thrown off from operations.



Measures of Financial Strength  
(dollars in millions)

	Q88-1	Q87-4	Change	% Change
Cash flow from operations	\$ 24.4	\$ 19.6	\$ 4.8	14.8
Cash and short-term investments	152.1	132.5	19.6	14.8
Working capital	168.5	166.4	2.1	1.3
Total assets	343.5	287.8	55.7	19.4
Stockholders' equity	262.2	239.1	23.1	9.7

Microsoft's overall financial strength is also reflected by several critical growth indicators. For instance, using stockholders' equity as of the beginning of FY'88, Microsoft's annualized return on investment (ROI) for the first quarter was 35.6%. Moreover, based on assets as of the beginning of FY'88, Microsoft's return on assets (ROA) was 24.6%. Despite these excellent rates of return, they continue to be dramatically less than the Company's rates of return on non-cash equity (80.0%) and non-cash assets (54.8%), as listed in the table below.

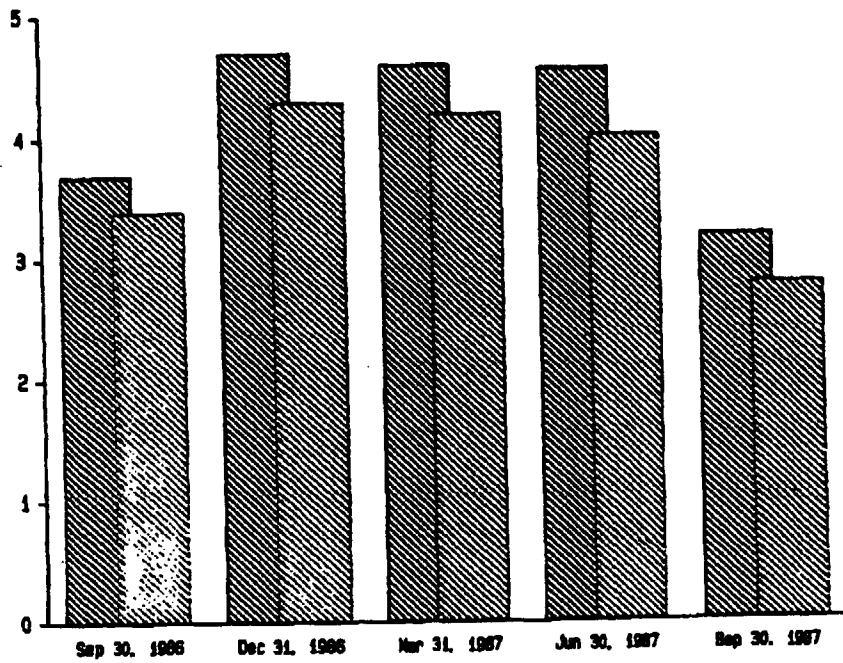
GROWTH INDICATORS

Return On:	FY'86	FY'87	Q88-1*
Equity	40.5%	38.0%	35.6%
Assets	33.3%	31.4%	24.6%
Non-cash equity	108.8%	100.3%	80.0%
Non-cash assets	68.8%	64.4%	54.8%
Net revenues	19.9%	20.8%	20.7%

\* annualized

Finally, during the first quarter, book value per share increased 9.0% to \$4.95, while shares outstanding increased 0.5% or 271,940 shares to 52,984,996 shares (adjusted for the 100% stock dividend).

### Current and Quick Ratios



▨ Current Ratio    ▨ Quick Ratio

DATE: 8/87

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**Cash and Short-Term Investments**

As previously noted, cash and short-term investments (at cost) increased \$19.6 million to \$152.1 million during the first quarter of FY'88. These liquid assets comprise 61.9% of current assets and 44.3% of total assets. As of quarter-end, the portfolio consisted of the securities listed below (also, see the accompanying pie chart and detailed listing of securities on the following pages):

<u>Security</u>	<u>\$ in Millions</u>	<u>Percent</u>
<b>Domestic Portfolio</b>		
Money Market Preferreds	\$ 59.9	41.5%
Municipal Bonds	46.2	31.8
Increasing Rate Notes	11.0	7.6
Money Market Funds	5.0	3.4
Risk Arbitrage	5.5	3.8
Dividend Rollover	4.8	3.3
Repo Agreements & Corporate Debt	3.8	2.6
Domestic Portfolio Total	136.2	93.8
<b>MS-International BV (Ireland) Portfolio</b>		
Increasing Rate Notes	9.0	6.2
<b>Worldwide Portfolio Total</b>	<b>\$145.2</b>	<b>100.0%</b>

In discussing the composition of the portfolio, it should be noted that no U.S. Treasury Bills were purchased over quarter-end, since the preliminary word from the SEC is that they will rule favorably on our request that Microsoft be deemed an operating company for purposes of the Investment Company Act of 1940.

During the latter half of the quarter, interest rates crept up about 100 basis points right across the entire yield curve. Moreover, the spread between money market preferreds (MMP's) and municipal securities widened as all rates rose making MMP's even more attractive than municipals. Furthermore, because of the uncertain impact of the corporate alternative minimum tax this fiscal year, municipals are potentially even less attractive, as they could be subject to a surtax of 10% or 20%, depending on the particular characteristics of the issues held. Therefore, new investment commitments were skewed toward MMP's. As of quarter-end, the approximate annualized, after-tax return on MMP's and municipals in the portfolio was 5.1% and 5.5%, respectively, which was approximately equivalent to 7.7% and 8.4%, respectively, on a pre-tax basis using a 34% marginal tax rate.

In an attempt to improve the overall rate of return on the portfolio, we are continuing to acquire high yielding increasing rate notes (IRN's). On average, the fully taxable rate on IRN's acquired to date is 12.3% which would equate to 8.1% after-tax using our marginal tax rate of 34%.

Because of the severity of the recent market crash, special mention of this subsequent event should be noted. Fortunately, Microsoft suffered virtually no loss in value to its portfolio of securities which are managed in-house, primarily for the following reasons:

1. All securities are fixed income or quasi-fixed income;
2. All maturities are relatively short. Virtually nothing longer than one year. (Although IRN's are issued with maturities ranging from 3 to 5 years, they are designed to be redeemed in 3 to 12 months.);
3. During the crash in equities, there was a flight to quality (viz. U.S. Government securities) which quickly pushed the yield curve down and proved bullish for the fixed income sector.

Unfortunately, we were not so lucky with the funds which are under outside management. First, the dividend rollover program managed by Drexel Burnham Lambert was down 2.1% as of September 30, but since the crash, the value of this fund is off some 10%. As discussed in the last quarterly board report, the hedging technique utilized in this program has not proven effective; therefore, we have issued a directive to Drexel to liquidate our position in this rollover program in an orderly fashion over the next three months.

Second, the arbitrage fund managed by Oppenheimer & Co. was ahead just over 10% as of quarter-end; however, the crash devastated these volatile takeover issues, and our fund is currently off about 26%. Nevertheless, this fund should rebound smartly with a general market recovery.

As of October 23, 1987, we have an unrealized valuation loss of approximately \$2.2 million resulting from the subsequent-to-quarter end decline in the market value of our dividend rollover and arbitrage programs.

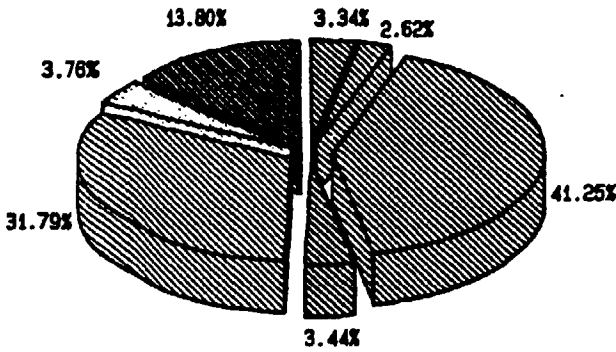
#### Hedging Foreign Exchange Exposure

The Company recognized foreign currency transaction gains totaling \$1.2 million during the first quarter. These gains flow from the positive effect of the weaker dollar on that portion of our unhedged international activities. Although the dollar has trended lower against most major currencies this first quarter and although many FX pundits forecast an even lower dollar in the longer run, we shall be recognizing the effect of the dollar's volatility monthly on our unhedged intercompany trade and short term obligations. Thus, in order to minimize the potential roller coaster effect this could wreak on our income statement, we must become much more active in our hedging activities. As of September 30, we have the following hedges in place, and they are lifted in installments as the subsidiaries repay their intercompany indebtedness.

Currency	Date Initiated	U.S. \$ Equivalent
Pounds Sterling	January 1987	\$1.2 million
Japanese Yen	April 1987	\$1.1 million
French Francs	August 1987	\$1.0 million



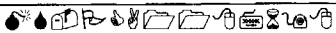
Investment Portfolio  
September 30, 1987



- Dividend Rollover
- Repo's & Corp Debt
- Money Market Preferreds
- Money Market
- Municipal Securities
- Arbitrage
- Increasing Rate Notes

Total Investments  
 Domestic \$136.2 M  
 Int'l 9.0 M  
 -----  
 \$145.2 M

20007.000

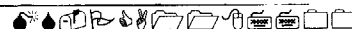


**MICROSOFT CORPORATION**  
**Domestic Investment Portfolio**  
**As of September 30, 1987**

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
<b>Money Market Preferred - 80% Tax Free</b>					
1 Heller Finance (B)	Oct 2, 87	4.925%	2,000,000	1.47%	A3/A-
2 Rhone Poulenc	Oct 6, 87	4.900%	3,000,000	2.20%	AAA
3 Ultramar	Oct 7, 87	4.940%	4,000,000	2.94%	AAA
4 Union Texas Petroleum	Oct 13, 87	5.050%	2,000,000	1.47%	AAA/AAA
5 Crossland N.Y.	Oct 14, 87	4.770%	2,000,000	1.47%	AAA/AAA
6 Par Fund	Oct 15, 87	7.300%	1,014,250	0.74%	N/A
7 Thorn EMI "C"	Oct 16, 87	4.850%	2,000,000	1.47%	AAA/AAA
8 AFS	Oct 20, 87	5.535%	2,000,000	1.47%	AAA/AAA
9 Manufacturers Hanover	Oct 20, 87	5.700%	2,000,000	1.47%	BAA1/BBB+
10 Chrysler	Oct 22, 87	5.300%	3,000,000	2.20%	BBB/BBB
11 Union Bankcorp (AFS)	Oct 23, 87	5.110%	1,000,000	0.73%	A1/BBB
12 Konica	Oct 26, 87	4.900%	2,000,000	1.47%	AAA/AAA
13 Golden Tulip-KLM	Oct 26, 87	4.850%	1,000,000	0.73%	AAA/AAA
14 Com Fed Funding	Oct 27, 87	5.190%	2,000,000	1.47%	AAA/AAA
15 Manufacturers Hanover	Oct 27, 87	5.900%	2,000,000	1.47%	BAA1/BBB+
16 USAT II	Oct 27, 87	5.150%	2,000,000	1.47%	NR/AAA
17 Crossland II	Oct 28, 87	5.230%	2,000,000	1.47%	AAA/AAA
18 Dollar Finance	Oct 28, 87	5.230%	2,000,000	1.47%	AAA/AAA
19 Arlington	Oct 28, 87	5.250%	1,000,000	0.73%	AAA/AAA
20 FFM Finance IV	Oct 28, 87	5.360%	2,000,000	1.47%	AAA/AAA
21 First Arkansas Funding	Oct 28, 87	5.300%	1,000,000	0.73%	AAA/AAA
22 Ultramar	Oct 28, 87	5.230%	1,000,000	0.73%	AAA
23 Landmark	Oct 30, 87	5.390%	2,000,000	1.47%	AAA/AAA
24 Meritor III	Nov 2, 87	5.350%	2,000,000	1.47%	AAA/NR
25 Arvin Industries	Nov 3, 87	6.100%	1,000,000	0.73%	BAA/BBB
26 ASB Capital	Nov 3, 87	5.350%	1,000,000	0.73%	AAA/AAA
27 Hawaii Pacific	Nov 4, 87	5.750%	1,000,000	0.73%	AAA
28 Texas Instruments C	Nov 4, 87	5.595%	900,000	0.66%	A2/A+
29 Bombardier	Nov 5, 87	5.200%	1,000,000	0.73%	AA
30 Republic National Bank	Nov 5, 87	5.400%	1,000,000	0.73%	A1/A+
31 Heller Finance A	Nov 6, 87	5.590%	1,000,000	0.73%	A3/A-
32 Cleveland Electric	Nov 9, 87	8.550%	1,000,000	0.73%	BBA2/BB+
33 Mattel	Nov 13, 87	5.400%	2,000,000	1.47%	AAA/AAA
34 Mid America	Nov 18, 87	5.650%	2,000,000	1.47%	AAA/AAA
35 Union Carbide	Dec 18, 87	5.650%	2,000,000	1.47%	AAA/AAA
			59,914,250	43.98%	

MICROSOFT CORPORATION  
 Domestic Investment Portfolio  
 As of September 30, 1987

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
<b>Municipal Securities - 100% Tax Free</b>					
1 Hutchinson, KS. IDA	Oct 1, 87	5.0600%	2,001,800	1.47%	NON-RATED
2 Brazos River Auth.-Texas	Oct 1, 87	4.5000%	2,000,000	1.47%	AAA/A1+
3 Snohomish, Cty. WA. Pilchuck	Oct 1, 87	5.2500%	2,000,000	1.47%	A1
4 Niagara Falls City-School District	Oct 1, 87	4.3000%	1,002,170	0.74%	BAA 1
5 Topeka, KS.- IDR	Oct 1, 87	5.0600%	1,000,900	0.73%	NON-RATED
6 Everett, Wa. LID #719	Oct 1, 87	5.5000%	1,000,000	0.73%	Underlying A
7 Everett, Wa. LID 714	Oct 1, 87	5.3750%	1,000,000	0.73%	Underlying A
8 Lee County Florida Capital Improvements	Oct 1, 87	5.6250%	1,000,000	0.73%	MIG 1
9 Tri County, Oregon METRO	Oct 1, 87	5.2500%	101,740	0.07%	SP 1+
10 Selah, Washington	Oct 9, 87	5.9000%	400,000	0.29%	NON-RATED
11 Redmond, Washington LID #5	Oct 21, 87	5.0000%	1,000,000	0.73%	NON-RATED
12 New Hampshire IDA-Timco	Nov 1, 87	5.5000%	994,850	0.73%	A
13 Aurora, Co. Muni. Build	Dec 1, 87	5.0000%	997,180	0.73%	SP 1+
14 Louisiana Pub. Fac	Dec 1, 87	5.4000%	784,290	0.58%	AAA
15 Iowa State School District	Dec 30, 87	5.0020%	1,005,200	0.74%	SP 1+
16 El Mirage, AZ.	Dec 31, 87	6.6200%	1,022,500	0.75%	MIG 1/AAA
17 South Tucson, Az IDA	Dec 31, 87	5.9940%	1,017,810	0.75%	MIG 1
18 Chandler, Az. IDA	Dec 31, 87	5.9950%	1,016,900	0.75%	MIG 1
19 Utah Cnty, Trans	Dec 31, 87	4.9960%	997,020	0.73%	NON-RATED
20 Bellevue LID 269, Washington	Jan 1, 88	5.5000%	1,004,100	0.74%	NON-RATED
21 Kentucky Turnpike	Jan 1, 88	5.0000%	1,000,000	0.73%	A/A
22 Fulton Cnty, GA. Bldg. Auth	Jan 1, 88	5.1790%	997,500	0.73%	AA/AA
23 Leavenworth, KS.-Sewer	Jan 4, 88	4.5000%	373,104	0.27%	NON-RATED
24 Denver, CO. City & Cnty Water	Feb 1, 88	4.0000%	1,001,170	0.73%	MIG 1
25 Washington County, Pa. Lease Pool	Feb 1, 88	5.3680%	1,000,000	0.73%	VMIG 1
26 Salt Lake City, UT.	Feb 1, 88	5.2500%	600,000	0.44%	AAA
27 Wichita, Ks.-Ramada Inn	Mar 1, 88	6.0000%	1,000,000	0.73%	NON-RATED
28 Montana Econ. Dev. Brd.	Mar 1, 88	6.0000%	985,930	0.72%	NON-RATED
29 KENT, OH. Land -O-Lakes	Mar 1, 88	6.7500%	925,734	0.68%	NON-RATED
30 Albia, Iowa	Jun 1, 88	5.0000%	1,097,635	0.81%	NON-RATED
31 Los Angeles, Cnty, CA. Transportation	Jun 30, 88	6.0000%	1,967,700	1.44%	MIG 1
32 N.J. Econ Dev. Auth.-Ocean Spray	Jul 1, 88	5.0000%	1,997,680	1.47%	A+
33 Washington St. Health Care Facility	Jul 1, 88	5.0000%	924,177	0.68%	NON-RATED
34 St. James Parish-Texasco	Jul 15, 88	7.5400%	1,012,500	0.74%	NON-RATED
35 St. James Parish-Texasco	Jul 15, 88	7.4300%	1,012,500	0.74%	NON-RATED
36 San Diego, Cnty. CA.	Aug 1, 88	6.2000%	1,964,100	1.44%	MIG 1
37 Utah Muni Fin Co-op	Oct 1, 88	6.2650%	1,990,000	1.46%	SP1+
38 Louisiana Pub. Fac. Auth	Dec 1, 88	6.3000%	1,980,000	1.45%	VMIG 1
39 Washington St. HSG Auth.	Jan 1, 89	5.6000%	2,000,000	1.47%	NON-RATED
40 Everett, Wa. LID #726	Aug 1, 89	5.2650%	1,000,000	0.73%	NON-RATED
			46,176,190	33.90%	

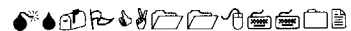


**MICROSOFT CORPORATION**  
**Domestic Investment Portfolio**  
**As of September 30, 1987**

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
<b>Repurchase Agreements</b>					
1 First Interstate Bank	Oct 1, 87	6.700%	2,800,000	2.06%	N/A
			2,800,000	2.06%	
<b>Corporate Bonds</b>					
1 Citicorp	Dec 1, 88	8.600%	1,001,460	0.74%	A1/AA
			1,001,460	0.74%	
<b>Money Market</b>					
1 Metropolitan Federal Savings & Loan	Oct 16, 87	7.100%	5,000,000	3.67%	N/A
			5,000,000	3.67%	
<b>Dividend Rollover</b>					
1 Drexel Burnham Lambert	N/A	N/A	4,855,127	3.56%	N/A
			4,855,127	3.56%	
<b>Arbitrage</b>					
1 Oppenheimer	N/A	N/A	5,468,865	4.01%	N/A
			5,468,865	4.01%	
<b>Increasing Rate Notes</b>					
1 R-C Holdings Senior A	Jul 15, 88	11.0625%	1,500,000	1.10%	NON-RATED
2 R-C Holdings Subordinated	Jul 15, 88	12.0625%	500,000	0.37%	NON-RATED
3 Community Newspapers	Nov 1, 89	11.5000%	1,000,000	0.73%	NON-RATED
4 Charlie Holdings-Revlon B	May 1, 90	10.9300%	2,002,500	1.47%	NON-RATED
5 TWA	Oct 1, 92	14.5000%	2,000,000	1.47%	NON-RATED
6 Uniroyal-Chemical	Nov 1, 93	11.4800%	4,005,000	2.94%	NON-RATED
			\$11,007,500	8.08%	
<b>Total Domestic Investments</b>			<b>\$136,223,391</b>	<b>100.00%</b>	

MICROSOFT INT'L BV  
 Int'l Investment Portfolio  
 As of September 30, 1987

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
<b>Increasing Rate Notes</b>					
1 Theatre Holdings	Sep 1, 88	12.6500%	1,037,500	11.48%	NON-RATED
2 Charlie Holdings-Revlon	May 1, 90	12.0000%	1,000,000	11.07%	NON-RATED
3 Charlie Holdings-Revlon	May 1, 90	12.7500%	1,000,000	11.07%	NON-RATED
4 Sunshine Mining Co.	Jun 1, 90	12.5000%	2,000,000	22.13%	NON-RATED
5 General Felt	Jan 15, 92	12.0500%	1,000,000	11.07%	NON-RATED
6 Vanguard Cellular	May 1, 92	12.0000%	1,000,000	11.07%	NON-RATED
7 TWA	Oct 1, 92	14.5000%	2,000,000	22.13%	NON-RATED
			9,037,500	100.00%	



**Accounts Receivables**

Corporate-wide accounts receivables (net) remained stable when compared to Q87-4. As can be seen in the table below, individual channel receivables fluctuated but resulted in a minor increase to total net accounts receivables of 1.3% (from \$55.1 million to \$55.8 million).

	% Change from Prior Quarter		Total	Current	Days Over		
	Revenue	A/R			30	60	90+
<b>Retail</b>							
USSMD	(10.7)	(11.8)	\$16,419	\$13,415	\$ 2,241	\$ 471	\$ 292
International	9.1	13.7	24,530	12,789	5,129	3,091	3,521
Worldwide Retail	(1.8)	1.9	40,949	26,204	7,370	3,562	3,813
<b>OEM</b>							
Domestic	14.7	(22.8)	2,099	1,380	522	44	153
International	(6.5)	(3.8)	1,825	7,233	337	682	566
Worldwide OEM	5.2	(8.2)	10,924	8,613	859	733	719
<b>Print</b>	(7.7)	(10.4)	1,517	1,610	(18)	2	(7)
<b>CD-ROM</b>	N/A	N/A	0	0	0	0	0
<b>Systems Journal</b>	N/A	N/A	(69)	(415)	138	211	0
<b>ESS</b>	N/A	N/A	53	45	7	0	1
Accounts Receivable-Collectible		(0.8)	53,377	\$36,057	\$8,356	\$4,508	\$4,456
Aging in percent				67.6%	13.7%	8.4%	8.3%
OEM GAAP adjustment			10,689				
Allowances			(8,231)				
Accounts Receivable-Net		1.3	\$55,835				
Total Quarterly Net Revenues	2.8		\$102,636				
Days Sales Outstanding			46.8				

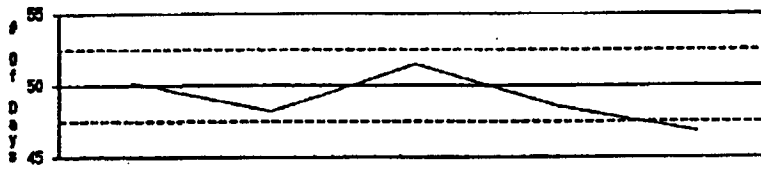
Days sales outstanding calculation uses "accounts receivable - collectible" and is based on current quarter net revenues.

Days sales outstanding (DSO), decreased slightly from 48.5 days at the end of Q87-4 to 46.8 days at the end of Q88-1.

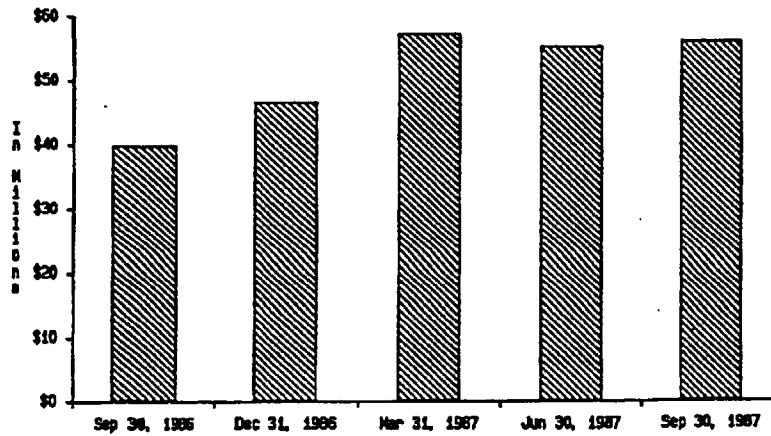
<u>FY Quarter</u>	<u>DSO</u>
Q88-1	46.8
Q87-4	48.5
Q87-3	51.5
Q87-2	48.2
Q87-1	50.2

An analysis of the aging of Corporate-wide receivables shows accounts over 60 days comprised 16.7% of collectible receivables compared to 14.0% at the end of Q87-4. International retail accounts for 46.0% of total collectible receivables and 73.8% of total collectible receivables over 60 days. The allowance for doubtful accounts at \$8.2 million represents 91.8% of all accounts over 60 days past due compared to 92.4% in the prior quarter. In comparing the allowance for doubtful accounts against total collectible receivables, our reservation percentage is 15.4% compared to 12.9% in Q87-4.

**Days' Sales Outstanding**  
 (Based on Revenues for the Quarter)



**Accounts Receivable - Net**



1770C-000

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MS-PCA 1187705  
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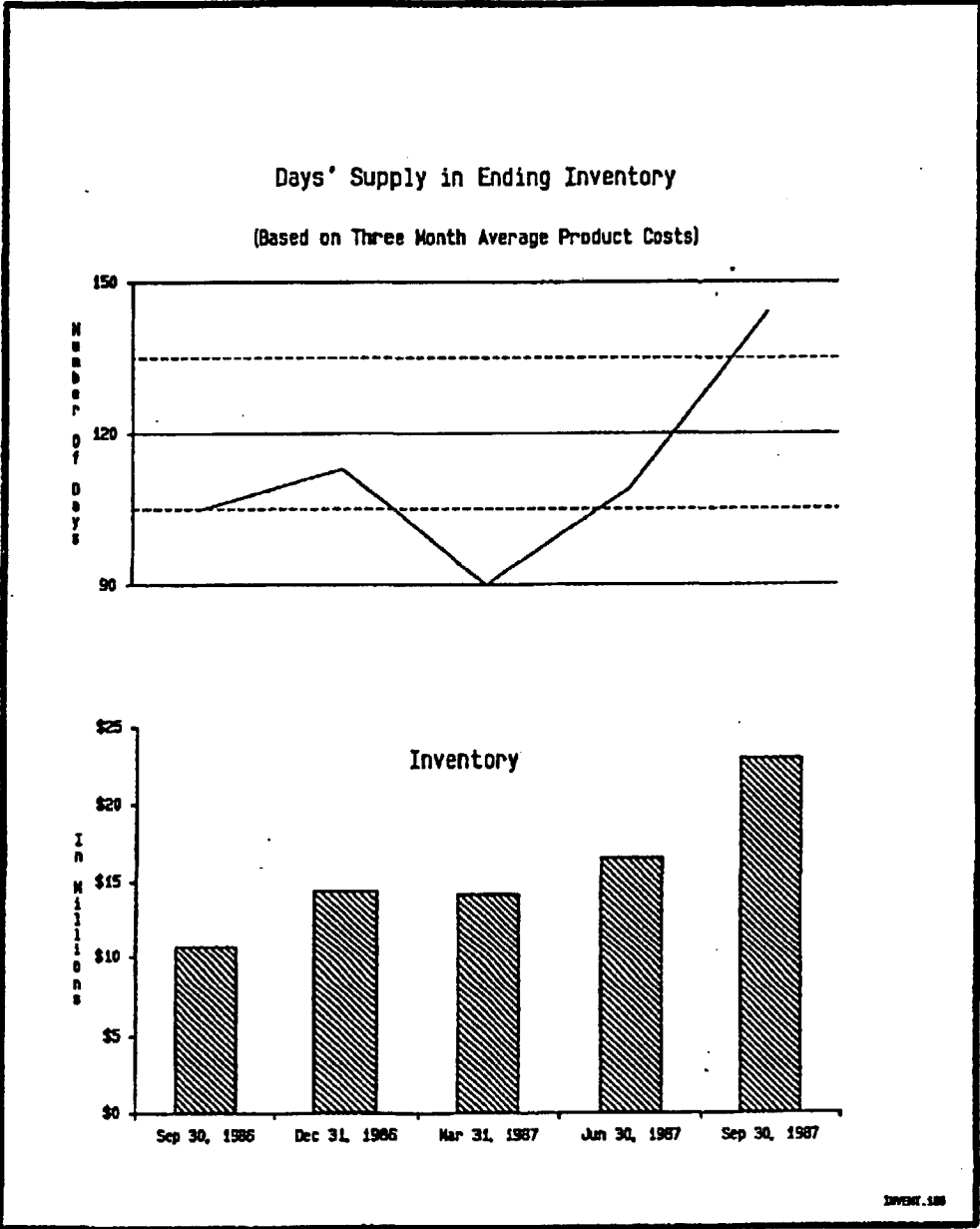


**Inventories**

Inventories increased at the end of Q88-1 to \$23.0 million from \$16.6 million at the end of Q87-4. The total rise of \$6.4 million consisted of \$3.2 million increases in both domestic and international inventories. In anticipation of releases of new products and versions, the domestic inventory increase consisted almost entirely of raw materials. Raw materials for PC-based applications accounted for most of this increase with \$1.9 million. Products in this category include PC Word 4.0, Project 4.0, PC Chart 3.0, and PC Excel. In contrast, the \$3.2 million increase in international inventory was primarily due to finished goods which increased by \$2.5 million. This is a result of subsidiaries building up their inventories to accommodate growing sales in the upcoming quarter. In support of new software releases, work-in-process grew by \$230,000 to slightly over \$1.0 million. Domestic work-in-process accounted for almost all of this growth with a \$219,000 increase. Inventories ending Q88-1 and Q87-4 were as follows (in thousands):

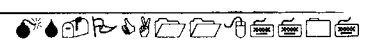
	<u>September 30</u>	<u>June 30</u>	<u>Change</u>
Raw materials	\$ 13,766	\$ 9,931	\$3,835
Work in process	1,026	795	231
Finished goods	11,402	9,010	2,392
Allowances	<u>(3,189)</u>	<u>(3,180)</u>	<u>(9)</u>
	<u>\$ 23,005</u>	<u>\$16,556</u>	<u>\$6,449</u>





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Property, Plant and Equipment

Net property, plant and equipment increased 11.5% in Q88-1 to \$78.1 million from \$70.0 million at June 30, 1987. As usual the increase can be primarily attributed to computer equipment and the expansion of our facilities to accommodate growth in headcount. Property, plant and equipment at September 30, 1987 and June 30, 1987 consists of the following (in thousands):

	<u>September 30</u>	<u>June 30</u>	<u>Change</u>
Land	\$31,430	\$31,437	\$ (7)
Buildings	15,639	12,262	3,377
Leasehold improvements	4,099	3,909	190
Office furniture and equipment	11,915	10,465	1,450
Computer equipment	<u>36,075</u>	<u>30,525</u>	<u>5,550</u>
Accumulated depreciation	99,158	88,598	10,560
Net	<u>(21,080)</u>	<u>(18,587)</u>	<u>(2,493)</u>
	<u>\$78,078</u>	<u>\$70,011</u>	<u>\$ 8,067</u>

The significant increase in buildings (\$3.4 million) relates to final additions to buildings 5 and 6 (\$2.1 million), and construction on the combined manufacturing and distribution facility in Canyon Park (\$1.2 million). The increase in office furniture and equipment (\$1.5 million) is attributed to the following areas (in thousands):

Furniture	\$ 311
Manufacturing & distribution equipment	491
Telecommunication equipment	368
Subsidiaries	261
Other	<u>19</u>
	<u>\$1,450</u>

In the past two quarters computer equipment has increased approximately \$5 million each quarter. The following table summarizes some of the more significant additions during Q88-1 (total costs are in thousands):

	<u>Quantity Purchased</u>	<u>Total Costs</u>
Compaq 386	253	\$1,902
VAX equipment	-	1,064
Wyse 286	291	791
Networking equipment	-	656
Apple computers	136	476
IBM System 2	47	221
IBM AT	36	182
Sun servers/systems	-	<u>139</u>
		<u>\$5,431</u>

Intellectual Property Rights

On July 31, 1987, the Company acquired intellectual property rights in the desktop presentations category by acquiring 100% of the outstanding capital stock of Forethought, Inc. Of the acquisition price of \$14.0 million, \$1.9 million was recorded as capitalized net operating loss and \$12.1 was recorded as intellectual property rights. The remainder of the assets acquired (cash, accounts receivable, property, etc.) were offset by liabilities assumed. The capitalized net operating loss will be utilized to offset future tax obligations. The \$12.1 million of intellectual property rights will be amortized to product development over a three-year period (estimate life of the acquired technology). The amortization will equal approximately \$1.0 million per quarter.

### Other Assets

Other assets increased \$3.5 million in Q88-1 to \$8.3 million from \$4.7 million at June 30, 1987 primarily as a result of the capitalization of Forethought's net operating loss (\$1.9 million) and additional funding to the EIKON joint venture (\$956,000). The joint venture is between Microsoft, Olivetti and SEAT (Societa Elenchi Officiali Degli Abbonati AL Telefono p.A.) and was created to develop CD ROM technology in Europe. Additionally, Microsoft KK made a lease deposit for office space and parking with amounted to \$1.0 million.

### Current Liabilities

Current liabilities increased \$30.7 million in Q88-1 to \$77.3 million from \$46.6 million at June 30, 1987. The largest portion of the increase (\$15.7 million) relates to income taxes payable and results because the Company's estimated income tax payments for Q88-1 were not due until October 15. The next largest increase was in accounts payables (\$3.7 million in administrative payables and \$ 1.9 million in manufacturing payables). The last sizable increase related to deferred revenues which increased \$3.5 million. Deferred revenue at September 30, 1987 and June 30, 1987 consisted of the following (in thousands):

	September 30	June 30	Change
OS/2 SDK - Product	\$5,086	\$1,938	\$3,148
OS/2 SDK - DIAL	921	813	108
OS/2 SDK - Seminars	584	435	149
MSU Courses	<u>83</u>	<u>—</u>	<u>83</u>
	<u>\$6,674</u>	<u>\$3,186</u>	<u>\$3,488</u>

The deferred revenue on OS/2 SDK - Product will be recognized during Q88-2, at which time Presentation Manager code development will be substantially complete and shipment imminent. The DIAL deferred revenue is recognized ratably over the annual subscription period. Revenue from the seminars is recognized upon seminar attendance. The final seminar occurred in Dallas on October 20, 1987.

### Long-term Liabilities

As noted in the discussion above, Microsoft KK made a \$1.0 million lease deposit on their new office space and parking lot. The funds used to pay the deposit were borrowed from Sumito Bank because of favorable interest rates (approximately 4 to 5%). The total loan was for \$2.0 million dollars and the balance of the loan was used for working capital and a \$750,000 cash dividend paid to Microsoft Redmond.

### Stockholders' Equity

Stockholders' equity increased \$23.1 million during Q88-1 to \$262.2 million from \$239.1 million at June 30, 1987. The increase results primarily from net income for the quarter of \$21.3 million and the issuances of shares relating to the Company's Employee Stock Purchase Program (\$2.3 million).

ADMINISTRATION

MSC 007010340  
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MS-PCA 1187710 )  
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**TAX MATTERS**

**MSC 007010341  
CONFIDENTIAL**

**MS-PCA 1187711  
CONFIDENTIAL**

## TAX MATTERS

### DOMESTIC - PLANNING

Outlook for FY 88: This fiscal year will reflect for the first time the significant changes made by the Tax Reform Act of 1986. The single most important change is the reduction of the highest corporate tax rate from 46% to 34%. This should result in a decrease of our consolidated effective tax rate from 40.8% for FY 87 to 32.5% for FY 88.

The Alternative Minimum Tax (AMT) for corporations, as implemented by the Tax Reform Act of 1986, will make tax planning more important and more difficult. Unless present tax laws change it is likely that we will be liable for an AMT in FY 88. The "spread" generated by our stock option plans causes a tax preference item for AMT purposes. The incurrence of an AMT will result in a reduction of the tax benefit from the "spread" and a corresponding reduction in the bonus paid to employees.

Other changes made by the 86 Act which will affect Microsoft this year include repeal of the reserve method for bad debts; capitalization of additional costs for inventory; new foreign tax credit limitations; treatment of foreign corporations, such as BV International (MS Ireland), as Passive Foreign Investment Companies (PFICs); and new rules for reporting gains and losses on foreign currency transactions and determining the amount of royalties paid on the transfer of intangible property to related parties.

In summary, while the dramatic decrease in tax rates will benefit Microsoft during FY 88, other changes enacted by the 86 Tax Act may have a negative impact. All of these changes underscore the need for tax planning now more than ever.

Cash Flow: In September 1987 we received a \$7.2 million quick refund of federal income taxes paid for FY 87. This refund was primarily due to the "spread" and R&D credits.

Working Capital/Anticipated Liquidity Needs: As of September 30, 1987, Microsoft's estimated working capital at the end of the fiscal year and forecasted liquidity needs are summarized in the table below (in thousands):

Estimated working capital at June 30, 1988	\$275,411
Estimated working capital needs (based upon Bardahl formula)	(120,446)
Estimated working capital before other anticipated needs and contingencies	154,995
Other anticipated needs and contingencies	(226,800)
Potential borrowing requirements	\$ (71,805)

A detailed analysis follows this report.

**Acquisitions:** During the first quarter of FY 88, Microsoft completed the acquisition of Forethought, Inc. The treatment of the purchase price of Forethought, \$14 million, differs for financial reporting and tax purposes. The discussion of the financial reporting treatment appears in the Financial Condition section of this report. For tax purposes, the purchase price has been treated as an investment in Forethought's stock. Forethought, as a corporate entity, has been continued for tax purposes rather than liquidated. All of its assets and liabilities immediately prior to the acquisition have been carried over on its books. The value of the intellectual property (Power Point) cannot be amortized for taxes as it has been for financial reporting. Prior to Microsoft's acquisition, Forethought incurred net operating losses totalling \$5.7 million. These losses will be used to offset future income generated from Forethought's products.

#### **DOMESTIC - COMPLIANCE**

**Tax software:** Two PC based tax software packages have been installed and training on both systems has begun. MIS has worked with the Tax Department during the installation and training phases thus enabling MIS to properly support the systems in the future.

**B&O Tax:** After the Supreme Court ruled that parts of Washington's B&O tax were unconstitutional, the State Legislature convened a special session to address the issues. During that session the Legislature passed a bill providing a tax credit mechanism to solve the unconstitutional elements of the B&O tax. Shortly thereafter the governor signed the bill. We are currently complying with the B&O tax laws as amended. Thus we have resumed paying B&O taxes on all net revenues at the lower manufacturing rate. We continue to accrue B&O taxes on OEM revenues at the rate applicable to services until this issue has been cleared with the Department of Revenue.

**Examinations:** In this first quarter of FY 88, tax agents from the states of Massachusetts and California visited Microsoft to conduct income tax and sales tax examinations. The final results of these exams are not yet available.



#### INTERNATIONAL - PLANNING

**Dividends:** A \$700,000 dividend from MS KK's FY 87 earnings was received. The Japanese taxes paid on these earnings were included in the foreign tax credits claimed in computing the FY 88 first quarter federal income tax estimate and resulted in a reduction of the estimated payment by approximately \$500,000. After taking into consideration the withholding taxes paid on the dividend, the tax savings at the consolidated level exceeded \$400,000.

**Tax Lobbying/Legislation:** Recently the House Ways and Means Committee and the Senate Finance Committee completed markup of their respective versions of the Technical Corrections Act. Both Committees acted without Republican participation. As a result several key sponsors of our amendments were excluded from debate. The House version does contain an amendment which appears to provide relief from the immediate impact of the Passive Foreign Investment Company provisions. On the Subpart F issue, Senator Packwood has agreed to support our effort when, and if, the opportunity arises during the highly partisan legislative process. We are continuing to work with our lobbyists in an attempt to have our proposed amendments included in the final version of the Act.

**Cost Sharing:** As a result of the 86 Act, we are examining the feasibility of entering into a cost sharing agreement between Microsoft and MS Ireland for research and development expenses in lieu of the current royalty arrangement. Obviously many legal and business issues are involved and will be considered prior to making a recommendation to enter into such an agreement.

#### INTERNATIONAL - ACCOUNTING

**Tax Provisions:** Beginning with September 1987, the tax provisions of the foreign subsidiaries will be reviewed on a monthly basis by the Tax Department. The purpose of this review is twofold. First, to determine the proper amount of the tax credits available for US taxes. Second, to ensure that the consolidated book tax provision bears a reasonable relationship to consolidated pretax income.

**MICROSOFT CORPORATON**  
**Anticipated Liquidity Needs**  
**Year Ending June 30, 1988**  
**(in thousands)**

**Working Capital Available**

Working Capital, September 30, 1987	\$168,471
Add: Anticipated working capital to be generated through June 30, 1988	106,970
Less: Estimated working capital to sustain the Company through fiscal 1989	<u>120,446</u>
<b>Total Before Other Anticipated Needs</b>	<b>\$154,995</b>

**Anticipated Needs**

Scheduled Expenditures

Facilities:

Computers	\$7,500
PSSCMS	2,300
Phase III Development	45,000
Mfg facility/ Canyon Park	18,000

Foreign Operations:

Purchase of Irish facility/new addition	10,000
Australian capital contribution	2,500
Capital contributions (GMBH, KK)	1,000
New foreign subsidiaries	2,000

Acquisitions

100,000

Dividends

2,800

191,100

Contingencies

Insurance 20,000

Foreign Operations:

Value Added Taxes	5,000
Other International Taxes	5,100

Litigation and contingencies:

Litigation	2,000
State Taxes	3,600

35,700

Total Anticipated Needs 226,800

Potential Borrowing Requirement \$ (71,805)



**MICROSOFT CORPORATION**  
**Estimated Working Capital Needs Worldwide- Peak Method**  
**Year Ending June 30, 1988**  
(in thousands)

**Step 1. Determine Operating Cycle**

<b>A. Inventory turnover percentage</b>		
1) Peak Inventory (9-87)	\$23,005	
2) COGS for the period (21.5% of estimated rev's)	107,500	
3) Inventory turnover percentage		21.40%
<b>B. Accounts receivable turnover percentage</b>		
1) Peak accounts receivable (3-87)	63,600	
2) Sales for the year ending 6-30-88	500,000	
3) Accounts receivable turnover percentage		<u>12.72%</u>
<b>C. Operating cycle percentage</b>		<b>34.12%</b>

**Step 2. Determine Working Capital**

1) COGS (21.5% of estimated rev's)	107,500
2) Other operating expenses (as budgeted)	210,000
3) Income taxes-worldwide basis *	<u>45,730</u>
	363,230
4) Less: depreciation	<u>-10,224</u>
5) Estimate of FY88 total operating expenses	<u><u>353,006</u></u>

Necessary Working Capital (34.12% x 353,006) \$120,446

**Notes:**

500,000 FY88 estimated rev's
<u>317,500</u> COGS + operating expenses
182,500 Pretax profit
<u>48,000</u> FY88 NQSO deduction
134,500
<u>34%</u> Tax rate
<u><u>45,730</u></u> Total worldwide tax liability

**INSURANCE MATTERS**

**MSC 007010347  
CONFIDENTIAL**

**MS-PCA 1187717 )  
CONFIDENTIAL )**

## INSURANCE MATTERS

There are only three open insurance items which merit comment at this time:

1. Although the D&O insurance market seems to be softening, the premiums are still very high. Therefore, the Corporation is pursuing a self-insurance alternative by creating a trust to be administered by a third party for the benefit of the Directors. A separate detailed report will be presented to the Board by our Legal department on this topic.
2. Now that we have many employees scattered about the world, we have initiated an exploratory examination of the potential economies of scale that might be realized by pooling our international employee benefits insurance. Johnson & Higgins' international group is spearheading this effort.
3. With the launching of Excel PC, our insurance carrier has expressed concern that we be very sensitive to potential advertising liability suits which can be extremely expensive. For example, they note that in the October 12 issue of Electronic News, there are numerous references in our ad to Lotus 123, including benchmark comparisons. Chubb recommends that we formalize our advertising strategy under the scrutiny of our Legal department.

# FACILITIES EXPANSION REPORT

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## FACILITIES EXPANSION REPORT

### Future Facilities Growth - Phase III, Building 6

The Board-approved master plan for Buildings 8, 9 and 10 is being implemented as follows. The first step is to amend the master plan on file with the City of Redmond for the recently acquired 56 acres and includes re-drawing the lot lines and the road locations. These amendments will be submitted to the City during the first week of November.

The second step is the submission of the design, siting and construction drawings for Building 8. These drawings will be submitted during the first two weeks of December.

Subject to City approval of the Master Plan Amendment and the building plans, construction is scheduled to begin in February. Completion and occupancy, originally targeted for October 1988, will be delayed due to the October 22, 1987 prohibition of the use of the "lift slab" construction process by OSHA. Microsoft has utilized this method in the construction of Buildings 1-6 because it is both time and cost efficient. Once the slabs are in place, there are no safety concerns.

This change in the construction process is being evaluated and the impact will be twofold. The cost will increase because the floors will be "cast in place." More significantly, it will take longer, thus impacting the completion schedule. Both impacts are being studied to determine more precisely dollar and time costs.

In the meantime, alternative short-term nearby locations to accommodate growth requirements are being developed so the delay of Building 8 will be minimized.

There are no plans to start Building 9 or 10.

In September, Microsoft hosted the City-elected officials and Department heads at an informal luncheon and tour of the Campus. Bill Gates and Jon Shirley spoke to the group.

### New Manufacturing and Distribution Facility

The construction of this new 260,000 SF facility is proceeding on schedule. With the aid of the dry weather, concrete for the 5.65 acre floor and the 97 wall panels were poured almost every other day from August 12 to October 16. The wall panels start being lifted into place during the week of October 26.

The shell and core are on schedule for completion in March, followed by the installation of equipment and fixtures for a late April occupancy.

### Irish Facilities Expansion

Contracts for the purchase of our existing facilities and land have been drafted. Both parties are shooting for October 30th as the date for signing. The final building plans are drawn and have been submitted to the Sandford County Council for planning approval and the building permit. This is expected to take slightly less than 3 months and as such, initial construction is scheduled to begin the first part of January. The original occupancy date of October still holds.

In completing the detailed plans for the building expansion it was decided that an additional one-half acre of land was necessary. This was due to the revised placement of the building on the land and the necessity of

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increasing the area provided for large trucks to turn and maneuver. This additional 1/2 acre cost \$37,700. There are no other project cost increases or decreases beyond those originally approved by the Board.

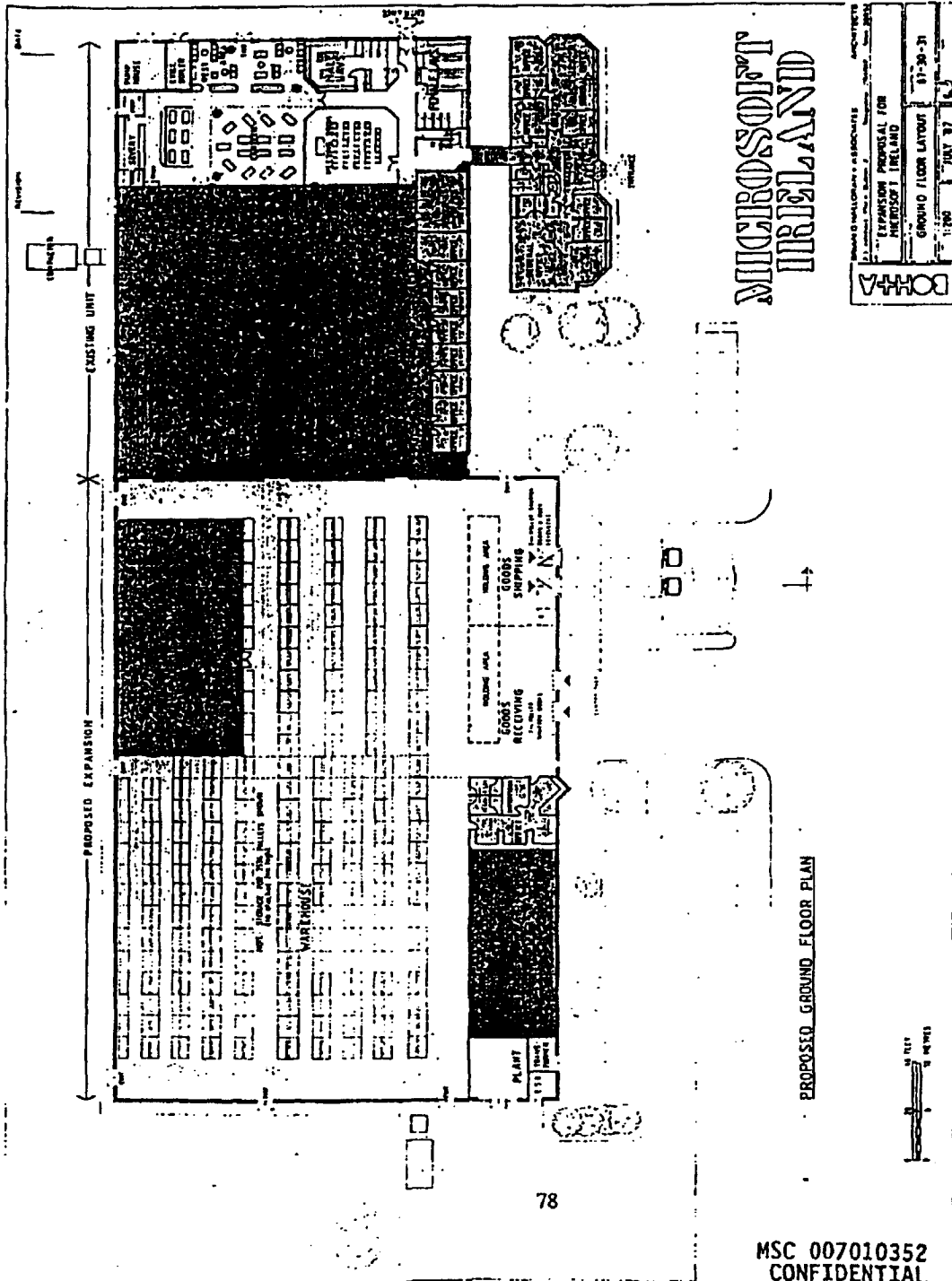
Construction bids are now being requested from 3 general contractors. We have received a bid from Cramptons who built our current facilities in Ireland. This bid was used in the original memo to the Board of Directors requesting approval for this project in July. We expect this bid process and the competitive nature of the construction industry to produce cost savings on the total construction costs.

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**MICROSOFT  
IRELAND**

BOHRA  
 ARCHITECTS  
 EXPANSION PROPOSAL FOR  
 MICROSOFT IRELAND  
 GROUND FLOOR LAYOUT  
 1:250 JULY 87  
 81-30-31

PROPOSED\_GROUND\_FLOOR\_PLAN

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MS-PCA 1187722  
 CONFIDENTIAL

# STOCK/INVESTOR RELATIONS

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MS-PCA 1187723 )  
CONFIDENTIAL )

STOCK/INVESTOR RELATIONS

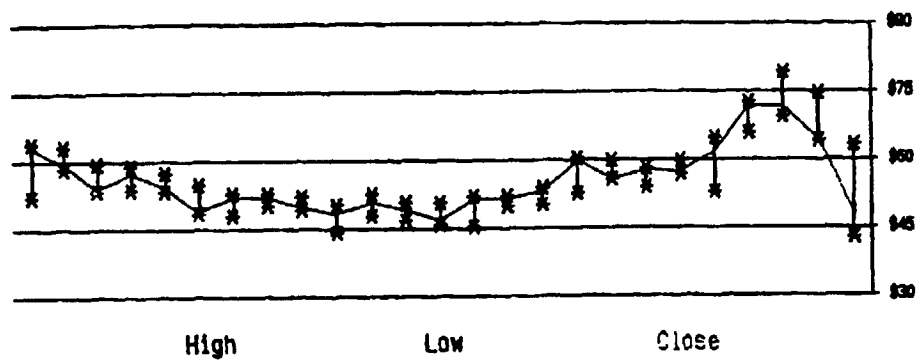
Research Analysts Earnings Estimates

The earnings estimates of the primary sell-side research analysts that follow Microsoft are listed below. The E.P.S. estimates are as currently reported including the stock option bonus.

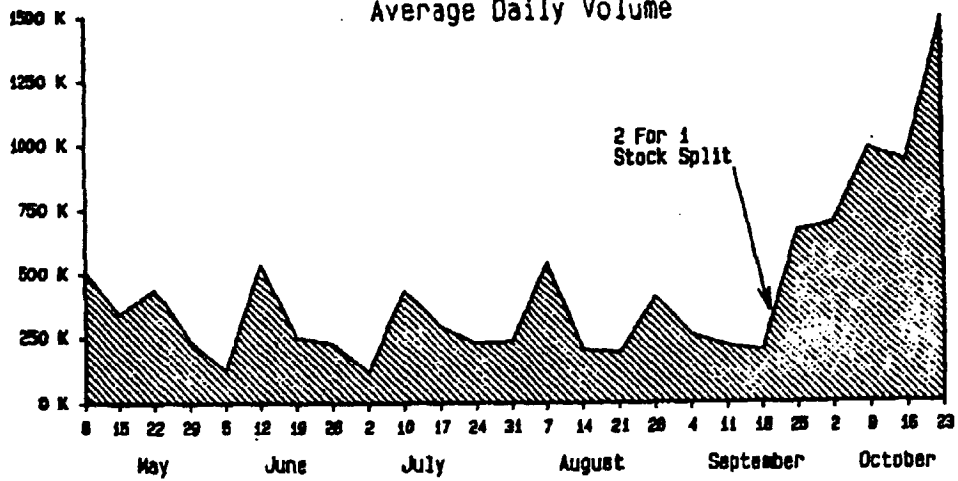
	2QFY88 E.P.S. Revenue	FY88 E.P.S. Revenue
1. Alex Brown & Sons Ruthann Quindlen	\$.45-.50 \$120M	\$1.90-2.00 \$450M
2. Cable Howse & Ragen Teresa Lotsegzell	\$.44 \$120M	\$1.80 \$490M
3. Cowen & Co. Dan Reeve	\$.50 \$123M	\$2.00 \$478M
4. D.H. Brown Associates Barbra Isgur	\$.43 \$120M	\$1.87 \$510M
5. First Boston Bruce Johnston	\$.50 \$128M	\$1.90-2.00 \$470M
6. Goldman Sachs & Co. Rick Sherlund	\$.55 \$120M	\$1.95 \$460M
7. Hambrecht & Quist Osman Eralp/David Thomas	\$.45-.50 \$116M	\$1.80-1.85 \$480M
8. Montgomery Securities Bill Shamck	\$.45 \$115M	\$1.80-2.00 \$470M
9. Paine Webber Bob Thernien	\$.51 \$123M	\$2.00 \$478M
10. Piper, Jaffray & Hopwood Tom Friedberg	\$.48 \$115M	\$1.95 \$475M
11. Robertson, Coleman & Stephens Brian Mutert	\$.55 \$125M	\$2.00 \$481M
12. L.F. Rothschild Charlone Walker	\$.43 \$115M	\$1.73 \$455M
13. Shearson Lehman Tom Galvin	\$.48 \$111M	\$2.00 \$470M
14. Smith Barney David Readerman	\$.45 \$121M	\$1.90 \$486M
15. Salomon Brothers Michele Preston	\$.56 \$120M	\$1.96 \$441M

# Weekly Stock Performance

## Price



## Average Daily Volume





NASDAQ/NMS SYSTEM STATISTICS

COMPOSITE INDEX ASSIGNED INDEX ( INDUSTRIAL )

HIGH	486.37	486.76
LOW	481.74	481.74
CLOSE	484.29	484.29
PREVIOUS CLOSE	484.57	484.52
% CHANGE	-2.34	-1.81

TOTAL NASDAQ VOLUME: 3,082,780,700  
 TOTAL NMS VOLUME: 2,110,116,191  
 TOTAL NMS TRADES: 1,208,838  
 TOTAL NMS SECURITIES: 3,065

SUMMARY FOR THIS SECURITY

1. PRICE RANGE: HIGH A 66 5/8 LOW A 53  
 2. LAST PRICE: (AUG) A 59 3/8 (SEP) 66 1/4 PERCENT CHANGE: A +11.58

3. VOLUME FOR MONTH: 7,897,380

4. TOTAL TRADES: 9,879

5. BLOCKS: NUMBER OF BLOCKS 75 NUMBER OF SHARES 865,500

MICROSOFT CORPORATION  
 Mr. Francis J. Gaughette  
 Vice President of Finance  
 16011 N.E. 36th Street  
 Box 87017  
 Redmond VA 98073

NASDAQ SYMBOL: MSFT  
 SECURITY DESCRIPTION: Common Stock (\$ .001 Par Value)  
 TOTAL SHARES OUTSTANDING: 52,740,000  
 SHORT INTEREST REPORTED: 764,376 AS OF 08/15/87  
 PLEASE NOTIFY NASDAQ OF ANY CHANGE IN COMPANY CONTACT OR ADDRESS

DATE	HIGH	LOW	LAST	NET CHANGE	SHARE VOLUME	TRADES	NMS VOLUME	NASDAQ VOLUME	COMPOSITE CLOSE
TUE 1	118 3/4	112 1/2	113 1/2	-5 1/2	335,417	387	116,819,332	178,772,500	432.50
WED 2	117 3/4	113 1/4	115 1/4	+1 1/2	272,400	354	100,782,082	147,148,700	448.36
THU 3	117 3/4	113 3/4	112	-3 1/2	246,419	248	81,275,134	131,634,700	446.48
FRI 4	115 1/2	111 3/4	112	-6 3/4	1,013,486	1,186	401,748,112	598,036,800	446.48
WEEK									
MON 7	HOLIDAY								
TUE 8	108 1/2	108 1/2	111 1/2	+1 1/2	231,116	283	104,140,018	145,488,200	437.50
WED 9	111 3/4	111 1/2	114 1/2	+1 3/4	211,000	262	90,076,643	125,298,500	443.48
THU 10	115 3/4	114	116 1/4	+1 3/4	202,884	185	103,676,050	158,218,500	448.17
FRI 11	116 1/2	108 1/4	116 1/4	+4 1/4	142,587	157	104,557,641	158,198,000	446.17
WEEK									
MON 14	116 1/2	116 1/2	119 1/4	+3 3/8	338,100	288	92,502,847	120,272,200	447.48
TUE 15	119 1/2	116 3/4	116 3/4	-1 1/8	135,878	185	52,152,471	141,803,500	440.75
WED 16	117 1/2	113 3/4	116	-1 3/4	200,826	247	85,194,757	141,803,500	440.75
THU 17	117 1/2	113 3/4	116	-1 3/4	241,514	307	88,800,510	154,450,800	440.75
FRI 18	116	113 3/4	119	+3 1/4	110,337	126	55,560,148	151,418,300	440.86
WEEK									
MON 21	57 1/4	53	53 1/2	A	594,736	531	97,014,687	157,888,500	436.01
TUE 22	57 3/4	53 3/4	57 1/4	+3 3/4	570,356	658	103,563,201	157,184,700	437.80
WED 23	60 3/8	57 3/8	60 1/4	+3	750,789	1,022	121,207,214	158,207,100	440.74
THU 24	60 1/4	57 1/4	60 1/4	+3	823,890	1,047	88,848,116	121,207,100	441.24
FRI 25	65	61 1/4	62	+1 3/4	623,610	1,047	88,848,116	121,207,100	441.24
WEEK									
MON 28	65 1/4	61 3/4	64 1/4	+2 1/4	598,899	878	101,299,755	137,008,500	442.28
TUE 29	66 5/8	62 5/8	66 1/4	+2 1/4	389,899	503	102,373,854	137,113,500	441.86
WED 30	66 5/8	61 3/4	66 1/4	+2 1/4	1,881,651	2,053	318,631,733	454,468,100	444.28
WEEK									

DEAN WITTER REYNOLDS  
 MERRILL LYNCH  
 SALOMON BROTHERS  
 SHEARSON LEHMAN BROTHERS  
 PIPER JAFFRAY & HOPEWOOD  
 ALEX. BROWN & SONS  
 TROSTER SINGER STEVENS  
 EDWIN & CO.  
 EDWARD A. VINER & CO  
 DREXEL BURNHAM LAMBERT  
 SMITH BARNEY HARRIS UPHAM  
 MORGAN GUINON COMPANY  
 MORGAN GUINON SECURITIES  
 MAYER & SCHWETZER  
 MORGAN GUNSTEAD KENNEDY  
 GOLDBIN SACHS & CO  
 KRAMER HUTTON COMPANY  
 KIDDER PEARSON & CO  
 ADLER, COLEMAN & COMPANY

AS OF 08/30/87

NASDAQ MARKET MAKERS IN THIS SECURITY

NASDAQ/NMS MONTHLY STATISTICAL REPORT  
 FOR MONTH ENDING 31 AUG 87



NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
 1735 K STREET NORTHWEST, WASHINGTON, D.C. 20006

SEP 2 2 1987

NASDAQ/NMS SYSTEM STATISTICS

COMPOSITE INDEX ASSIGNED INDEX ( INDUSTRIAL)

HIGH 484.39  
 LOW 0.00  
 CLOSE 484.52  
 PREVIOUS CLOSE 463.25  
 % CHANGE +4.59

TOTAL NASDAQ VOLUME: 2,135,766,300  
 TOTAL NMS VOLUME: 2,377,603,276  
 TOTAL NMS TRADES: 1,312,038  
 TOTAL NMS SECURITIES: 1,5040

SUMMARY FOR THIS SECURITY

1. PRICE RANGE: HIGH 121 1/4 LOW 81 1/4  
 2. LAST PRICE: (JUL) 94 (AUG) 118 3/4 PERCENT CHANGE: +26.33

3. VOLUME FOR MONTH: 7,073,604

4. TOTAL TRADES: 7,337

5. BLOCKS: NUMBER OF BLOCKS 82 NUMBER OF SHARES 1,171,850

NASDAQ SYMBOL: MSFT  
 SECURITY DESCRIPTION: Common Stock (\$.001 Per Value)  
 TOTAL SHARES OUTSTANDING: 26,146,448  
 SHORT INTEREST REPORTED: 755,160 AS OF 08/14/87

PLEASE NOTIFY NASDAQ OF ANY CHANGE IN COMPANY CONTACT OR ADDRESS

Microsoft Corporation  
 Mr. Francis J. Gaudette  
 Vice President of Finance  
 1601 N.E. 36th Street  
 Box 97017  
 Redmond VA 980739717

DATE	HIGH	LOW	LAST	NET CHANGE	SHARE VOLUME	TRADES	NMS VOLUME	NASDAQ VOLUME	COMPOSITE CLOSE
MON 3	84 1/2	81 1/4	81 3/4	-2 1/4	404,577	444	101,152,433	132,504,800	432.17
TUE 5	85 3/4	83 3/4	87 1/4	+2 1/2	470,259	507	104,484,033	140,252,100	432.17
WED 6	88 1/2	87 1/2	97 1/4	+9 3/4	734,215	610	105,041,833	151,825,800	436.25
THU 7	101 5/8	100 3/4	103 1/2	+2 1/2	530,670	480	112,239,626	149,571,800	440.00
FRI 13	104 1/2	100 3/4	103 1/2	+3 1/2	594,721	808	121,181,640	189,269,700	443.58
WEEK					2,734,370	2,549	648,110,564	740,634,200	443.58
MON 10	104 1/2	102 1/2	103 1/2	0	185,819	285	99,887,812	130,844,600	445.27
TUE 12	101 3/4	100	100	-1 1/2	232,559	246	144,759,888	195,425,000	445.27
WED 13	104 1/2	100 1/2	103 1/2	+3	147,233	211	124,697,438	172,117,800	448.23
THU 14	103 3/4	102 1/2	103 1/2	+1 1/2	290,211	280	123,804,633	169,212,300	451.55
FRI 14	104 1/2	100	103 1/2	+3	176,991	158	107,973,209	147,843,400	451.61
WEEK					1,028,973	1,280	511,128,101	786,248,100	451.61
MON 17	104 1/4	103 1/2	104 1/4	+1 1/4	134,819	135	91,217,208	126,298,800	451.65
TUE 18	102 3/4	100 1/2	102 1/2	-2 1/4	163,285	188	104,206,821	147,450,300	448.76
WED 19	105 3/4	102 1/2	105 1/2	+3 1/4	170,200	158	88,727,812	124,078,300	447.93
THU 20	108 3/4	102 1/2	105 1/2	+6 1/4	285,907	319	105,882,275	152,197,800	448.75
FRI 21	108 1/2	100 1/2	107	+1 1/2	571,883	1,045	504,788,107	722,214,800	455.18
WEEK					2,111,883	1,045	1,028,973	1,478,248,100	455.18
MON 24	112 3/4	109 1/2	111 3/4	+3 1/4	329,883	324	82,973,021	144,428,100	452.80
TUE 25	114 3/4	111 1/2	114 3/4	+2 1/4	648,282	659	105,494,000	147,586,100	455.10
WED 26	116 1/4	114 1/4	115 3/4	+1 3/4	355,022	340	102,404,511	138,672,800	453.28
THU 27	121 1/4	116 1/2	120 1/4	+4 1/2	555,855	2,115	113,034,378	153,630,800	453.28
FRI 28	121 1/4	105 1/2	120 1/4	+13 1/2	2,034,855	2,115	822,045,088	733,817,100	453.28
WEEK					2,034,855	2,115	822,045,088	733,817,100	453.28
MON 31	120 1/4	116 3/4	118 3/4	-1 1/2	282,318	338	81,824,418	132,888,100	454.57
WEEK					282,318	338	81,824,418	132,888,100	454.57

AS OF 08/31/87

DEAN WITTER REYNOLDS  
 MERRILL LYNCH  
 SALOMON BROTHERS

ALEX. BROWN & SONS  
 TROSTER SINGER STEVENS  
 EDWIN & CO.

NASDAQ MARKET MAKERS IN THIS SECURITY

SMITH BARNEY HARRIS UPHAM  
 CALLE HOUSE RAGAN  
 MONTGOMERY SECURITIES  
 WARD & SCHWARTZ

GOLDMAN SACHS & CO  
 HAMBRECHT & QUIST  
 E.F. MUTTON & COMPANY  
 KIDDER, PEABODY & CO

AUG 25 1987

**NASDAQ/NMS SYSTEM STATISTICS**

COMPOSITE INDEX ASSIGNED INDEX ( INDUSTRIAL )

HIGH 424.84  
 LOW 423.73  
 CLOSE 424.23  
 PREVIOUS CLOSE 424.67  
 % CHANGE +2.41

TOTAL NASDAQ VOLUME: 3,379,269,000  
 TOTAL NMS VOLUME: 2,122,419,892  
 TOTAL NMS TRADES: 1,192,210  
 TOTAL NMS SECURITIES: 3,010

**SUMMARY FOR THIS SECURITY**

1. PRICE RANGE: HIGH 105 3/4 LOW 86 1/2 PERCENT CHANGE: -7.64  
 2. LAST PRICE: (JUN) 102 (JUL) 84

3. VOLUME FOR MONTH: 6,315,081  
 4. TOTAL TRADES: 6,177  
 5. BLOCKS: NUMBER OF BLOCKS 73 NUMBER OF SHARES 977,800

NASDAQ SYMBOL: MSFT  
 SECURITY DESCRIPTION: Common Stock (\$ .001 Par Value)  
 TOTAL SHARES OUTSTANDING: 26,146,446  
 SHORT INTEREST REPORTED: 543,192 AS OF 07/15/87  
 PLEASE NOTIFY NASDAQ OF ANY CHANGE IN COMPANY CONTACT OR ADDRESS

Microsoft Corporation  
 Mr. Francis J. Gaulette,  
 1601 N.E. 36th Street  
 Box 87017  
 Redmond VA 220739717

DATE	HIGH	LOW	LAST	NET CHANGE	SHARE VOLUME	TRADES	NMS VOLUME	NASDAQ VOLUME	COMPOSITE CLOSE
WED 1	103 1/4	101 1/2	102 1/2	+ 2 1/2	76,280	114	87,316,621	243,808,900	424.45
THU 2	102 3/4	98 3/4	100	- 2	197,944	185	85,634,610	185,984,500	425.88
FRI 3	103 1/4	98 3/4	100	- 2 1/2	274,224	289	182,931,231	398,792,900	425.88
WEEK									
MON 5	101 1/4	97 1/2	97 1/2	- 2 1/2	227,790	276	92,406,346	139,274,200	425.10
TUE 6	94 3/4	89 1/2	90 1/4	+ 2 1/2	685,162	655	107,546,266	195,524,800	424.55
WED 7	94 3/4	88 1/4	90 1/4	+ 2 1/2	672,665	789	114,943,374	194,831,700	424.83
THU 8	98 1/4	89 1/4	89 3/4	+ 2 1/2	323,442	256	191,652,855	131,973,800	426.00
FRI 9	97 1/2	86 1/2	91	- 3	2,171,441	2,356	501,374,890	814,771,900	426.00
WEEK									
MON 12	89 1/2	86 1/2	89 1/4	+ 3 1/4	187,879	216	82,037,196	127,719,200	426.92
TUE 13	105 3/4	102 1/4	105 1/4	+ 3 1/4	53,045	395	19,227,064	150,175,000	431.74
WED 14	102 3/4	102 1/4	102 1/4	- 2 1/2	236,986	270	101,500,020	158,822,200	431.71
THU 15	102 3/4	102 1/4	102 1/4	+ 1 1/4	178,065	193	96,337,486	132,891,400	433.08
FRI 16	105 3/4	101 3/4	101 1/4	+ 5 1/4	1,467,650	1,391	488,869,120	782,901,500	433.08
WEEK									
MON 20	102 3/4	89 1/4	89 1/2	- 2 3/4	165,382	182	77,652,127	130,269,200	421.51
TUE 21	100 1/2	88 1/2	89 1/2	+ 3 1/4	175,280	167	107,078,872	156,229,100	428.37
WED 22	100 1/2	88 1/2	89 1/2	+ 3 1/4	185,245	141	98,797,064	154,103,700	428.37
THU 23	100 1/2	84 3/4	97 3/4	+ 2 1/2	515,955	439	98,494,735	152,355,000	428.83
FRI 24	99 1/2	97 3/4	98 1/2	+ 3 1/4	300,104	158	97,672,886	147,372,000	428.13
WEEK									
MON 27	99 3/4	97 1/4	98 3/4	+ 1 1/4	145,267	145	69,855,556	111,985,700	428.67
TUE 28	101 3/4	99 1/4	99 1/2	- 1 1/4	132,709	157	92,900,184	125,855,100	428.97
WED 29	99 3/4	97 3/4	99 1/4	- 1 1/4	186,487	105	101,330,474	135,952,200	431.40
THU 30	99 1/4	96 3/4	97 1/2	- 2 1/4	93,883	118	101,233,170	127,851,400	431.93
FRI 31	96 3/4	92	94	- 4 1/2	1,216,330	1,031	473,546,157	670,263,100	431.93
WEEK									

DEAN WITTER REYNOLDS  
 MERRILL LYNCH  
 HAMBRECHT & QUIST

ALEX BROWN & SONS SECURITIES  
 PRUDENTIAL SECURITIES  
 FOLEY, BRONKHORST, & ...

SMITH BARNEY/MERRIS UPHAM  
 ROBERT S. LANGER STEVENS  
 CRISP & COMPANY

NASDAQ MARKET MAKERS IN THIS SECURITY

COLMAN, SICAK & CO  
 CURTIS, MINTZ & PERLE  
 MONTGOMERY SECURITIES  
 THE FIRST FORTION CORP

Stock Dividend

The payment of the 100% stock dividend was mishandled by the transfer agent, First Jersey National Bank. All shareholders with restricted stock were to receive a dividend certificate for the same number of shares WITH the restrictive legend. This happened. These shareholders also received a certificate for the same number of shares WITHOUT the restrictive legend.

First Jersey moved quickly to correct the error by sending mailgrams to affected shareholders.

Obviously, First Jersey assumes all responsibility and liability for the mistake. At Microsoft's request, First Jersey had its outside auditors, Peat Marwick Main & Co., conduct a review of the correction action and process. PM & M's report, reviewed by Delloite Haskins & Sells, reconciled the corrective action so no incorrectly issued dividend certificates can be transferred.

Attached:

Dividend Release

Sample Mailgram

First Jersey Letter dated September 29, 1987

Peat Marwick & Main letter dated October 21, 1987



Microsoft Corporation  
16011 NE 36th Way  
Box 97017  
Redmond, WA 98073-9717

Tel 206 882 8080  
Telex 328945

## Microsoft News Release

For Release: Immediate

Contact: Raymond B. Ferguson  
Microsoft Corporation  
(206) 882-8080

Pam Edstrom  
The Waggner Group  
(503) 245-0905

### MICROSOFT DECLARES STOCK DIVIDEND

Redmond, Washington--August 3, 1987--Microsoft Corporation today announced that its board of directors declared a 100% stock dividend at its quarterly meeting held on Saturday. Microsoft will issue one additional share for each share held on the record date of August 21, 1987.

"Our decision to declare this stock dividend reflects the company's continuing desire to make our stock more accessible to a broader base of investors," said Jon Shirley, Microsoft's President and Chief Operating Officer.

As of August 1, 1987, Microsoft had approximately 26 million shares outstanding. Upon completion of the dividend, that number will increase to approximately 52 million shares outstanding.

The additional shares will be mailed on or about September 18, 1987 by the company's transfer agent, First Jersey National Bank.

Microsoft Corporation (NASDAQ "MSFT") develops, markets and supports a wide range of software for business and professional use, including operating systems, languages and application programs, as well as books and hardware for the microcomputer marketplace.

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*Microsoft*

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THE FIRST JERSEY NATIONAL BANK  
THE FIRST JERSEY NATIONAL BANK  
NEW YORK NY 10001 25PM

Western Union Mailgram



4-0511189268 09/25/87 ICB IPHMTZZ C8P 8EAB  
2126888888 MGMB TOMT NEW YORK NY 161 09-25 1052P EST

CARL STORK  
2532 ROYAL COURT EAST  
SEATTLE WA 98112

DEAR MR STORK,

WE ARE THE TRANSFER AGENT FOR MICROSOFT CORPORATION, RECENTLY, YOU WERE SENT STOCK CERTIFICATES IN CONNECTION WITH THE RECENT STOCK DIVIDEND OF THE COMPANY, THESE CERTIFICATES WERE ISSUED IN ERROR AND REPRESENT A GREATER NUMBER OF SHARES THAN YOU OWN, THESE CERTIFICATES CANNOT BE TRANSFERRED OR NEGOTIATED BY YOU.

IN ORDER TO CORRECT THIS ERROR, PLEASE RETURN THESE CERTIFICATES, IMMEDIATELY, TO EITHER:

BY HAND: MS KATE RUSSELL  
BUILDING 6  
MICROSOFT CORPORATION

BY MAIL: FIRST JERSEY SHAREHOLDER SERVICES, INC.  
520 PIKE STREET  
SUITE 2134  
SEATTLE, WA 98101

ALL MAIL DELIVERIES SHOULD BE MADE BY REGISTERED MAIL, RETURN RECEIPT REQUESTED, ONCE WE ARE IN RECEIPT OF THESE CERTIFICATES WE WILL ISSUE NEW CERTIFICATES FOR THE PROPER NUMBER OF SHARES PROMPTLY.

IF YOU HAVE ANY QUESTIONS, YOU MAY CONTACT THE TRANSFER AGENT AT (206)340-1011, WE APOLOGIZE FOR ANY INCONVENIENCE THIS MAY HAVE CAUSED YOU.

VERY TRULY YOURS,

THE FIRST JERSEY NATIONAL BANK  
22150 EST  
MGMCDHP

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CONFIDENTIAL

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TO REPLY BY MAILGRAM MESSAGE, SEE REVERSE SIDE FOR WESTERN UNION'S TOLL - FREE PHONE NUMBERS

MS-PCA 1187731  
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**FIRST JERSEY**

Dominick D'Agosta  
Executive Vice President

RECEIVED  
OCT 5 1987  
RBF

September 29, 1987

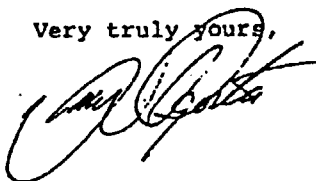
Mr. Raymond B. Ferguson, Director of Investor Relations  
Microsoft Corporation  
16011 N. E. 36th Way  
Box 97017  
Redmond, Washington 98073-9711

Dear Buck:

We regret the inconvenience caused you and your firm due to our mishandling of your recent stock dividend. This letter is to confirm our oral agreement that The First Jersey National Bank will absorb all costs relative to the processing of Microsoft's stock dividend, payable September 18, 1987, including all costs resulting from error. Expenses incurred by the Bank will not be billed to the Corporation and, additionally, any expenses incurred by the Corporation will be reimbursed by First Jersey. This agreement includes costs incurred as a result of efforts to recover incorrectly issued stock.

We value your relationship and sincerely apologize for this occurrence. The steps we have taken to remedy this episode will also prevent it from recurring in the future.

Very truly yours,



DDA:d

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First Jersey National Bank—One Exchange Place—Jersey City, N. J. 07302—(201) 547-7183

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**Peat Marwick**

Certified Public Accountants

Peat Marwick Main & Co.  
 New Jersey Headquarters  
 150 John F. Kennedy Parkway  
 Short Hills, NJ 07078

Telephone 201 467 9650  
 Telex 136584

Telecopier 201 467 7830

October 21, 1987

The Board of Directors  
 First Jersey National Bank  
 Jersey City, New Jersey:

We have applied certain agreed-upon procedures, as discussed below, to certain accounting records of First Jersey National Bank Stock Transfer Department, as of October 15, 1987, solely to assist you in accounting for all of the shares of common stock issued and outstanding of Microsoft Corporation. It is understood that this report is solely for your information and is not to be referred to or distributed for any purpose to anyone who is not a member of your management group, except for its distribution to The Board of Directors of Microsoft Corporation. Our procedures and findings are as follows:

- We reviewed First Jersey National Bank's reconciliation of Microsoft's shares outstanding as of August 21, 1987, the date of record for a 100% stock split. Such reconciliation included the following components:

Shares outstanding at Aug. 21, 1987 before calculation of 100% stock split		26,477,265	
Shares issued:	Common File	26,477,265	
	I-Restricted Legend File	73,137	
	L-Restricted Legend File	<u>18,496,235</u>	<u>45,046,637</u>
Excess shares issued			18,569,372
Shares recovered		18,949,559	
Valid shares recovered and being held in exchange for duplicate certificates		150,110	
Less: Shares reissued		<u>(600,223)</u>	<u>18,499,446</u>
Net shares unrecovered			<u>69,926</u>

- The shares outstanding at August 21, 1987 of 26,477,265 were confirmed with Microsoft's Department of Investor Relations.
- The shares issued in connection with the 100% stock split of 45,046,637 were agreed either to the First Jersey National Bank's Stock Split Dividend Activity Report (common file) or the Data Base History Report (restricted legend files).

**RPMG** Peat Marwick

The Board of Directors  
First Jersey National Bank

- 2 -

- We examined duplicate stock certificates returned to First Jersey National Bank through the close of business October 15, 1987. The total shares represented by these certificates were 18,949,559.
- We examined valid stock certificates incorrectly returned to First Jersey National Bank through the close of business October 15, 1987, which are being held in exchange for duplicated stock certificates. The total shares represented by these certificates were 150,110.
- The total number of shares reissued, 600,223, was agreed to a detailed schedule prepared by First Jersey National Bank management. Of the 227 certificates reissued, we selected 30 certificates and agreed share amounts to the Data Base History Report without exception.
- The net shares still unrecovered at October 15, 1987 were agreed to a detailed list of shareholders prepared by First Jersey National Bank management. We noted that each unrecovered certificate was cancelled in the department's Data Base History file. First Jersey National Bank management has informed us that these certificates cannot be transferred on Microsoft's shareholder data base file maintained by First Jersey National Bank as transfer agent.

Because the above procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on Microsoft's stock transfer account at First Jersey National Bank. In connection with the procedures referred to above, no matters came to our attention, except as noted above, which caused us to believe that the above-mentioned stock transfer account should be adjusted. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. This report relates only to the account specified above and does not extend to any financial statements of First Jersey National Bank taken as a whole.

Very truly yours,

PEAT MARWICK MAIN & CO.

  
Joseph J. Burke, Partner

JJB:deb

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Microsoft Corporation  
16011 NE 36th Way  
Box 97017  
Redmond, WA 98073-9717

Tel 206 882 8080  
Telex 328945  
Fax 206 883 8101

## Microsoft News Release

For Release: Immediate

Contact: Raymond B. Ferguson  
Microsoft Corporation  
(206) 882-8080

Pam Edstrom  
The Waggener Group  
(503) 245-0905

### MICROSOFT REPORTS FIRST QUARTER REVENUES OF \$102.6 MILLION

Redmond, Washington--October 19, 1987. Microsoft Corporation today reported revenues of \$102.6 million for the first quarter of fiscal year 1988 which ended September 30, 1987, a 54 percent increase over the \$66.8 million for the same period of fiscal 1987. Net income for the quarter was \$21.3 million, an increase of 34 percent over the \$15.8 million for the corresponding period of fiscal 1987. Earnings per share were \$.38, as compared with \$.29 a year ago.

As noted in previous quarterly results, during the past fiscal year the Company initiated two programs regarding its incentive stock options. Had these programs not been adopted, net income and net income per share would have been approximately \$23.3 million and \$.42, representing increases of 47 percent and 45 percent respectively.

Jon Shirley, President and Chief Operating Officer, said: "This eighth consecutive record quarter makes Microsoft the first microcomputer software company to do over \$100 million in sales in a quarter."

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**Microsoft**

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"As indicated two weeks ago, strong retail and OEM revenues worldwide contributed to our positive results," added Frank Gaudette, Vice President and Chief Financial Officer. "Financial performance was strong across all channels of distribution and product groups."

The Company was active on many fronts during the quarter, announcing several new products and product updates that deliver on the promise of research and development efforts.

The Applications group announced a variety of products designed to work with MS-DOS<sup>R</sup> based personal computers. These products will begin to ship and generate revenues during the second quarter. In August Microsoft announced version 4.0 of Microsoft<sup>R</sup> Word, which underscores an aggressive commitment to the word processing market. Another key introduction, Microsoft Works, is a multipurpose software package that combines word processing, a spreadsheet with charting, a database, and communications in a single program. Designed for the fast-growing home business and small business markets, Microsoft Works carries a suggested retail price of \$195.

Microsoft Excel For Windows was announced October 6. The first major Microsoft applications product for the Windows environment, Microsoft Excel is also the first spreadsheet designed to take advantage of today's new, more powerful personal computers. It is scheduled to begin shipping during the second fiscal quarter.

On the Systems front, the Company announced Microsoft Windows/386, a new version of our graphics-based operating

environment designed for optimal performance on personal computers built around the Intel<sup>R</sup> 80386 microprocessor. An ideal operating environment for MS-DOS based computers, Windows/386 provides users with an excellent transition to Microsoft OS/2 with Presentation Manager, which is scheduled for next year. Developed with Compaq Computer Corporation, Windows/386 will be shipped with 80386 based computers from Compaq and from other hardware manufacturers, and will also be made available directly to end users through retail distribution.

Microsoft Corporation (NASDAQ "MSFT") develops, markets, and supports a wide range of microcomputer software for business and professional use, including operating systems, languages and application programs, as well as books and hardware for the microcomputer marketplace.

###



CONSOLIDATED RESULTS OF OPERATIONS  
(In thousands, except net income per share)

	<u>Three Months Ended</u> <u>September 30</u>	
	<u>1987</u>	<u>1986</u>
Net revenues	\$102,636	\$66,780
Income before income taxes	32,479	27,384
Net income	21,259	15,824
Net income per share	.38	.29
Average shares outstanding	55,536	55,050

###

Microsoft and MS-DOS are registered trademarks of Microsoft Corporation.

MICROSOFT CORPORATION  
SUMMARY OF STOCK OPTION PLAN ACTIVITY  
AS OF 09/30/87

GST-2003

PLAN CODE: C  
PLAN: '81 Plan

PERIOD	BEGINNING OF PERIOD GRANT SHARES AVAILABLE	(1)	(2)	NO. OF GRANT SHARES FORFEITED	END OF PERIOD GRANT SHARES UNDER OPTION	END OF PERIOD GRANT SHARES AVAILABLE	NO. OF EXERCISED SHARES AT PERIOD END
		GRANT SHARES	TRANSFERRED, GRANT SHARES				
07/01/81-06/30/82	4,048,000	( 1,818,150 )	96,850	7,300	( 1,714,000 )	4,326,000	0
07/01/82-06/30/83	4,326,000	( 2,245,536 )	370,936	225,600	( 3,343,000 )	2,677,000	3,800
07/01/83-06/30/84	2,677,000	( 2,051,726 )	534,496	831,702	( 4,048,528 )	1,991,472	147,384
07/01/84-06/30/85	1,991,472	( 2,124,632 )	805,202	443,836	( 4,924,122 )	1,115,878	577,190
New Pool-12/13/85	400,000						
New Pool-01/27/86	400,000						
New Pool-04/26/86	2,000,000						
07/01/85-06/30/86	3,915,878	( 3,825,968 )	1,355,810	442,506	( 6,951,774 )	1,888,226	1,785,222
New Pool-05/09/87	4,000,000						
07/01/86-06/30/87	3,889,068	( 2,435,500 )	80,400	355,942	( 8,950,932 )	3,889,068	3,466,784
07/01/87-09/30/87	3,889,068	( 557,450 )	0	50,188	( 9,458,194 )	3,381,806	3,615,747
TOTALS:	12,840,000	( 15,058,962 )	3,243,694	2,357,074	( 9,458,194 )	3,381,806	3,615,747
Pending		( 0 )	0		( 9,458,194 )	3,381,806	

NET GRANT ACTIVITY BY QUARTER STARTING FY 87:

PERIOD	GRANTS	LESS TRANSFERS	NET		DRAIN ON POOL
			NEW GRANTS	LESS FORFEITS	
1st QTR FY 87	518,600	80,400	438,200	87,878	350,322
2nd QTR FY 87	836,300		836,300	129,124	707,176
3rd QTR FY 87	344,900		344,900	65,124	279,776
4th QTR FY 87	735,700		735,700	73,816	661,884
1st QTR FY 88	557,450	0	557,450	50,188	507,262
	2,992,950	80,400	2,912,550	406,130	2,506,420

NOTE:

1. Includes reissuance of converted ISOs to NSOs
2. ISOs converted to NSOs

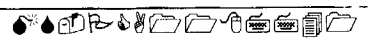
**SUMMARY OF RELATED PARTY LOANS**

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MS-PCA 1187740  
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**SUMMARY OF RELATED PARTY LOANS**

	Jul 1, 87 Balance	Additions	Payments & Retirements	Sep 30, 87 Balance
Short term employee loans	596,891	12,440	226,044	383,287
Long term employee loans	552,453	9,182	2,488	559,147
Stock purchase agreements	<u>900,132</u>	<u>17,498</u>	<u>0</u>	<u>917,630</u>
<b>Total</b>	<b>2,049,476</b>	<b>39,120</b>	<b>228,532</b>	<b>1,860,064</b>



**SHORT TERM EMPLOYEE LOANS**

	Jul 1, 87 Balance	Additions	Payments & Retirements	Sep 30, 87 Balance
Sunny Baker	10,015	225	0	10,240
Dan Carter	5,460	120	0	5,580
Bob Free	0	1,013	0	1,013
Frank Gaudette	41,300	1,050	0	42,350
Rick Hansen	26,775	563	0	27,338
Roland Hansen (1)	20,217	0	20,217	0
Rich MacIntosh	64,542	1,408	0	65,950
Nancy Mitchell	34,704	0	34,704	0
Nathan Myrhvold	32,212	611	15,000	17,823
Peter Neupert	159,854	3,190	0	163,044
Scott Oki	41,596	1,058	0	42,654
Rao Remala	7,116	180	0	7,296
Kim Torp-Pederson	153,100	3,024	156,124	0
<b>Total</b>	<b>596,891</b>	<b>12,441</b>	<b>226,045</b>	<b>383,287</b>

(1) This terminated employee paid his note in full in July 1987.

**SHORT TERM EMPLOYEE LOANS**

\*\*\* PRINCIPAL \*\*\*

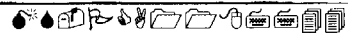
	Original Principal	Jul 1, 87 Balance	New Loans	Principal Payments & Retirements	Sep 30, 87 Balance
Sunny Baker	9,000	9,000	0	0	9,000
Dan Carter	4,000	4,000	0	0	4,000
Bob Free	1,000	0	1,000	0	1,000
Frank Gaudene	60,000	35,000	0	0	35,000
Rick Hansen	25,000	25,000	0	0	25,000
Roland Hanson	25,856	15,856	0	15,856	0
Rich MacIntosh	179,430	62,585	0	0	62,585
Nancy Mitchell	31,157	31,157	0	31,157	0
Nathan Myrsvold	116,000	30,548	0	14,398	16,150
Peter Neupert	159,500	159,500	0	0	159,500
Scott Oki	150,000	35,250	0	0	35,250
Rao Remala	6,000	6,000	0	0	6,000
Kim Torp-Pederson	153,100	153,100	0	153,100	0
<b>Total</b>		<b>566,996</b>	<b>1,000</b>	<b>214,511</b>	<b>353,485</b>

\*\*\* INTEREST \*\*\*

	Date of Loan	Jul 1, 87 Balance	New Interest	Interest Payments & Retirements	Sep 30, 87 Balance
Sunny Baker	5/86	1,015	225	0	1,240
Dan Carter	10/83	1,460	120	0	1,580
Bob Free	8/87	0	13	0	13
Frank Gaudene	9/84	6,300	1,050	0	7,350
Rick Hansen	9/86	1,775	563	0	2,338
Roland Hanson	6/83	4,361	0	4,361	0
Rich MacIntosh	10/86 & 12/86	1,957	1,408	0	3,365
Nancy Mitchell	3/86 & 6/86	3,547	0	3,547	0
Nathan Myrsvold	7/86	1,664	611	602	1,672
Peter Neupert	6/87	354	3,190	0	3,544
Scott Oki	4/84	6,346	1,058	0	7,404
Rao Remala	12/85	1,116	180	0	1,296
Kim Torp-Pederson	6/87	0	3,024	3,024	0
<b>Total</b>		<b>29,895</b>	<b>11,441</b>	<b>11,534</b>	<b>29,802</b>

**LONG TERM EMPLOYEE LOANS**

	<b>Jul 1, 87 Balance</b>	<b>Additions</b>	<b>Payments</b>	<b>Sep 30, 87 Balance</b>
Steve Ballmer	419,175	7,086	0	426,261
Charles Simonyi	57,644	959	2,488	56,115
Gordon Letwin	54,860	874	0	55,734
Chris Larson	<u>20,774</u>	<u>263</u>	<u>0</u>	<u>21,037</u>
<b>Total</b>	<b>552,453</b>	<b>9,182</b>	<b>2,488</b>	<b>559,147</b>



LONG TERM EMPLOYEE LOANS

\*\*\* PRINCIPAL \*\*\*

	Remaining Shares	Jul 1, 87 Balance	New Loans	Principal Payments	Sep 30, 87 Balance
Steve Ballmer	3,410,000	404,938	0	0	404,938
Charles Simonyi	466,334	55,377	0	2,375	53,002
Gordon Letwin	440,000	49,936	0	0	49,936
Chris Larson	126,400	15,010	0	0	15,010
Total		525,261	0	2,375	522,886

\*\*\* INTEREST \*\*\*

	Date Of Loan	Jul 1, 87 Balance	New Interest	Interest Payments	Sep 30, 87 Balance
Steve Ballmer	7/81 & 4/82	14,237	7,086	0	21,323
Charles Simonyi	7/81 & 4/82	2,267	959	113	3,113
Gordon Letwin	7/81 & 4/82	4,924	874	0	5,798
Chris Larson	12/81 & 4/82	5,764	263	0	6,027
Total		27,192	9,182	113	36,261



**NOTES ISSUED IN CONNECTION WITH STOCK PURCHASE AGREEMENTS**

	Jul 1, 87 Balance	Additions	Payments & Retirements	Sep 30, 87 Balance
Ida Cole	36,206	675	0	36,881
Bill Neukom	685,081	13,781	0	698,862
Robert O'Brien	155,184	2,592	0	157,776
Scott Okj	23,661	450	0	24,111
<b>Total</b>	<b>900,132</b>	<b>17,498</b>	<b>0</b>	<b>917,630</b>

**NOTES ISSUED IN CONNECTION WITH STOCK PURCHASE AGREEMENTS**

**\*\*\* PRINCIPAL \*\*\***

	Remaining Shares	Jul 1, 87 Balance	New Notes	Payments & Retirements	Sep 30, 87 Balance
Ida Cole	10,001	30,003	0	0	30,003
Bill Neukom	35,000	612,500	0	0	612,500
Robert O'Brien	5,000	148,100	0	0	148,100
Scott Oki	6,667	20,001	0	0	20,001
<b>Total</b>		<b>810,604</b>	<b>0</b>	<b>0</b>	<b>810,604</b>

**\*\*\* INTEREST \*\*\***

	Date of Note	Jul 1, 87 Balance	New Interest	Payments & Retirements	Sep 30, 87 Balance
Ida Cole	3/85	6,203	675	0	6,878
Bill Neukom	3/86	72,581	13,781	0	86,362
Robert O'Brien	10/86	7,084	2,592	0	9,676
Scott Oki	6/85	3,660	450	0	4,110
<b>Total</b>		<b>89,528</b>	<b>17,498</b>	<b>0</b>	<b>107,026</b>

HUMAN RESOURCES

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# SAVINGS PLUS PLAN UPDATE

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## SAVINGS PLUS PLAN UPDATE

### Internal Revenue Service Determination Letter

Microsoft received a favorable determination from the IRS for the Savings Plus Plan's (401k) tax qualification on October 15, 1987. Plan documents will be distributed to all eligible and participating employees within the month.

### Investment Selection Amendment

The approved Savings Plus amendment to change investment selection and contribution rate from semi-annually to quarterly will assist in increasing plan participation for two reasons. First, employees gain more control over their investments in Savings Plus by the increased ability to re-direct their funds within the investment options offered with Savings Plus. Second, the change to adjusting contribution rates into Savings Plus on a quarterly basis offers the employee more flexibility in their short and long-term financial planning.

### New Participants

The participation rate of newly eligible employees in the Savings Plus plan has averaged 40% over the last 6 months. Beginning in November '87, the Benefits area will be conducting monthly meetings for all newly eligible participants to explain the tax and savings benefits of Savings Plus. The goal of these meetings is to increase new participation to 70% over the next 6 months.

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# RECRUITING STATUS REPORT

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## RECRUITING STATUS REPORT

### Campus Program

The 1986-1987 campus recruiting season was the most successful to date. We recruited at 16 schools for system development engineers (SDE) candidates and 6 business schools for product/program management candidates. Results are as follows:

Full time SDE's hired	36
Summer SDE's (interns) hired	30
Full-time product/program managers hired	13
Summer product/program managers (interns) hired	13

These numbers are a significant increase over the total 13 development hires and one MBA hire made last year in '85-'86.

Campus continues to be a critical source of SDE and product/program management talent for the Company. Campus is not only our most cost-effective method of recruiting, but consistently provides us the caliber of candidates we seek.

### Co-op Program

We designed, developed, and implemented successful Co-op program for Product Support Services/OEM. Not an easy task, given the fact that campus season had just ended and we were too late to participate fully in school Co-op programs for the fall. Results are as follows:

Initial hiring objective for summer:	30	Hired: 48
Fall work term:		
Target number:	66	
Hires made:	57	
Winter work term:		
Target number:	71	
Hires made:	27 (still currently interviewing)	

We were able to hire from local Washington schools which brought anticipated recruiting costs down significantly as well. To date, recruiting for these positions is recognized as tremendously successful.

By June 1988, the program will be fully staffed with approximately 130 Co-op students as a base number.

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## Recruiting

### Activity/Results to date:

	Exempt Reqs	Non-Exempt Reqs	Exempt Hires	Non-Exempt Hires
July	6	22	23	29
August	51	30	42	27
September	30	29	32	19
Total	148	81	97	75

Obviously, with the majority of headcount '87 position open in first quarter, the recruiting volume has been extremely heavy.

### Microsoft South

We are now aggressively recruiting for "Microsoft South" - Forethought. We currently have 3 developer positions, 2 product/program management positions, a user education manager position, and a testing manager position to staff in the Bay area.

### Non-United States Recruiting

We are just now making our first attempt at foreign recruiting, in an effort to attract senior SDE's (level 12 and above) and project leads. India and Israel are the countries we will emphasize for the following reasons:

- Both have a strong computer/software industry
- Both countries have low salaries and a lower standard of living, thus, we feel we can attract people to the United States
- Both have engineering schools that are highly rated
- Candidates we have interviewed/hired have been exceptional

Systems and Applications have agreed to fund \$10,000 toward initial advertising. The advertising response will determine if we will send a team to conduct interviews there. The advertising effort began this month.



### Advertising

An ad media campaign designed to attract SDE's and product/program managers was implemented in January of 1987 through April. Active recruiting/interviewing off this campaign continued through September 1987. Although we are still conducting interviews, statistics to date are as follows:

Cost of campaign	\$400,000
Technical hires	20
Offers extended	1
Offers pending	1
Offers turned down	8
Reasons:	
Opportunity	1
Salary	5
Relocation	2
Interviews turned down by candidate	28
Interviews still to be scheduled	4
Responses received	3,117
Number of candidates interviewed	86
Cost per hire	\$20,000

Although the overall result was not as great as we had hoped, 20 technical hires at a cost of \$20,000 per hire should be considered a success. A success because of the fact that we actually made 20 technical hires (agencies could not hire this caliber of candidates, nor this volume) and the cost per hire is just under what we would typically pay for an average agency hire (roughly \$20,000 - \$25,000).

We believe the campaign would have proven itself much more successful had we not been short of recruiting staff during the campaign. This was an obstacle we did not foresee and could not prevent. Because of our staffing situation, we were not able to follow through in as timely a manner on candidates and resumes.

It is our firm opinion that advertising is not the most cost-effective method of recruiting. By far, our campus program is. None-the-less, because divisions have not appropriately planned for headcount to be hired off campus, we are forced to use advertising as means of attracting candidates. Ideally 3/4 of our technical hires should come from campus and 1/4 should be experienced candidates recruited from other sources. Advertising then would still be a necessity to recruit experienced candidates, but at a fraction of the cost we have spent in the past.

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# EMPLOYMENT CATEGORIES

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## EMPLOYMENT CATEGORIES

### GENERAL

#### Regular Full-Time:

At Microsoft, the majority of our assignments are categorized as regular full-time. This is a typical long-term employment situation in which the incumbent works a nominal 40+ hours per week and is eligible for our full benefits package.

In certain situations, we have chosen to structure assignments differently. These employment categories are more cost-effective and assure more quality output than freelancers/independent contractors. This allows us to tap into currently underutilized labor pools (i.e., students, housepersons, part-time professionals, etc.).

The various categories other than regular full-time that Microsoft currently utilizes are:

#### Regular Part-Time:

These assignments are long-term with a scheduled work week less than 40 hours. Benefits are prorated based on the scheduled hours of work per week. Part-time assignments are located both on the corporate campus and in the field.

#### Temporaries:

Temporaries are brought into Microsoft for short periods of time primarily to perform clerical functions (i.e., switchboard operators and receptionists). They are paid on an hourly basis and receive no benefits.

### SPECIAL

#### USSMD - Associate Assignments:

Associate Sales Representative (ASR) - These individuals are located throughout the U.S. and report in through field offices. ASR's are responsible for supporting a specific dealer base/territory.

The original ASR program strategic objective was to develop an economic and effective means to provide day-to-day, personal attention to the needs of dealers. The 59 ASR's (as of October 19) have initially focused their efforts on the PC Word product. In addition to training dealers on PC Word, ASR's will also train dealers on PC Excel, PC Works and PowerPoint. Expanding the original objective, ASR's have supported Microsoft University and selected trade shows, and will provide support for rollouts with OEM customers such as Compaq and AST, as well as providing in store support for Works Days. There are plans for training to be conducted in December to teach ASR's the Macintosh product line.

ASR's are paid a base monthly salary of \$500 and receive additional compensation for support activities. With the additional responsibilities, the ASR average salary is \$1,500 per month rather than the \$1,200 per person per month budgeted. Planned ASR activities include \$35 per presentation to a dealer, with a maximum of 15 presentations per month. In addition, ASR's receive \$10 for the 41st to 60th calls made each month to dealers. When supporting trade shows and Microsoft University, the ASR receives \$17.50 per hour. Benefits average \$1,400 per annum which includes 401(k), employer FICA, and software discounts. As U.S. Sales and Marketing focuses in on selected products, special bonuses sometimes are enacted. ASR's received up to \$500 for the group goal achieved during Word Wars (\$21,000 in total), and will receive a bonus for dealers signed up for Work Days. ASR's are provided a Wyse 286 computer,

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which remains the property of Microsoft and are reimbursed for travel expenses.

Associate Education Support Representative (AESR) - Primary responsibility of this assignment is to increase college campus awareness of Microsoft products.

The AESR program began in September, 1986, and has grown to a total of 20 students. The AESR is Microsoft's on campus representative. The student works closely with the book store and with selected departments, such as the Business Law and Engineering Schools, to promote the use of Microsoft products. Occasionally, AESR's assist with trade shows in the education field, such as EDUCOM and NECC (National Educational Computing Conference). Monthly salaries average \$335. Students participating are paid \$5.00 per hour for up to 10 hours per week, base. In addition, AESR's are paid \$120 to attend a three day training session in Redmond, and \$240 to assist at a three day trade show, such as EDUCOM. Benefits average \$500 per annum which includes 401(k), employer FICA, and software discounts. U.S. Sales and Marketing has established a scholarship program for AESR's. In December, March, and June, a \$500 scholarship will be awarded in each of the three regions to an outstanding AESR. Besides wages and benefits, the only costs of the AESR program are miscellaneous office costs such as duplication expenses, postage, and telephone. Microsoft has made arrangements for AESR's to receive special Macintosh pricing from Apple, so does not provide the AESR with a computer.

Associate Government Support Representative (AGSR) - Responsibility is to increase visibility of Microsoft products within the government channels. Individuals are based in the field. Base salary is \$900 per month with a bonus maximum of \$600 per month. Bonuses can be achieved by support at trade shows, group product presentations, signed sales agreements and travel time. Individuals are also reimbursed for expenses (i.e., travel, phone, parking, etc.). Average salaries paid per month are \$1,130 and benefits of \$1,000 per annum which includes 401(k), employer FICA, and software discounts. Currently there are 4 incumbents.

#### Interns

Interns are college students hired through our campus recruiting efforts. They typically work during their summer breaks from school and/or on a part-time basis throughout the school year. These are primarily professional assignments, i.e., software design engineers, writers, administrators, etc. During the summer months of 1987, we had approximately 77 development interns and 2 interns working in non-development areas. Average salaries are \$1,387 per month plus benefits of \$120 per month which includes 401(k), employer FICA, software discounts and P.R.O. club

#### Co-Op

Co-ops are college students identified through a formal co-op campus recruiting program. They work throughout the school year and at the same time receive academic credit for their work at Microsoft.

Product Support Services - As fiscal year 1988 planning proceeded, Product Support Services (PSS) looked for creative ways of increasing customer support without becoming cost (headcount) prohibitive. This co-op program is the result. As of October 17, there were 47 co-ops at Microsoft in the PSS program.

Students participating in the co-op program spend one quarter out of three on site at Microsoft performing product support. The Microsoft program cost is the travel to and from their school, in transit lodging, initial training and wages which average about \$1,500 per month plus annual benefits of approximately \$1,400 which includes 401(k), employer FICA, software discounts and P.R.O. club while the student is at Microsoft. To date, most of these students have been recruited from local area universities, thus, relocation and related costs have been minimal. When a student completes three terms at Microsoft, the student is permitted to keep the Wyse 286 personal computer that he/she used in the program.

#### Co-op Programmers:

Co-op programmers are technical software developers assigned to projects in CD-ROM, Applications, or System's. Presently, we have 4 of these individuals with an average monthly salary of \$1,800 and annual benefits of \$1,700 per annum which includes 401(k), employer FICA, P.R.O. club and software discounts.

#### Comment

Overall, the programs have been successful. Recruiting candidates from colleges/universities into regular full-time positions has increased 62% from 1986 to 1987. We are hiring excellent candidates whom we have observed in our work environment over a period of time and whom have a solid Microsoft knowledge base to draw upon.

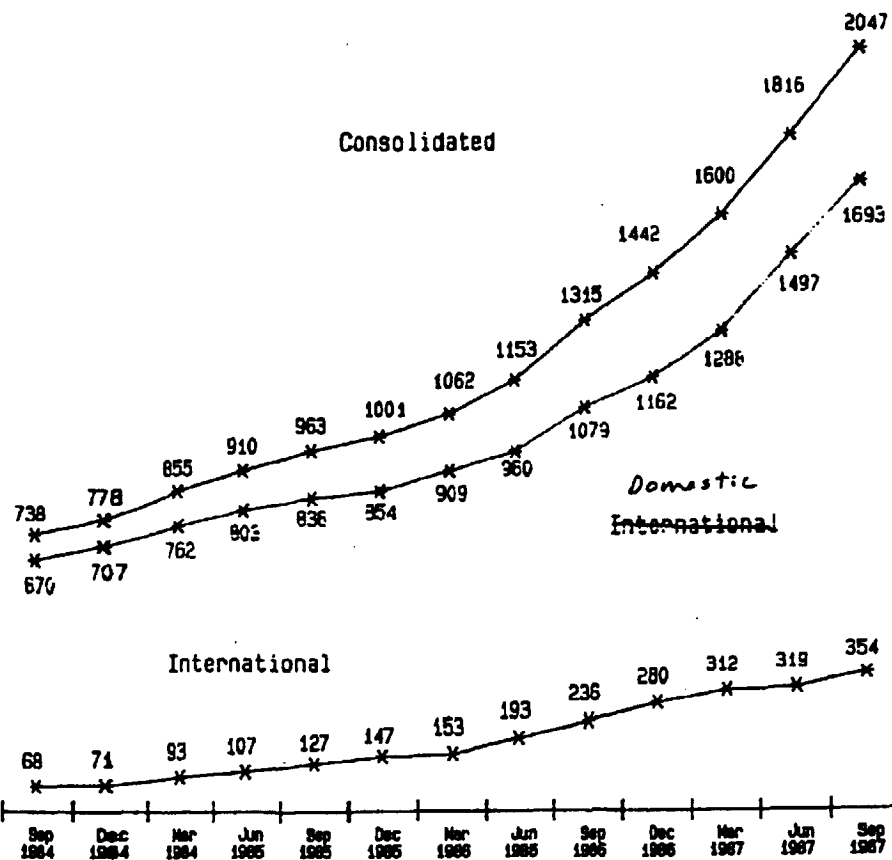
In the Field assignments, the cost saving is primarily related to salaries and benefits. Operating expenses, (travel, car allowance, corporate sales meeting attendance, management time, etc.) tends to be equivalent to regular full-time employees.

HEADCOUNT AND TERMINATION  
CHARTS

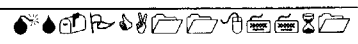
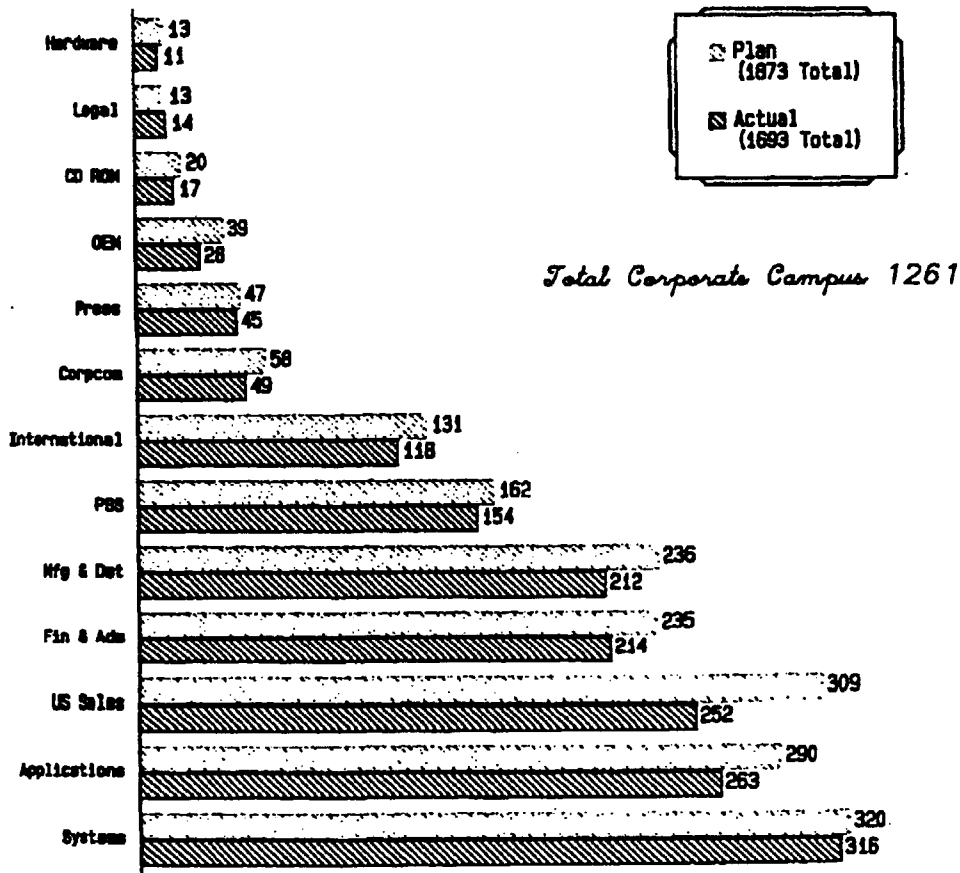
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# Number of Employees

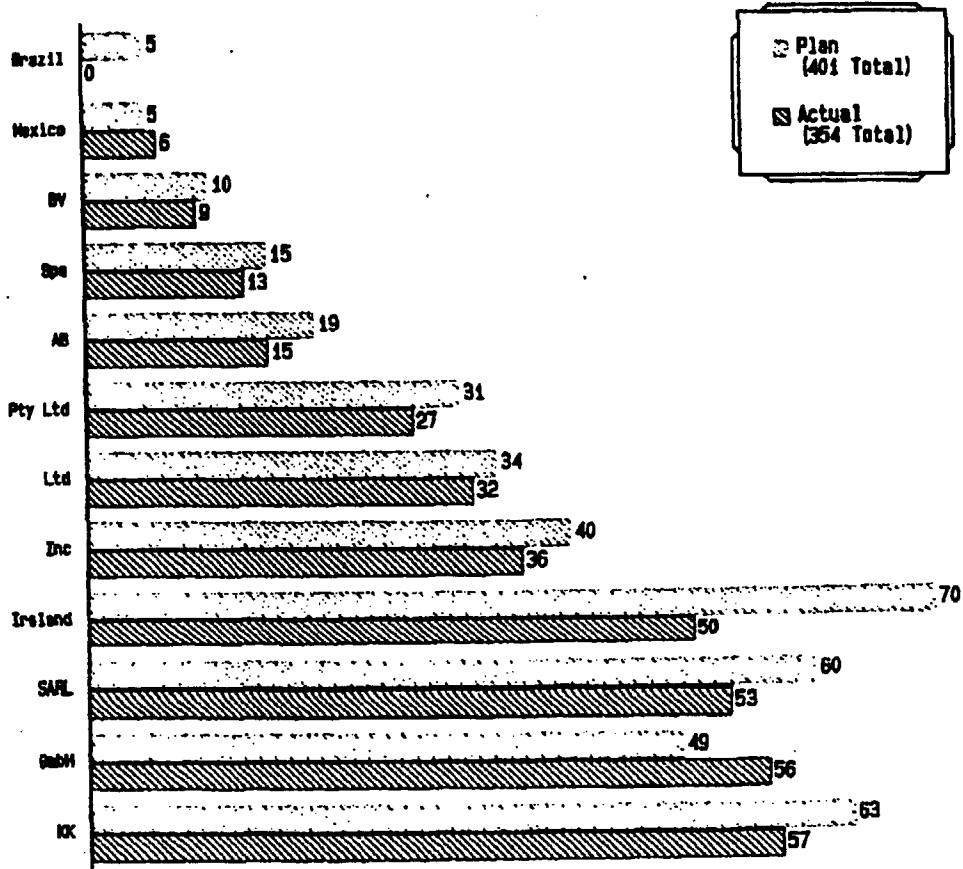


## Domestic Headcount September 30, 1987

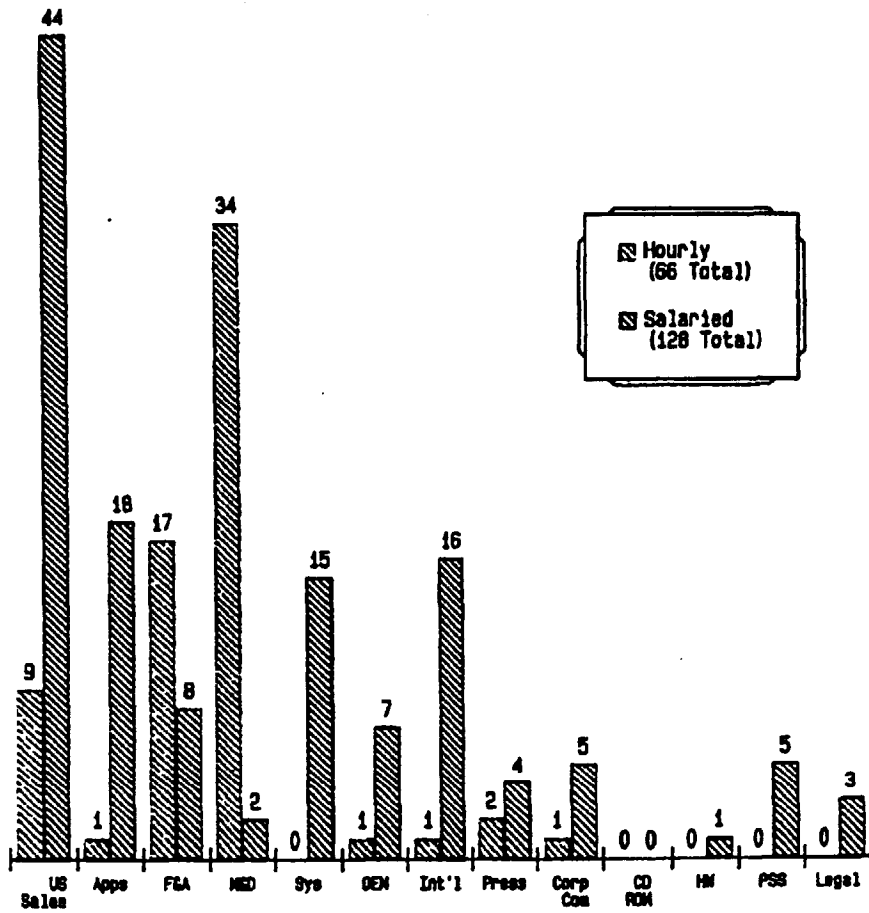




## International Headcount September 30, 1987



## Domestic Terminations Last 12 Months



TOTAL 200



## Domestic Employee Turnover Analysis For The Last 12 Months - As 9-30-87

