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Q98-1

Q98-1 BOARD OF DIRECTORS' REPORT

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

EXECUTIVE SUMMARY

INCOME STATEMENT

GAAP RESULTS

(in millions, except earnings per share)	Q98-1		Q97-1		Growth	Q97-4		Growth
Revenue	\$3,130	100.0%	\$2,295	100.0%	36%	\$3,175	100.0%	(1)%
Cost of revenue	253	8.1%	250	10.9%	1%	242	7.6%	5%
Gross profit	2,877	91.9%	2,045	89.1%	41%	2,933	92.4%	(2)%
Operating expenses:								
Research and development	567	18.1%	432	18.8%	31%	516	16.3%	10%
Acquired in-process technology	296	9.5%	-	-	nm	-	-	nm
Sales and marketing	788	25.2%	625	27.2%	26%	744	23.4%	6%
General and administrative	95	3.0%	86	3.7%	10%	94	3.0%	1%
Total operating expenses	1,746	55.8%	1,143	49.8%	53%	1,354	42.6%	29%
Operating income	1,131	36.1%	902	39.3%	25%	1,579	49.7%	(28)%
Interest income	142	4.5%	92	4.0%	54%	127	4.0%	12%
Other expenses	(71)	(2.3%)	(49)	(2.1%)	nm	(80)	(2.5%)	(11)%
Income before income taxes	1,202	38.4%	945	41.2%	27%	1,626	51.2%	(26)%
Provision for income taxes	539	17.2%	331	14.4%	63%	569	17.9%	(5)%
Net income	\$663	21.2%	\$614	26.8%	8%	\$1,057	33.3%	(37)%
Earnings per share	\$ 0.50		\$ 0.47		6%	\$ 0.80		(38)%
Weighted avg shares outstanding	1,333		1,294			1,327		

	Q96-2	Q96-3	Q96-4	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1
Revenue (in millions)	\$2,195	\$2,205	\$2,255	\$2,295	\$2,680	\$3,208	\$3,175	\$3,130
Operating income (% of net revenue)	35.8%	35.1%	35.9%	39.3%	40.3%	48.9%	49.7%	36.1%
Net income (% of net revenue)	26.2%	25.5%	24.8%	26.8%	27.6%	32.5%	33.3%	21.2%
Earnings per share	0.45	0.44	0.43	0.47	0.57	0.79	0.8	0.5

HIGHLIGHTS

- Revenue as reported externally for Q98-1 was \$3.13 billion, an increase of 36% over the first quarter of fiscal 1997. The slight decline from Q97-4 was due to the recognition of Office 97 coupon revenue of \$185 million in the prior quarter. The growth in revenue was driven by continued strength of Windows 95 and Office 97 product sales. Total unearned revenue as of September 30, 1997 was \$1.67 billion, compared to \$1.41 billion as of June 30, 1997.
- Cost of revenue as a percent of revenue declined to 8.1% in Q98-1 from 10.9% in Q97-1 due to the shift in mix to CD-ROMs, OEM and other licensing, and higher margin products such as Windows NT Server and BackOffice products. The increase from Q97-4 was due to the lack of COGS for the coupon revenue the prior quarter and the higher volumes of hardware and entertainment products in Q98-1.
- Research and development (R&D) totaled \$567 million in the first quarter, which represented 31% growth over Q97-1 and 10% over Q97-4. Higher headcount-related development costs, increased third party development, and charges from purchased R&D were the main drivers of the increases. In connection with the acquisition of WebTV, a one-time nondeductible write-off of \$296 million was recorded for in-process technologies.
- Sales and marketing expenses totaled \$788 million in Q98-1, which represented 25.2% of revenue, 2 percentage points below Q97-1. Lower relative marketing costs drove down total expense as a percent of revenue.
- Other expenses includes MS's portion of joint venture activities and miscellaneous nonoperating expenses. The total expense for MSNBC, including funding and amortization of the equity investment was \$19 million for the quarter.
- For Q98-1, net income increased to \$663 million, compared to \$614 million in Q97-1 and \$1.06 billion in Q97-4. Excluding the charge for in-process technologies, net income and earnings per share would have been \$959 million and \$0.72, respectively.

CONSOLIDATED MANAGEMENT P&L

INTERNAL MANAGEMENT RESULTS

(in millions, variance to plan)	Q98-1				Var %
	Actual		Plan		
Gross revenue (as billed)	\$3,712.2	107.6%	\$3,157.6	106.2%	18%
Revenue adjustments	(262.4)	(7.6%)	(184.1)	(6.2%)	(43%)
Net revenue	3,449.8	100.0%	2,973.5	100.0%	16%
Cost of revenue	301.6	8.7%	312.1	10.5%	3%
Gross profit	3,148.2	91.3%	2,661.3	89.5%	18%
Operating expenses:					
Product development:					
Platforms & Applications	351.4	10.2%	376.2	12.7%	7%
Interactive Media	132.9	3.9%	150.0	5.0%	11%
Interactive Media JV	24.4	0.7%	27.5	0.9%	11%
	508.7	14.7%	553.7	18.6%	8%
Product marketing	84.3	2.4%	111.8	3.8%	25%
Other	16.8	0.5%	21.0	0.7%	20%
	609.8	17.7%	686.5	23.1%	11%
Sales & marketing:					
Sales expense	289.3	8.4%	327.7	11.0%	12%
Marketing	143.5	4.2%	196.2	6.6%	27%
Broad reach	19.4	0.6%	26.9	0.9%	28%
Product support	114.9	3.3%	144.6	4.9%	21%
	567.0	16.4%	695.4	23.4%	18%
General & administrative					
	75.6	2.2%	87.9	3.0%	14%
Total operating expenses	1,252.4	36.3%	1,469.8	49.4%	15%
Operating income	\$1,895.8	55.0%	\$1,191.5	40.1%	59%
Avg worldwide headcount	23,396		24,898		6%

	Q96-2	Q96-3	Q96-4	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1
Percentage of net revenue:								
Cost of revenue	15.5%	13.2%	12.3%	10.5%	10.4%	9.1%	9.5%	8.7%
Marketing	11.4%	7.4%	13.4%	7.1%	9.4%	8.6%	11.9%	7.2%
Product development	13.7%	15.1%	17.8%	16.5%	14.1%	15.6%	21.8%	15.2%
PSS	6.0%	5.1%	5.0%	4.2%	3.4%	2.8%	3.7%	3.3%
Average worldwide headcount	19,399	20,016	20,406	20,566	20,876	21,319	21,796	23,396

NOTES TO CONSOLIDATED MANAGEMENT REPORTS

- The consolidated management P&L is based on functional responsibility and prepared in accordance with Microsoft accounting principles (MAP). These results exclude the impact of certain adjustments and reclassifications required by generally accepted accounting principles (GAAP) for external reporting, non-operating items, and income taxes. Significant differences between MAP and GAAP results are described in the bullets following.
- Revenue under MAP is generally recognized "as billed". Under GAAP, net revenue includes adjustment for certain billed, but unearned revenue, such as a portion of operating system revenue that will be recognized over the product life cycle. Conversely, certain revenue that is earned but not yet billed, such as unreported OEM and Select revenue, is also recognized for external purposes.
- For external reporting purposes, the net cost of Microsoft Network (MSN) operations is included as research and development expenses. For internal management reporting, MSN revenue and cost of operations are shown grossed up as a business channel.
- Interactive Media joint venture expenses represent Microsoft's share of joint venture operating loss. These product development costs are reflected as non-operating expenses for GAAP purposes.
- For external reporting purposes, all product marketing related activities are classified as a sales and marketing expense. For internal reporting purposes, product marketing departments and related marketing expenses are included in product development.

REVENUE

PRODUCTS

Gross Revenue by Product

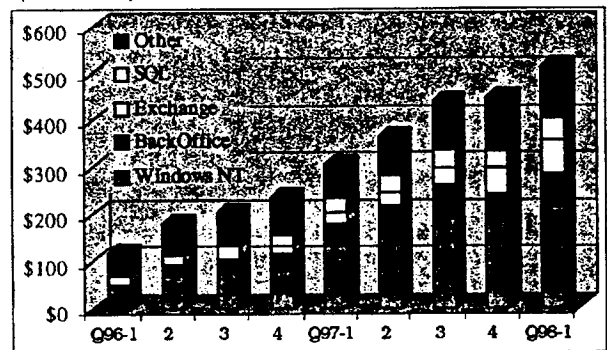
<i>(in millions, as shipped)</i>	Q98-1		Q98-1	Q97-1	Var % to	
	Actual	% of total	Plan		Plan	Q97-1
Office (Std. Pro. & Sm Bus Ed)	\$1,156.1	31%	\$982.3	\$784.2	18%	47%
Windows 95	796.3	21%	697.4	557.6	14%	43%
Windows NT Workstation	241.6	7%	199.9	109.8	21%	120%
Windows 3.x & MS-DOS	56.1	2%	52.2	153.9	7%	(64%)
Windows NT Server	214.6	6%	157.0	134.8	37%	59%
Exchange Server	67.3	2%	44.8	23.0	50%	193%
BackOffice Server	73.1	2%	74.0	43.9	(1%)	66%
Learning and Entertainment	88.8	2%	66.3	41.4	34%	115%
Microsoft Network	113.4	3%	80.4	17.6	41%	546%
Developer Tools	143.5	4%	149.3	106.6	(4%)	35%
Hardware	154.4	4%	104.7	80.0	47%	93%
All other products	606.9	16%	549.2	184.4	10%	229%
Gross revenue	\$3,712.2	100%	\$3,157.6	\$ 2,237.2	18%	66%

- Gross revenue for Q98-1 totaled \$3.71 billion, \$555 million (18%) over plan and \$1.48 billion (66%) over Q97-1. Including continued strong volume licensing of Office 97 and OEM sales of Windows 95, other key drivers of the positive variances were higher OEM sales of Windows NT Workstation, growth in server volume, and earlier than anticipated holiday sell-in of hardware and and entertainment products.
- Desktop Applications gross revenue totaled \$1.42 billion, 18% over plan and 38% over Q97-1. The growth was fueled by strong Office/Office Pro Select and Open licensing in Europe and North America.
- Office revenue, including Standard, Professional and Small Business editions, was \$1.16 billion in Q98-1, nearly one-third of total gross revenue. Office revenue grew 47% over Q97-1 and was 18% over plan due to high Select and Open licensing. Office 97 licenses and applications sold to date total 11.5 million (nearly 17 million including maintenance agreements).
- Q98-1 gross revenue for Personal Systems totaled \$1.18 billion, 18% over plan and 36% over the year ago quarter led by OEM channel revenues of Windows 95 and Select Windows NT Workstation licensing. Windows 95 gross revenue was \$796 million for the quarter, including \$657 million from the OEM channel, the largest OEM quarter, and strong packaged product sales from holiday and back-to-school restocking. Windows 95 total licenses to date reached 94 million. Windows NT

Workstation grew 120% over Q97-1 and was 21% over plan reflecting strong OEM sales.

- Business Systems gross revenue was \$513 million for Q98-1, 13% over plan and 67% over the prior year quarter. All major product groups were over plan for the quarter. Windows NT Server revenue was \$215 million for the quarter, a 59% growth over Q97-1 and 37% above plan. BackOffice Server revenue totaled \$73 million, 66% over Q97-1 and 27% higher than Q97-4. Exchange Server totaled \$67 million, nearly 200% growth over Q97-1 and 50% over plan due to strong client access licenses. SQL Server grew 36% over Q97-4 after experiencing slow growth rates at the end of FY97. Below is a quarterly trend of Business Systems gross revenue.

Business Systems Gross Revenue
(\$ in millions)



- Interactive Media Group gross revenue, excluding MSN billings, totaled \$261 million in Q98-1, nearly double year ago quarter levels and 39% over plan. Most of the variance to plan stemmed from hardware sales and early holiday sell-in of learning and entertainment products. Heavy European and North American sales of the newly released Encarta 98 pushed Learning and Entertainment revenue to \$89 million, 34% above plan.
- Hardware sales in Q98-1 reached \$154 million, 47% over plan and 93% over Q97-1. Mouse, gaming devices, and Actimates (Barney) were the key drivers of the strong results. Mouse revenue was \$88 million, 26% over plan and 44% over same quarter a year ago. Healthy holiday sell-in contributed to gaming devices 61% positive variance to plan for a total of \$24 million in sales for the quarter. Actimates (Barney) sell-in for the quarter was \$30 million.
- MSN gross revenue totaled \$113 million in the quarter, 41% above plan due to catch-up on

subscription billings, which were as much as six weeks delayed at the end of Q97-4. MSN subscribers averaged 2 million in Q98-1, down from 2.1 million at the end of Q97-4 and below the plan of 2.4 million. Metro MSN 2.5, based on Internet Explorer 4.0, was released in October.

- Developer Tools fell short of plan this quarter by \$6 million with \$144 million in gross revenue, but grew 35% over Q97-1. A declining growth rate was expected given the release of Version 5.0 Developer Tools in March. Visual Studio, the suite of developer tools, and MSDN revenue were above plan, 54% and 8%, respectively, but were offset by slow sales of the stand-alone products.
- Internet Explorer 4.0 was released on September 30 with over 2 million downloads within the first week. IE browser share is at 35%, up from 32% at the end of Q97-4.

CHANNELS

Gross Revenue by Channel

(in millions)	Q98-1		Q98-1	Q97-1	Var % to	
	Actual	% of Total	Plan		Plan	Q97-1
North America FG	\$1,145.0	31%	\$1,015.0	\$637.1	13%	80%
Europe FG	715.0	19%	533.5	409.4	34%	75%
ICON FG	256.5	7%	218.1	173.3	18%	48%
Far East FG	377.3	10%	317.6	236.8	19%	59%
Total finished goods	2,493.8	67%	2,084.3	1,456.5	20%	71%
OEM	1,064.0	29%	945.9	741.0	12%	44%
Other	154.4	4%	127.4	39.7	21%	289%
Gross revenue	\$3,712.2	100%	\$3,157.6	\$2,237.2	18%	66%

Finished Goods

- For Q98-1, finished goods channel gross revenue was \$2.49 billion, 20% over plan and 71% over Q97-1. Increases in volume licensing agreements, particularly of desktop applications, drove the positive variances to plan and the growth over prior year.
- North America posted \$1.15 billion in quarterly gross revenues, 13% over plan driven by volume licensing of Windows 95 and package product sales of entertainment and hardware products. Channel inventory is estimated to be at steady levels, averaging 6 weeks.
- Europe reported first quarter gross revenue of \$715 million, 34% over plan and 75% over Q97-1 due to strong Select and Open licensing of personal and business systems along with high sell-in of reference and hardware products. The impact from

foreign exchange was a negative \$15 million or 3% of budgeted gross revenue. The top 5 European subsidiaries - Germany, the UK, France, the Netherlands, and Italy represented 70% of total Europe FG gross revenue and were collectively 20% over plan and grew 42% over Q97-1. Select and Open licensing continued at high levels in Q98-1 at \$237 million (17% over Q97-4 and 58% over Q97-1) and \$116 million (75% over Q97-4 and doubled from Q97-1), respectively.

- In the Far East, Q98-1 gross revenue was \$377 million, 19% over plan and 59% over Q97-1, inclusive of \$22 million of Office replacement product in Japan. Adjusted for this, Q98-1 FG gross revenue in Japan was \$295 million, 6% above plan. Strong revenue from Taiwan (87% over Q97-1), Hong Kong (101% over Q97-1), and China (116% over plan), collectively 73% over

plan, was driven by sales of Office and business systems products. The impact from foreign exchange was a positive \$7 million, 2% of budgeted gross revenue.

- ICON FG gross revenue for Q98-1 was \$257 million, 18% above plan and 48% over Q97-1 with exceptional performance in Malaysia, Indonesia,

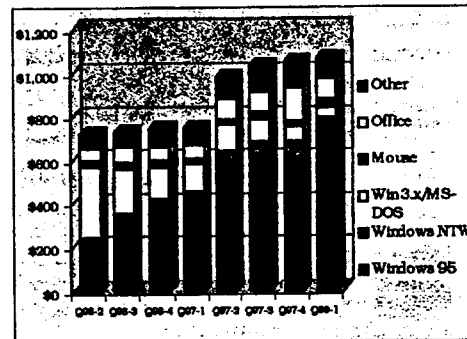
OEM

- Q98-1 OEM billings were \$1.06 billion, a record quarter at 12% over plan and 44% over the prior year driven primarily by continued growth in worldwide PCs including 32-bit operating systems and the increased penetration of Windows NT Workstation. North American multinationals provided 75% of the positive variance to plan, offset by lower than planned system builders revenue.
- OEM revenue from operating systems totaled \$840 million, 6% higher than Q97-4, with significant increases in Windows 95 and Windows NT Workstation licenses offsetting lower 16-bit operating systems licenses. Windows NT Workstation revenue of \$137 million grew 46% over Q97-4 and comprised 13% of total OEM revenue this quarter. The graph depicts the mix of operating systems in the OEM channel for the last 8 quarters.

Argentina, Mexico, and Brazil. Brazil became the tenth largest revenue producing subsidiary in Q98-1, growing 71% over Q97-1. Thailand, which continues to face poor economic conditions, fell 17% below plan.

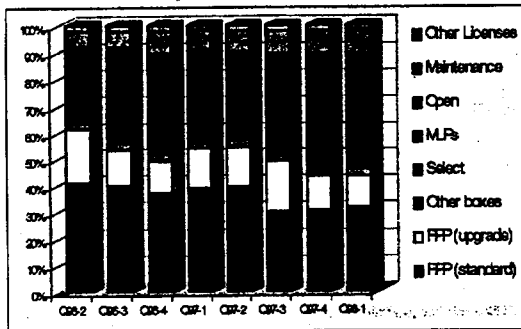
- Mouse OEM billings were \$44 million, 52% over Q97-1. OEM revenue from Office 97 fell 61% from Q97-4 levels in the quarter, but were still above plan.

OEM Revenue by Product
(in millions)



License Mix

FG Gross shipments based on units



- Full packaged product (FPP) shipments were 35% of all FG units in Q97-1, 2 percentage points higher than Q97-4 due to sell-in of hardware and entertainment products as well as increased volume of Office products and Windows 95.
- Select and Open licensing billings in the quarter were strong at over 39% of total licensed units. The quarter's Select and Open licensing billings were \$540 million and \$346 million, driven primarily by desktop application and personal systems products. Select Custom agreements totaled \$46 million in the quarter, about even with Q97-4 levels due to slower than anticipated ramp-up of signed agreements. Note: revenue from Custom Agreements is recognized ratably while gross shipments include annual billings. See the sales and marketing section for more details on the accounting policy for custom agreements.

FOREIGN EXCHANGE

(in millions)	Q98-1 Variance to plan				
	Volume	FX	FX %	Total	Total %
North America FG	\$130.1	-	-	\$130.1	13%
Europe FG	196.5	(15.0)	(3%)	181.5	34%
ICON FG	40.5	(2.1)	(1%)	38.4	18%
Far East FG	52.0	7.6	2%	59.6	19%
OEM & other channels	145.1	-	-	145.1	14%
	\$564.1	(\$9.4)	-	\$554.6	18%

- Compared to planned rates, the continued strength of the dollar caused a negative foreign exchange variance. Weaknesses in several European currencies, offset by the strength in the Japanese yen, impacted gross revenues less than a half of a percent, or \$9 million dollars, compared to a \$27 million negative impact in Q97-4.
- In the ICON region, the Australian and New Zealand currencies were weaker than plan resulting in a \$2 million negative impact to gross revenue. In spite of a speculative drive on Southeast Asian (SEA) currencies and economic problems in Thailand, MS's SEA region suffered little foreign exchange impact. Although a general currency devaluation of 25% occurred across the region, only Thailand's revenue was significantly affected, 42% below plan.
- In the European region, the U.S. dollar was stronger than planned against most foreign currencies, except the British pound, as displayed below.

Currency	Rates per dollar		Var % to plan
	Q98-1	Plan	
British Pound	0.61	0.62	1%
Deutsche Mark	1.78	1.70	(5%)
French Franc	6.01	5.73	(5%)
Italian Lira	1,744	1,686	(3%)
Japanese Yen	116	119	2%
Australian Dollar	1.32	1.28	(3%)

- The Japanese yen per dollar exchange rate averaged 116 yen per dollar in Q98-1, versus a planned rate of 119, resulting in a positive exchange variance of \$7 million.

COST OF REVENUE

(as a % of net revenue)	Q98-1			
	Sales Mix	Weighted Avg Cost	Actual Cost of revenue	Plan
By Channel				
North America FG	29.6%	2.8%	9.6%	10.7%
Europe FG	19.3%	1.5%	8.0%	9.9%
ICON FG	6.7%	0.6%	9.3%	12.6%
Far East FG	9.8%	0.7%	7.0%	10.0%
Total Finished Goods	65.4%	5.7%	8.7%	10.6%
OEM	30.7%	0.8%	2.8%	3.7%
Other (includes MSN)	3.9%	2.2%	56.4%	60.5%
	100.0%	8.7%	8.7%	10.5%
By Product Division				
Desktop Apps/Web Authoring	36.9%	1.5%	4.1%	6.4%
Personal Systems	32.9%	0.5%	1.5%	2.6%
Business Systems	14.0%	0.6%	4.6%	5.2%
Internet Client & Collab.	-	0.1%	225.0%	41.7%
Developer Tools	3.9%	0.6%	15.6%	16.5%
Consumer Platforms	0.1%	-	3.2%	nm
Softimage	0.3%	-	9.5%	7.5%
Other	0.3%	0.3%	106.1%	54.3%
Platforms & Applications	88.4%	3.7%	4.2%	5.4%
Interactive Service Media	0.3%	0.2%	49.7%	29.8%
Microsoft Network	2.5%	1.4%	57.0%	72.5%
Hardware	4.4%	2.4%	54.4%	64.1%
Learning and Entertainment	2.8%	0.5%	19.0%	28.6%
News and Publishing	-	-	nm	20.0%
Desktop Finance	0.3%	0.1%	26.8%	48.0%
Interactive Media Group	10.2%	4.6%	44.9%	54.9%
Other	1.3%	0.4%	34.6%	47.9%
	100.0%	8.7%	8.7%	10.5%

- Product costs continue to be positively impacted by the higher mix of licensed product, CD-ROM media and higher than plan revenues. Cost of revenue for Q98-1 was 8.7% of revenue, almost 2 percentage points below plan.
- Licensed units, primarily Select and Open sales of desktop applications and personal and business systems, accounted for 63% of finished goods shipments for the quarter, versus 67% in Q97-4 and 55% in Q97-1.
- CD-ROM media sales comprised 88% of the non-hardware package product licenses for the quarter, versus 58% in Q97-1 and slightly down from 89% in Q97-4, primarily due to holiday sell-in of entertainment and hardware products.
- Non-product costs, as a percent of net revenue, were 1.1%, favorable to plan from the higher net revenue due to their usual fixed dollar characteristic and were \$12 million under plan due to lower inventory charges and operations expenses.

OPERATING EXPENSES

(in millions, except cost per head, variance to plan)	Q98-1			
	Actual	Plan	Q97-1	Var %
People costs	\$518.7	\$572.0	\$417.2	9%
Contingent staff and outsourcing	205.7	220.0	133.9	6%
Infrastructure costs	218.4	244.6	161.5	11%
Marketing expenses	271.2	340.8	173.5	20%
PSS/MCS cost recovery	(107.3)	(108.4)	(72.7)	1%
Third party product development	74.3	102.5	62.7	28%
Broad reach	19.4	26.9	23.2	28%
Other misc. expenses	51.9	71.5	91.4	27%
	<u>\$1,252.4</u>	<u>\$1,469.8</u>	<u>\$990.6</u>	<u>15%</u>
Avg non-operations headcount	22,331	23,715	19,220	6%
People cost per head	\$92,912	\$96,474	\$86,824	4%
Infrastructure cost per head (annualized cost per average MS head)	\$39,127	\$41,254	\$33,617	5%
Contingent staff and outsourcing (as a percentage of People costs)	39.7%	38.5%	32.1%	

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

- Operating expenses for Q98-1 were \$1.25 billion, 15% below plan due to lower headcount levels than planned, slow acceleration of marketing programs and third party development.
- Q98-1 annualized people cost per head were \$92,912, 4% below plan mainly due to lower recruiting costs and travel expenses. Payroll taxes per employee were also below plan levels.
- Contingent staff expenses were \$206 million for the quarter, 6% below plan. However, higher levels of outsourced and hired temporary substituted for regular heads and slow conversion of contingent staff to regular employees in some divisions caused the increase from Q97-4.
- Total headcount excluding manufacturing operations at the end of September was 22,757, 6% below plan.
- Infrastructure costs in the quarter totaled \$218 million, 11% below plan, driven by below plan PC depreciation expense. On a cost per head basis, infrastructure costs were \$39,127, 5% below plan.
- Marketing expenses were 20% below plan for Q98-1 at \$271 million, as marketing spending slowly increased after high spending in the last quarter of the year.
- PSS revenue in the quarter totaled \$43 million, 4% under plan driven by lower Priority and Premier contract revenue. MCS revenue was \$4 million below plan due to lower consultant revenue partially offset by favorable subcontractor revenue.
- Q98-1 third party product development was \$74 million, 28% below plan due to lower localization, MSN content purchases, and international development costs than planned.
- Other expenses, which include bad debts, taxes and licenses, and miscellaneous operating expenses, were \$52 million, 27% below plan in Q98-1 due to lower professional fees.

PRODUCT GROUP COSTS

(in millions, variance to plan)	Q98-1					
	Actual		Plan		Var %	
Platform & Applications Group						
Desktop Apps/Web Authoring	\$61.1	10%	\$73.2	11%	16%	
Operating Systems	73.9	12%	78.7	11%	6%	
Server Applications	75.0	12%	72.6	10%	(3%)	
PBSG Mgmt/Mktg	11.7	2%	14.4	2%	19%	
Developer Tools	30.1	5%	36.1	5%	17%	
Internet Client and Collaboration	60.8	10%	58.3	8%	(4%)	
Consumer Platforms	16.4	3%	18.1	3%	9%	
Softimage	5.6	1%	6.7	1%	17%	
Web TV	7.0	1%	9.5	1%	26%	
Group Management	9.7	2%	18.1	3%	46%	
Total	351.4	58%	385.6	55%	9%	
Interactive Media Group						
Interactive ServiceMedia	26.8	4%	31.7	5%	16%	
Learning and Entertainment	29.7	5%	29.9	4%	1%	
News and Publishing	25.9	4%	29.1	4%	11%	
Microsoft Network	41.4	7%	45.8	7%	10%	
Desktop Finance	7.8	1%	8.6	1%	9%	
Hardware	11.8	2%	15.2	2%	23%	
Group Management	14.0	2%	17.1	2%	18%	
Total	157.3	26%	177.5	26%	11%	
Other	16.8	3%	21.0	3%	20%	
Product marketing	84.3	14%	111.8	16%	25%	
Total	\$609.8	100%	\$696.0	100%	12%	

- Product group costs totaled \$610 million in the first quarter, 12% below plan due to slow ramp up of product marketing and localization spending coupled with lower headcount driven expenses.
- Platforms and Applications group product expenses for the quarter were 9% under plan at \$351 million due to overall lower headcount-related expenses and marketing spend. Regular headcount in the Platforms and Applications group at the end of the quarter was at 7,390, but below plan by 166 people (2%).
- Interactive Media group (IMG) expenses totaled \$157 million, 11% below plan largely due to timing of MSN marketing expenses and lower

intellectual property and vendor rates, in addition to lower overall spending. Interactive Service Media contingent staff expenses were over planned levels due to spending in Sidewalk cities to compensate for under budgeted regular headcount levels. Desktop Finance had heavy marketing and contingent staff spending offset by favorable people costs and a loss for MSFDC. Interactive Media group regular headcount at the end of the quarter was 1,790, 11% (215 people) below planned levels.

- Included in News & Publishing, Interactive Media joint venture operational costs for the quarter were \$15 million for MSNBC Cable Joint Venture and \$11 million for the Interactive Joint Venture.

SALES, MARKETING & SUPPORT COSTS

(in millions, variance to plan)	Q98-1				
	Actual		Plan		Var %
Sales Expenses					
North America FG	\$99.1	17%	\$107.0	15%	7%
Europe FG	79.1	14%	98.0	14%	19%
ICON FG	40.4	7%	47.4	7%	15%
Far East FG	28.9	5%	33.4	5%	13%
OEM	35.5	6%	32.4	5%	(10%)
Other	6.3	1%	9.6	1%	34%
Total sales expenses	289.3	51%	327.7	47%	12%
Channel marketing	143.5	25%	196.2	28%	27%
Broad reach	19.4	3%	26.9	4%	28%
Support costs	114.9	20%	144.6	21%	21%
Total	\$567.0	100%	\$695.4	100%	18%

- Sales expenses were \$289 million for the first quarter, \$38 million and 12% below plan primarily due to lower headcount across all regions offset by the KPMG agreement for \$10 million and OEM business and occupation tax and bad debt expense.
- Channel marketing expense was \$53 million below plan in the quarter due to the slow ramp up of new

marketing programs after the peak in marketing expense last quarter.

- Product support costs were also less than plan for the quarter by \$30 million (21%) due to the delayed start-up of the India resource center, reduced number of support incidents, and lower depreciation expenses.

GENERAL & ADMINISTRATIVE COSTS

(in millions, variance to plan)	Q98-1				
	Actual		Plan		Var %
HR/Admin Services	\$ 105.7	52%	\$ 112.6	50%	6%
ITG	47.1	23%	53.3	24%	12%
Legal	25.5	13%	31.1	14%	18%
Finance	16.8	8%	23.0	10%	27%
Other	6.5	3%	6.3	3%	(3%)
Gross spending	201.5	100%	226.3	100%	11%
Distribution	(125.9)		(138.4)		
Total general & administrative	\$ 75.6		\$ 87.9		

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

and support, recruiting, real estate expenses and services such as the copy center and company store.

- Q98-1 gross G&A costs were \$25 million (11%) below plan from lower domestic headcount costs and related services costs including recruiting, benefits, and ITG support.

COST OF STOCK OPTIONS

- MS follows APB Opinion 25 to account for stock option plans for published financial statements, whereas no compensation cost is recognized because the option exercise price is equal to market price of the underlying stock on the date of grant. Earnings per share calculations reflect exercised options and the effect of outstanding stock options under the "treasury stock" method.
- In the proforma income statement below, the cost of option grants, based on the Black-Scholes value of the options, is expensed through the income statement operating expense line items in the quarter that the options are granted. It is also assumed that the options are "hedged" through the purchase of offsetting call options and therefore excluded from average shares outstanding used to calculate earnings per share.
- This proforma income statement was included in the Q98-1 earnings release and Form 10-Q filing with the SEC.
- In Q98-1, a total of 28 million stock options were granted, versus 49 million in Q97-1. The total pre-tax cost of the options granted in the first quarter was \$1.1 billion, versus \$934 million in Q97-1. The lower number of options granted in Q98-1 reflects the stock split and retention of absolute grant guidelines. The total cost of options was similar in Q98-1 and Q97-1 because options with higher strike prices have greater Black-Scholes values than options with lower strike prices.

<i>(in millions, except earnings per share)</i>	Twelve Months Ended Sept. 30, 1997		Three Months Ended Sept. 30, 1997	
	Reported	Proforma	Reported	Proforma
Revenue	\$12,193	\$12,193	\$3,130	\$3,130
Cost of revenue	1,088	1,132	253	293
Gross profit	11,105	11,061	2,877	2,837
Operating expenses:				
Research and development	2,060	2,729	567	1,137
Acquired in-process technology	296	296	296	296
Sales & marketing	3,019	3,472	788	1,192
General & administrative	371	523	95	210
Total operating expenses	5,746	7,020	1,746	2,835
Operating income	5,359	4,041	1,131	2
Interest income	493	493	142	142
Other expenses	(281)	(281)	(71)	(71)
Income before income taxes	5,571	4,253	1,202	73
Provision for income taxes	2,068	1,596	539	133
Net income	\$3,503	\$2,657	\$663	(\$60)
Earnings per share	\$ 2.65	\$ 2.05	\$ 0.50	\$ (0.05)
Weighted avg shares outstanding	1,322	1,298	1,333	1,305
Options granted	34	34	28	28

CASH FLOW SUMMARY

<i>(in millions)</i>	Q97-4	Q98-1	Change
Beginning cash & equivalents	\$3,852	\$3,706	(\$146)
<i>Cash flow from operations</i>			
Net income	1,057	663	(394)
Depreciation	140	228	88
Write-off of WebTV in-process R&D	-	296	296
Unearned revenue	535	533	(2)
Recognition of unearned revenue from prior periods	(402)	(280)	122
Other current liabilities	(26)	53	79
Accounts receivable	(91)	180	271
Other current assets	(148)	7	155
Net cash from operations	1,065	1,680	615
<i>Cash flow from financing</i>			
Common stock issued	191	207	16
Common stock repurchased	-	(913)	(913)
Put warrant proceeds/(payments)	(31)	280	311
Preferred stock dividend	(7)	(7)	-
Stock option income tax benefits	313	199	(114)
Net cash from financing	466	(234)	(700)
<i>Cash flow from investments</i>			
Additions to property, plant and equipment	(172)	(117)	55
Cash portion of purchase of WebTV	-	(190)	(190)
Equity investments and other	(1,510)	(455)	1,055
Short-term investments	(26)	(429)	(403)
Net cash used for investments	(1,708)	(1,191)	517
Net change in cash and equivalents	(177)	255	432
Effect of exchange rates on cash and equivalents	31	(16)	(47)
Ending balance of cash and equivalents	3,706	3,945	239
Ending balance of short term investments	5,260	5,689	429
Ending cash & short term investments	\$8,966	\$9,634	\$668

- Cash and short-term investments at the end of September were \$9.63 billion, \$668 million higher than the June ending quarter and \$2.5 billion higher than a year ago. The growth was mainly due to increases in cash from operations.
- Cash from operations was \$1.68 billion, a \$615 million increase from the prior quarter primarily due to improved accounts receivable collections and increased profitability.
- Net cash from financing decreased by \$700 million from Q97-4 due to the buyback of common stock offset by the proceeds received from the sale of put warrants in the current quarter. A total of 23 million shares of put warrants were outstanding on September 30, 1997.
- Within the quarter, a total of 2.1 million shares were repurchased on the open market. Under an agreement with an independent third party, an additional 5.8 million shares were purchased through a forward purchase arrangement, whereas a portion of the purchase price will be paid in the next five years and determined based upon the price of MS common stock at that time. The difference between the cash paid and the price of stock on the date of the agreement is reflected in equity.
- Net cash used for investments incorporates several investments this quarter including \$150 million in Apple Computer and \$45 million in Lernout & Hauspie.

Operations

FINISHED GOODS COST OF REVENUE SUMMARY

- Total cost of revenue for Q98-1 was less than plan by \$5.5 million or 1.8% of net revenue. The following table summarizes the variance to plan:

Category	Q98-1 Variance	
	\$	% net rev
Product costs	\$ 0.7	1.0%
Royalties	(4.5)	(0.1%)
Pipe costs	3.9	0.4%
Obsolete & scrapped inv	3.8	0.3%
Channel Costs	1.6	0.2%
Total variance	\$ 5.5	1.8%

- Product costs as a percentage of net revenue were 1.0% below plan due to lower turnkey costs, improved pricing of hardware raw materials, and lower freight costs. Manufacturing costs were less than planned due to lower costs in the manufacturing facilities in Puerto Rico and Ireland. Standard product costs as a percentage of net revenue was 0.3% favorable to plan, due to a greater mix of high margin products, licensing, and CD-ROM media.

- Royalties were \$4.5 million over plan (0.1% of net revenue), primarily due to higher than plan sales of Actimates and the early payment of license fees to Mainsoft for Internet Explorer.
- Pipe costs were \$4 million below plan (0.4% of net revenue), primarily due to lower people costs resulting from lower than planned headcount. In addition, contingent staff costs were under plan due to lower Electronic Commerce project costs.
- Obsolete and scrapped inventory costs were under plan resulting from lower product returns volume and obsolete inventory expense. Obsolescence scrap was also favorable in North America and ICON as a result of low inventory levels and strong sales of full packaged product.
- Channel costs were \$2 million below plan due to lower freight costs in North America and lower fulfillment costs. North America freight experienced less ground shipments than planned and lower freight costs for Actimates. Fulfillment costs were lower than planned primarily due to lower outsourced fulfillment activity for direct marketing and lower spending for the E-Open licensing project.

Cost of Revenue by Business Stream

(\$ millions)	Packaged Products				Licensing				Programs				Total	
	Software		Hardware		OEM		Retail		Subscriptions		Fulfillment		TC & OEM	
	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%
Net revenue	\$884.4	100%	\$154.3	100%	\$1,099.6	100%	\$1,166.6	100%	\$357	100%	\$651	100%	\$3,215.7	100%
Product costs	53.5	6.0%	66.6	43.2%	-	(0.0%)	2.2	0.2%	8.6	24.2%	9.3	14.5%	140.3	4.2%
Royalties	2.5	1.0%	7.6	4.9%	2.9	0.3%	5.0	0.4%	0.3	0.8%	0.3	0.5%	24.7	0.7%
Pipe costs	11.7	1.3%	3.7	2.4%	0.2	0.0%	5.8	0.5%	3.3	9.4%	3.5	5.5%	28.3	0.9%
Obsolete & scrapped inv	9.3	1.1%	1.1	0.7%	0.0	0.0%	-	-	0.1	0.2%	0.5	0.7%	11.0	0.3%
Channel costs	2.6	0.3%	1.9	1.2%	0.4	0.0%	2.4	0.2%	5.8	16.2%	7.4	11.6%	21.6	0.7%
Total cost of revenue	86.7	9.8%	81.0	52.4%	3.7	0.3%	15.3	1.3%	18.1	50.8%	21.0	32.8%	225.9	6.8%
Gross margin	\$797.7	90.2%	\$73.3	47.4%	\$1,095.9	99.6%	\$1,151.2	98.7%	\$17.6	49.2%	\$43.1	67.2%	\$2,989.8	93.2%
Variance to plan - Fav/(Unfav)														
Net revenue	\$114.0		\$54.1		\$113.3		\$197.2		\$1.6		\$14.7		\$466.8	
Product costs	15.0	1.6%	(12.6)	10.6%	-	-	0.4	0.1%	1.1	4.3%	(1.4)	1.5%	2.5	0.8%
Royalties	0.4	-	(5.3)	(2.6%)	0.2	-	0.4	0.2%	(0.0)	-	0.0	0.2%	(4.4)	-
Pipe costs	2.2	0.2%	0.9	2.2%	2.6	0.3%	0.5	0.2%	0.4	1.6%	0.5	2.7%	7.2	2.1%
Obsolete & scrapped inv	2.6	0.2%	0.7	1.1%	(0.0)	-	-	-	0.2	0.7%	0.2	0.7%	3.8	0.3%
Channel costs	0.9	0.1%	0.1	0.8%	(0.1)	-	(0.0)	0.1%	(0.2)	0.3%	1.0	5.5%	1.7	0.1%
Total cost of revenue	21.1	2.2%	(16.2)	12.1%	2.7	0.3%	1.2	0.6%	1.6	6.9%	0.4	10.6%	10.8	1.5%
Gross margin	\$7.1	2.2%	\$37.9	12.1%	\$116.0	0.3%	\$298.4	0.6%	\$2.1	6.9%	\$15.2	10.6%	\$477.6	1.5%

- This presentation of cost of revenue by business stream reflects the operations group's changing business model from manufacturing packaged

product to licensing and programs based organization. See Appendix for business stream definitions.

PACKAGED PRODUCTS

- Software package product cost of revenue was \$21 million (2.2% of net revenue) below plan. The favorable variance in product costs resulted primarily from a higher CD-ROM media mix, combined with a favorable to plan product mix to higher margin products in Desktop Applications. Favorable pricing received for turnkey product also contributed to the favorable variance in product costs. Obsolete and scrapped inventory was below plan due to lower than plan returns volume. The favorable pipe cost variance was due to a combination of lower than plan spending in customer operations and supply chain

management, and lower than plan outsourcing-storage charges.

- Hardware cost of revenue as a percentage of net revenue was 12.1% favorable to plan due to sales of higher margin products within the Actimates product unit (608 thousand licenses versus a plan of 134 thousand), primarily higher than plan volumes of the Actimates CD Pack. In addition, pipe costs were favorable, due to below plan spending for hardware operations. In terms of dollars spent, product costs and royalties were unfavorable due to strong sales of Actimates products.

LICENSING

- OEM licensing cost of revenue was favorable to plan due to accelerated certificate of authenticity cost recoveries, combined with lower MSLI transition costs. Retail licensing cost of revenue

was favorable to plan due to lower product costs for disk and documentation fulfillment in Europe combined with favorable spending variances in central services and pipe operations.

PROGRAMS

- Subscriptions cost of revenue was favorable to plan primarily due to a favorable variance in product costs, resulting from lower than plan volumes for MSDN. Fulfillment cost of revenue was also favorable due to lower than plan channel costs, primarily due to lower outsourcing fulfillment activity for direct marketing programs.

Additionally, pipe costs were favorable in both streams due to lower than plan contingent staff costs as a result of a delay in the ramp up of the Electronic Commerce project. In contrast, product costs for the fulfillment stream was unfavorable, due to higher than plan product costs for Courseware products.

COST OF REVENUE BY FG REGION

(in millions)	North America		Japan		Europe		Latin East		IL/ON		Total (Excl. Costs)	
	Actual	Plan	Actual	Plan	Actual	Plan	Actual	Plan	Actual	Plan	Actual	Plan
Net revenue	\$ 1,027.7	\$ 894.4	\$ 674.6	\$ 510.8	\$ 339.0	\$ 304.8	\$ 232.8	\$ 212.0	\$ 2,274.1	\$ 1,922.0	\$ 2,274.1	\$ 1,922.0
Costs of revenue												
Product costs	60.1	55.7	29.1	25.0	15.3	21.2	11.7	15.1	116.3	117.0	116.3	117.0
Royalties	14.9	10.4	4.3	4.1	1.5	1.5	0.4%	0.4%	21.7	17.2	21.7	17.2
Pipe costs	10.7	12.9	9.4	10.1	2.1	2.4	0.8%	0.8%	27.4	31.3	27.4	31.3
Obso. and scrapped inv.	4.0	6.4	0.7%	3.0	0.4%	2.1	0.6%	2.5	10.9	14.7	10.9	14.7
Channel costs	8.3	9.8	1.1%	7.4	1.5%	2.7	0.8%	2.9	20.3	22.0	20.3	22.0
Cost of revenue	98.0	95.3	10.7%	53.2	7.9%	50.0	9.8%	30.5	10.0%	26.5	198.6	202.3
Gross margin	\$ 929.7	\$ 799.1	89.3%	\$ 621.4	92.1%	\$ 460.8	90.2%	\$ 314.3	93.0%	\$ 274.3	\$ 2,077.6	\$ 1,719.9
License mix												
Full packaged product	38%		34%		46%		30%		37%			
CD-ROM mix, by division *												
Desktop Applications	87%		86%		99%		83%		90%			
Desktop Finance	100%		60%		3%		100%		96%			
Consumer Platforms	100%		100%		100%		100%		100%			
Developer Tools	97%		96%		99%		96%		97%			
Business Systems	89%		96%		99%		98%		95%			
Interactive Service: Media	99%		100%		100%		100%		100%			
Internet Client & Collab	100%		100%		100%		100%		100%			
Learning & Entertainment	85%		98%		97%		97%		92%			
Personal Systems	69%		75%		71%		65%		70%			
Total	84%		91%		96%		89%		88%			

* CD-ROM Media mix calculated using total FPP license counts, excluding Hardware product division.

Note: CD-ROM mix may exceed 100%, depending upon the quantity of disk-based product returns during the period.

OPERATIONAL HIGHLIGHTS

PACKAGED PRODUCTS

- Product, media, and license mix combined with improved inventory management and expense control resulted in continued lower than plan cost of revenue.
- Effective July 1, Packaged Products reorganized into three regional silos (Western, Central, and Eastern) designed to leverage the geographic and logistical advantages of these continental regions.
- The Western Silo continued to see improvements in fill rates (above 96%) and cost efficiencies from turnkey vendors. Both the Central and Eastern Silos are aggressively pursuing turnkey solutions.

LICENSING

- During Q98-1, MS announced the formation of an independent licensing subsidiary, Microsoft Licensing, Inc. (MSLI), to be located in Reno, NV effective February 1, 1998. Significant efforts were dedicated during this quarter to prepare for a smooth transition of the underlying process and the systems infrastructure.
- Licensing Operations continued its focus on electronic commerce initiatives designed to improve responsiveness and lower costs. Microsoft Order Entry Tool (MOET97) was released into production during Q98-1. This

PROGRAMS

- The worldwide exam delivery fee charged to MS by Sylvan was renegotiated and decreased by \$10.75 to \$35.25 per exam. Based on current trends of 50,000 exams per month, this new pricing agreement will save MS nearly \$7 million in FY98.

Both silos should finalize vendor decisions within Q98-2.

- The transition of AMME (Africa, Morocco, Middle East) Operations from Canyon Park to the European Operations Service Center (EOC) was completed during Q98-1.
- Worldwide finished goods inventory was reduced by \$17 million as a result of improved inventory management and higher packaged product sales.

internet based order entry tool allows channel partners selling Package Product, Open licenses, and Select to enter and validate orders electronically, sharply reducing headcount needs, invalid order problems and order processing cycle times. In addition, the usage of the VLOR Internet site as the primary source of secure agreement, transaction, pricing and Select program content increased to greater than 90% of the Select channel partners worldwide.

- Program operations successfully supported advance orders and the fulfillment of over 200,000 units of the CD-ROM version of the MS Internet Explorer 4.0 via a web based order site available to customers in over forty countries.

KEY PERFORMANCE METRICS

PACKAGED PRODUCT

	North America			Latin America			EOC + AMME		
	Actual	Plan	Var %	Actual	Plan	Var %	Actual	Plan	Var %
Fill rate % (a)	96%	95%	1.1%	80%	80%	-	84%	80%	5.0%
AR % current (b)	93%	95%	(2.1%)	79%	89%	(11.2%)	89%	88%	1.1%
FPP	100%	98%	2.0%	86%	90%	(4.4%)	98%	90%	8.9%
Open	99%	98%	1.0%	81%	90%	(10.0%)	95%	90%	5.6%
Select	79%	90%	(12.2%)	48%	85%	(43.5%)	77%	85%	(9.4%)
Inv. turns/historical (c)	11.6	7.7	50.6%	3.3	3.0	10.0%	7.2	2.5	188.0%
Obso % of net revenue (d)	0.9%	1.3%	30.8%	1.9%	2.5%	24.0%	1.2%	1.6%	25.0%
Cost per head	\$22,156	\$23,440	5.5%	\$25,224	\$25,209	(0.1%)	\$18,000	\$16,000	(12.5%)

	SEA/SPR/ISC			IF Corp		
	Actual	Plan	Var %	Actual	Plan	Var %
Fill rate % (a)	66%	70%	(5.7%)	68%	65%	4.6%
AR % current (b)	78%	85%	(8.2%)	86%	87%	(1.1%)
FPP	86%	90%	(4.4%)	74%	87%	(14.9%)
Open	81%	90%	(10.0%)	78%	87%	(10.3%)
Select	48%	80%	(40.0%)	70%	87%	(19.5%)
Inv. turns/historical (c)	5.4	4.5	20.0%	2.9	2.5	16.0%
Obso % of net revenue (d)	1.8%	2.1%	14.3%	0.8%	2.5%	68.0%
Cost per head	\$21,712	\$22,912	5.2%	\$22,247	\$23,106	3.7%

- (a) Fill rate is the percentage of total line items filled within the targeted number of calendar days.
- (b) Percent accounts receivable current is based on invoice date plus 30 days.
- (c) Inventory turnover - historical is measured by taking the annualized total FPP standard product costs of the previous three months and dividing it by the ending gross inventory balance of the current month. Inventory turns - forecast is calculated by dividing three months forecast of FPP cost of goods sold by the ending gross inventory.
- (d) Obsolete and scrapped inventory is measured in aggregate costs and as a percent of net revenue. Costs and net revenue are taken from the finished goods channel management reports.

- Inventory turns were favorable to plan during the quarter due to the high volume of packaged sales of entertainment and hardware products, combined with a decrease in finished goods inventory of \$17 million. The high inventory turns in North America is also attributable to continued implementation of the Supply Chain Blueprint, which dictates that channel inventory levels be managed on a regional basis, rather than focusing on inventory levels by distributor.
- Inventory obsolescence and scrap were below plan in every region due to lower inventory levels and a more current inventory mix. In addition, returns were below plan.
- Fill rates exceeded plan in all regions except SEA/SPR/ISC. The favorable variances were due to improved relationships with turnkey vendors and outsourcing partners. As a result, fewer resources were needed to aggressively manage channel inventory by holding customer orders.
- Accounts receivable % current was lower than plan in all regions, except EOC and AMME, which was driven primarily by Select account receivables.

LICENSING (OEM & SELECT)

		Q98-1	FY98 Goal
Pipe cost per transaction without recovery (a)	OEM	\$481	\$745
	Select	\$93	\$153
Pipe cost per transaction with recovery (a)	OEM	\$132	\$596
Processing cost per transaction (b)	OEM	\$49	\$43
	Select	\$19	\$28
Transaction per headcount (c)	OEM	37	33
	Select	181	143
Transaction per processing headcount (c)	OEM	156	146
	Select	260	203
OEM Kits released per product org headcount (d)	OEM	8	13
Ops contract cycle time (Valid) (e)	OEM	2	2
	Select	4	3
Ops order/report cycle time (Valid) (e)	OEM	8	5
	Select	3	3
Accounts Receivable % current (f)	OEM	78%	85%
	Select	74%	85%

- (a) Pipe cost per transaction is measured by dividing total pipe costs in the Licensing P&L by total number of transactions for the period. It is measured with or without the Certificate of Authenticity and Authorized Replicator cost recoveries.
- (b) Processing cost per transaction is measured by dividing the total processing related expenses by the total number of transactions processed.
- (c) Transactions per head count per month is total financial transactions (invoices and memos) divided by total regular and temporary headcount.
- (d) OEM kits released per total headcount is the number of OEM kits released in the period divided by the total headcount in the Product Release organization.
- (e) Contract and Order cycle times are times, in days, from the receipt of the order to its entry into the licensing system and from the receipt of the order to the processing of the invoice, respectively.
- (f) Percent accounts receivable current is based on invoice date plus 30 days.

- Pipe costs per transaction in Q98-1 for both major streams of business in WWLO had favorable variances due to a combination of factors which include lower overall spending on controllable expenses, reduced expenses in central services and lower than plan headcount during the quarter. In addition, for OEM licensing, the cost recoveries due to authorized replicator fees and COA recoveries were also higher than plan making the total pipe cost per transaction (with recoveries) lower than the plan by \$463 million.
- Processing cost per transaction for OEM licensing was \$5.96 higher than budget predominantly due to relatively lower transaction volume for the quarter. This metric for Select licensing was \$9 million favorable as a result of some unusually high adjustment transactions (related to quarterly maintenance reporting errors by LARs) that had to be processed during the quarter. This high

transaction volume is also reflected in the productivity measures of transaction per headcount for Select licensing which spiked this quarter and reflects a 28% increased load during the quarter. The transaction count per head for OEM licensing was also higher than plan, despite overall lower transactions, due to lower average headcount in the organization during the quarter. There has been some transition in headcount in OEM licensing due to the upcoming transfer of this department to MSLI Reno.

- The operations controllable contract cycle time for both OEM and Select licensing were very close to goal and show a continuation of the positive trend from FY97. The operations controllable order/report cycle time for OEM shows a 2.7 day unfavorable variance primarily due to the MSLI related transition activities (travel, recruiting, data conversions etc) and employee turnover. However

despite these, the applicable revenue has been recognized within the fiscal month. For Select licensing, this cycle time is approximately 51.5% improved from FY97 and down to sub 4 days for the first time in four quarters.

- Accounts receivable % current was below goal for OEM licensing mainly due to the impact of the

European customers' summer holiday cycle. However compared to Q97-1 the accounts receivable % current for OEM licensing was 2 points higher in Q98-1. Select licensing showed an improvement of 5 points over the comparable quarter in FY97 and this positive trend should continue during the rest of FY98.

PROGRAMS

Region	Measurement Description	Benchmark	MSDN		Org customer mil				Licensing		Direct		Weighted Average
			MSDN	Inbound	MSDP	MCP	Exams	Courseware	Select	Direct	Share Points		
NA	Cust Sat - at least somewhat sat	90%	91%	91%	85%	-	-	-	-	-	82%	-	87%
	Cust Sat - very satisfied	80%	71%	71%	64%	-	-	-	-	-	63%	-	68%
	Phone Service Level	80%/20 sec	89%	88%	84%	86%	83%	84%	83%	89%	84%	-	88%
	Order Fill Rate	95%/48 hrs	79%	82%	97%	94%	-	99%	89%	40%	43%	-	79%
	Distribution Process Accuracy	95%/Quote	99%	100%	100%	99%	-	100%	100%	-	99%	-	99%
Europe	Cust Sat - at least somewhat sat	90%	92%	95%	94%	89%	-	-	-	-	-	-	92%
	Cust Sat - very satisfied	80%	47%	48%	57%	58%	-	-	-	-	-	-	52%
	Phone Service Level	80%/30 sec	83%	76%	94%	89%	84%	99%	95%	97%	90%	-	86%
	Order Fill Rate	95%/48 hrs	97%	100%	94%	77%	-	95%	99%	100%	67%	-	97%
	Distribution Process Accuracy	95%/Quote	99%	100%	100%	99%	-	100%	100%	-	99%	-	99%
AMME	Phone Service Level	80%/30 sec	91%	86%	94%	-	-	-	-	-	-	-	88%
	Order Fill Rate	95%/48 hrs	100%	100%	87%	100%	-	-	-	-	-	-	98%
FE	Phone Service Level	80%/20 sec	97%	98%	-	-	66%	-	-	-	99%	-	86%
	Order Fill Rate	95%/48 hrs	100%	100%	-	-	-	-	-	-	-	-	100%
	Distribution Process Accuracy	95%/Quote	100%	100%	94%	92%	-	92%	97%	-	-	-	97%
SPK	Cust Sat - at least somewhat sat	90%	80%	80%	-	-	97%	-	-	-	-	-	86%
	Cust Sat - very satisfied	80%	39%	39%	-	-	59%	-	-	-	-	-	46%
	Phone Service Level	80%/60 sec	88%	91%	-	-	92%	88%	-	-	87%	-	90%
	Order Fill Rate	95%/72 hrs	96%	96%	-	-	-	98%	-	-	56%	74%	81%
	Distribution Process Accuracy	95%/Quote	100%	100%	94%	100%	-	100%	96%	-	-	-	96%
SEA	Cust Sat - at least somewhat sat	90%	80%	80%	-	-	97%	-	-	-	-	-	86%
	Cust Sat - very satisfied	80%	39%	39%	-	-	59%	-	-	-	-	-	46%
	Phone Service Level	80%/60 sec	-	-	-	-	-	-	-	-	-	-	93%
	Order Fill Rate	95%/72 hrs	99%	99%	-	-	-	-	-	-	-	-	99%
	Distribution Process Accuracy	95%/Quote	100%	100%	94%	-	-	100%	97%	-	-	-	97%
SPA	Phone Service Level	80%/20 sec	96%	94%	99%	99%	-	73%	-	-	-	-	93%
	Order Fill Rate	95%/48 hrs	60%	91%	-	-	96%	-	100%	-	-	-	74%
	Distribution Process Accuracy	95%/Quote	100%	100%	87%	98%	-	94%	92%	-	-	-	91%
Brazil	Distribution Process Accuracy	95%/Quote	100%	-	71%	-	-	100%	74%	-	-	-	79%
	Distribution Process Accuracy	95%/Quote	-	100%	75%	100%	-	100%	100%	-	-	-	94%
Total	Phone Service Level	80%	87%	84%	86%	87%	82%	87%	89%	90%	84%	-	87%
	Order Fill Rate	95%	85%	88%	96%	86%	-	98%	94%	41%	44%	-	84%
	Distribution Process Accuracy	95%/Quote	99%	100%	98%	98%	-	99%	98%	-	99%	-	99%

Customer satisfaction is the percentage of callers satisfied with the quality of service received during calls, based on a sampling of one hundred callers surveyed by program each month.

Phone service level is the percentage of inbound calls answered by a representative within a specified amount of time after a call enters a queue in relation to total calls received.

Order fill rates are the percentage of compliant order lines shipped complete within forty-eight hours in relation to total compliant order lines entered, including those on backorder.

Distribution process accuracy is the percentage of shipments delivered to a consignee within the quoted distribution time, including actual domestic transit, international transit, carrier performance and customs factors.

- Phone service levels achieved performance standard of 80% or above across all regions. Exceptions were for Europe TechNet and Beta CD programs where service level suffered in July due to a large influx of calls caused by unannounced campaigns. In addition, service levels were below goal in the Far East where calls for Windows NT 4.0 MCP Exams test applicants drove unanticipated volumes.
- Order fill rate for MSDN in North America and Spanish America did not meet the performance level of 95% within forty-eight hours, primarily due to shipment holds caused by rework of product in August. MSDN did rebound in September with a 100% order fill rate. TechNet achieved goal by achieving 95% in August and 100% in September. North America Select CD order fill rate was below goal for the quarter due to MS changes to Office and Windows NT Enterprise.

- North America direct marketing and supplemental parts experienced low order fill rates due to the impact of RTM's and prioritization of direct orders in FPP manufacturing builds. A direct marketing vendor in the South Pacific Region experienced system errors resulting in a backorder situation and low order fill rates versus goal. A system correction is in place for October.
- Significant improvements have been made in shipments to Brazil and the Philippines. Worldwide Programs Operations' Logistics and Global Trade Standards implemented changes to carriers and procedures for shipments originating from US manufacturing sites. As a result, delays due to import license paperwork and customs have been significantly decreased. Shipping delays in Brazil have improved from an average of forty days to sixteen days and in the Philippines from an average of forty-nine days to twenty-two days.

Product
Development

CONSOLIDATED PRODUCTS

Q98-1 P&L SUMMARY

(\$ in millions, variance to plan)	Net revenue		Cost of revenue			Responsibility margin			Contribution margin		
	Actual	Var %	Actual	Var %	% of net rev	Actual	Var %	% of net rev	Actual	Var %	% of net rev
Desktop Applications/Web Authoring	\$ 1,274.3	(11)%	\$ 52.7	(1)%	4.1%	\$ 1,032.8	27%	81%	\$ 924.5	34%	73%
Personal Systems	1,136.0	16%	17.0	34%	1.5%	997.6	21%	88%	941.1	15%	83%
Business Systems	484.5	16%	22.1	(2)%	4.6%	270.2	61%	56%	170.0	15%	35%
Internet Client & Collaboration	1.4	(79)%	3.2	(14)%	225.1%	(61.6)	5%	nm	(80.4)	16%	nm
Developer Tools	135.5	(1)%	21.2	7%	15.6%	65.7	45%	48%	39.6	17%	29%
Consumer Platforms	2.1	(37)%	0.1	65%	3.2%	(16.7)	20%	(796)%	(20.0)	18%	nm
Software	8.6	(4)%	0.8	(22)%	9.5%	0.0	100%	0%	(4.6)	16%	(53)%
WebTV	7.0	111%	10.5	(9)%	150.5%	(16.3)	(23)%	nm	(16.0)	(27)%	(229)%
Total Platforms and Applications	3,052.4	14%	127.7	17%	4.2%	2,273.0	31%	74%	1,964.9	43%	64%
Learning and Entertainment	96.3	30%	18.3	14%	19.0%	25.2	(674)%	26%	14.6	185%	15%
Interactive Service Media	11.7	(12)%	5.8	(46)%	49.7%	(28.5)	(14)%	(244)%	(33.9)	14%	(291)%
Desktop Finance	9.2	92%	2.5	(7)%	26.8%	(5.8)	(42)%	(63)%	(8.1)	37%	(88)%
News and Publishing	0.1	18%	1.4	nm	nm	(28.1)	(7)%	nm	(28.4)	7%	nm
Hardware	150.3	170%	81.8	(27)%	54.4%	47.4	420%	32%	40.3	nm	27%
Microsoft Network	85.4	6%	48.7	16%	57.0%	(50.5)	(29)%	(59)%	(53.8)	39%	(63)%
Total Interactive Media	352.9	29%	158.4	(6)%	44.9%	(40.3)	(74)%	(11)%	(69.3)	63%	(20)%
Total Product Groups	3,405.3	16%	286.1	(6)%	8.4%	2,322.8	41%	66%	1,895.6	60%	56%
MS Research	5.0	-	-	-	-	(7.8)	(52)%	(156)%	(10.2)	(47)%	(203)%
Other	39.6	12%	15.4	(9)%	39.0%	(329.5)	(17)%	(833)%	10.4	155%	26%
Total	\$ 3,449.8	16%	\$ 301.6	(6)%	8.7%	\$ 1,895.5	50.0	55%	\$ 1,895.8	62%	55%

PLATFORMS & APPLICATIONS

Q98-1 P&L SUMMARY

(in millions, except cost per head, variance to plan)	Dktp Apps/Web Auth		Personal Systems		Business Systems		Internet CC		Developer Tools	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net revenue	\$ 1,274.3	15%	\$ 1,136.0	16%	\$ 484.5	16%	\$ 1.4	(79%)	\$ 135.5	(1%)
Cost of revenue	52.7	26%	17.0	34%	22.1	(2%)	3.2	(14%)	21.2	7%
% of net revenue	4.1%		1.5%		4.6%		225.1%		15.6%	
Gross margin	1,221.5	18%	1,119.0	17%	462.3	17%	(1.8)	(145%)	114.4	(0%)
% of net revenue	96%		98%		95%		(125%)		84%	
Operating expenses										
People	41.9	7%	19.6	12%	57.4	7%	22.9	7%	17.0	(1%)
Infrastructure	15.7	7%	9.7	4%	28.9	(3%)	11.1	1%	6.0	9%
Contingent staff	6.4	24%	10.6	(25%)	18.3	(18%)	7.4	(21%)	3.1	39%
Product development	11.3	22%	5.9	(15%)	10.5	30%	4.0	(2%)	1.9	65%
Other	0.2	122%	0.2	nm	0.2	(126%)	0.2	38%	0.0	71%
Product marketing	20.4	8%	10.0	29%	11.4	12%	14.5	26%	2.2	58%
Controllable operating expenses	95.9	10%	56.0	7%	126.8	3%	60.1	9%	30.1	23%
FG customer unit	21.7	28%	14.0	17%	19.2	29%	2.1	11%	5.6	28%
FG non-customer unit	16.6	41%	8.7	40%	14.9	39%	1.7	62%	2.1	58%
Channel and int'l marketing	(0.0)	nm	0.0	nm	0.0	nm	0.0	nm	0.0	nm
Taxes, insurance, and settlements	3.1	(1%)	15.4	(31%)	1.2	3%	0.0	(203%)	0.2	25%
Product support services	30.8	14%	19.9	21%	22.3	27%	2.8	(37%)	10.7	38%
Bad debt expense	8.8	(11%)	5.9	(21%)	3.5	(8%)	0.0	39%	0.9	(7%)
R&D shared resources	11.9	20%	1.4	24%	4.3	41%	(6.9)	(24%)	(0.9)	(106%)
Product-related operating expenses	92.9	23%	65.4	13%	65.3	30%	(0.3)	109%	18.5	39%
Total operating expenses	188.8	17%	121.4	10%	192.1	15%	59.8	13%	48.7	30%
Responsibility margin	1,032.8	27%	997.6	21%	270.2	61%	(61.6)	(5%)	65.7	45%
% of net revenue	81%		88%		56%		nm		48%	
Corporate allocations	98.3	15%	56.5	15%	100.2	15%	18.8	16%	26.1	17%
Contribution margin	\$ 934.5	34%	\$ 941.1	25%	\$ 170.0	242%	\$ (80.4)	(8%)	\$ 29.6	187%
% of net revenue	73%		83%		35%		nm		29%	
Headcount	1,619	7%	2,956	4%	Note: Headcount and costs per head apply to PSBD.		1,151	(1%)	742	0%
People costs per head	\$ 73,546	(2%)	\$ 88,309	4%			\$ 84,330	6%	\$ 82,763	(4%)
Infrastructure costs per head	\$ 11,356	(19%)	\$ 17,566	2%			\$ 16,754	8%	\$ 10,147	7%

(in millions, except cost per head, variance to plan)	Consumer Plats		Softimage		Web TV		Other		Plat & Apps	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net revenue	\$ 2.1	(37%)	\$ 8.6	(4%)	\$ 7.0	111%	\$ 2.9	327%	\$ 3,052.4	14%
Cost of revenue	0.1	65%	0.8	(22%)	10.5	(9%)	0.0	99%	127.7	17%
% of net revenue	3.2%		9.5%		150.5%		0.1%		4.2%	
Gross margin	2.0	(36%)	7.8	(6%)	(3.5)	(44%)	2.9	833%	2,924.7	16%
% of net revenue	97%		90%		(50.5%)		100%		96%	
Operating expenses										
People	7.7	4%	3.1	16%	5.1	(83%)	5.9	39%	180.7	7%
Infrastructure	3.2	2%	1.9	6%	2.2	(163%)	3.3	20%	81.9	1%
Contingent staff	2.8	25%	0.2	(43%)	1.1	(155%)	1.3	35%	51.2	(3%)
Product development	2.7	13%	0.0	96%	1.0	(18%)	0.7	72%	37.8	26%
Other	0.0	nm	0.0	nm	1.9	(311%)	0.2	88%	3.1	(56%)
Product marketing	1.3	70%	0.5	29%	0.1	nm	0.0	nm	60.4	24%
Controllable operating expenses	17.7	21%	5.8	20%	11.4	(113%)	11.5	43%	415.2	10%
FG customer unit	0.0	na	0.0	nm	0.0	na	1.6	nm	64.2	24%
FG non-customer unit	0.0	69%	0.0	nm	0.0	100%	0.0	nm	43.9	47%
Channel and int'l marketing	0.0	nm	2.0	34%	1.2	62%	0.0	nm	3.2	48%
Taxes, insurance, and settlements	0.1	(22%)	0.0	nm	0.0	nm	0.0	(561%)	19.9	(22%)
Product support services	0.2	(20%)	0.0	nm	0.0	nm	0.0	nm	86.8	22%
Bad debt expense	0.0	55%	0.1	58%	0.0	19%	0.0	nm	19.2	(12%)
R&D shared resources	0.7	36%	0.0	nm	0.0	78%	(11.4)	43%	(0.9)	(4%)
Product-related operating expenses	1.0	27%	2.0	35%	1.3	86%	(9.8)	51%	236.5	25%
Total operating expenses	18.7	22%	7.8	25%	12.7	14%	1.6	nm	651.7	16%
Responsibility margin	(16.7)	(20%)	0.0	(100%)	(16.3)	(23%)	1.3	343%	2,273.0	31%
% of net revenue	nm		0%		nm		44%		74%	
Corporate allocations	3.9	18%	4.6	16%	(0.2)	125%	0.1	24%	708.2	16%
Contribution margin	\$ (20.6)	(19%)	\$ 14.6	(39%)	\$ (16.0)	(27%)	\$ 1.2	494%	\$ 1,964.9	43%
% of net revenue	nm		(15.5%)		nm		42%		64%	
Headcount	282	(0%)	169	11%	181	42%	198	19%	7,297	2%
People costs per head	\$ 93,181	4%	\$ 69,582	4%	\$ 67,637	nm	\$ 80,499	3%	\$ 83,298	4%
Infrastructure costs per head	\$ 12,726	2%	\$ 24,830	(8%)	\$ 11,863	nm	\$ 14,701	1%	\$ 16,014	2%

BUSINESS RESULTS

- Desktop Applications (DAD) Q98-1 net revenue totaled \$1.27 billion, 15% over plan, 30% over Q97-1, but 1% lower than Q97-4. The quarterly results were driven by strong sales in Select and Open volume licensing programs, particularly in North America and Europe, as well as full packaged product sales in the Far East.
- Personal Systems Q98-1 net revenue of \$1.14 billion was 16% over plan and 6% above Q97-4 levels. Windows 95 gross revenue of \$796 million was \$103 million (15%) over plan due to strong retail channel sales and overall computer shipment growth. Windows NT Workstation gross revenue of \$242 million was \$52 million (28%) over plan, and 120% over Q97-1 as the percentage mix of Windows NT workstation product sold in the OEM channel continues to increase significantly.
- Business Systems Q98-1 net revenue of \$484 million exceeded plan by 16%. The key drivers for the quarter were Windows NT Server with \$215 million and Exchange with \$67 million of gross revenue.
- Developer Tools Q98-1 net revenue totaled \$136 million, 1% under plan, 12% less than Q97-4, but 18% over Q97:1 due to slower growth than recognized immediately following the launch of the version 5 tools in March. Visual Studio and MSDN sales were above plan, but offset by low sales of the stand-alone products.
- WebTV Q98-1 net revenue totaled \$7 million, 111% over plan. The significant variance to plan was due to higher than expected hardware and licensing revenue, along with lower than expected rebates and revenue sharing due to a lower subscriber base. At quarter-end, there were 137,000 subscribers, 21% below the 174,000 planned due primarily to a shortage of WebTV product in the channel.
- Cost of revenue, as a percent of net revenue, was 1.2 points favorable to plan, due to favorable license mix, CD-ROM media mix, and improved inventory management.
- Platforms and Applications controllable operating expenses were \$39 million less than plan, due primarily to timing of product marketing and localization spending.

OUTLOOK

- Desktop Applications Q98-2 revenue is expected to grow to \$1.5 billion, 6% higher than Q98-1. Anticipated revenue drivers are Office 97 migration, strength of maintenance renewals and custom agreements, increased word processor penetration of Home and Small Business editions, and strong holiday sales.
- Personal Systems Q98-2 revenue is expected to grow to \$1.3 billion. Overall demand for computers is expected to remain strong, especially in the fast-growing sub-\$1,000 market. OEM revenue is expected to grow as the mix of products continues to shift toward Windows NT Workstation.
- Business Systems Q98-2 revenue is expected to grow to approximately \$600 million. Server revenue is likely to grow 8% driven by continued deployment of Exchange and the launch of Small Business Server. The launch of Windows NT Enterprise is not expected to contribute significantly to Q98-2 revenue. However, it represents the delivery of a key component of MS's enterprise strategy.
- Developer Tools Q98-2 revenue is expected to be flat with Q98-1, as no new products will be released. Revenue results are dependent on Visual Studio suite adoption, upselling developers to enterprise editions, continuing sales of traditional tools, and ongoing MSDN subscription renewals.
- Following the September release of Internet Explorer 4.0 (IE4) for Windows 95/NT, IE4 for Windows 3.1, Macintosh, and Unix platforms will be released during the next few months. IE4 with Active Desktop integration, Active Channels push technology, email client Outlook Express, and NetMeeting Collaboration is anticipated to drive MS's share in the Internet browser market from the 30% range to above 50% during its product life.
- WebTV will ship the WebTV Plus platform and network service in Q98-2. New subscription rates should accelerate through the holiday season fueled by nationwide advertising campaign and a \$100 rebate on the WebTV Classic platform. However, Q98-2 subscriber levels are likely to fall short of plan due to continued inventory shortages.

DESKTOP APPLICATIONS

INVESTMENTS & PRODUCT HIGHLIGHTSMicrosoft
Office 97

- Through Q98-1, 17 million licenses of Office 97 and related applications have sold worldwide, of which 12 million were non-maintenance sales.
- While credited sales of Office were strong, migration status changed only minimally during the quarter, due to a delay in the availability of SR-1 until late September. SR-1 is an Office 97 update designed for large organizations to address migration issues like file format compatibility. SR-1 contains the Word 6.0/95 Binary converter for Word 97, performance enhancements for Outlook 97, along with updated file viewers, converters and filters. There is evidence SR-1 is beginning to unblock accounts where deployment was stalled.
- A significant number of accounts remain in the Office 97 evaluation stage. These accounts cite total cost of ownership (TCO) concerns, version coexistence issues during deployment, and deviation from standard corporate upgrade cycles as key barriers to migration. On the upside, Office 97 will continue to benefit from 32-bit operating system sales momentum.
- Computer Intelligence's StoreBoard estimates MS blended word processing (WP) retail license share was 75% in August, up from 66% in June when Corel launched WordPerfect Suite 8.0. Corel's share decreased to 22% from their June launch high of 31%. Lotus was flat at 3%.
- Computer Intelligence's StoreBoard estimates MS August blended WP license unit shares for Direct Market Resellers and outbound at 85% and 89%, respectively.
- FrontPage retail unit market share reached 36% in August, per PC Data. However, PC Data figures include Netscape Navigator Gold, a browser with limited web publishing and site management functionality. Excluding Navigator Gold browser only users, estimated FrontPage market share exceeded 44%.
- Front Page 98 shipped in October. Front Page 98 facilitates web site creation through templates, wizards, pre-packaged design themes, web site management tools, and new WYSIWYG frame set editing features. It supports new web technology including dynamic HTML, new "push" format via the channel definition wizard, and cascading style sheets. The beta version, which was released over the Internet in August, received favorable reviews. The new version should boost sales and market share in the coming quarter.
- Other new product releases include Project 98, Publisher 98, Home Essentials 98, Picture It 2.0, and Greetings Workshop Standard and Deluxe versions. Sixty-day trial versions of Project 98 and Publisher 98 were offered free over the Internet. Response to both promotions has been strong.
- Ralf Harteneck was named GM of the Word Product Unit during the quarter, which he will manage as well as remain GM of the PowerPoint group.

BUSINESS METRICS

	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
Office 97 migration (U.S.)						
% Top 30 accts desktops				20.0%	23.0%	45.0%
% Top 825 Large org accounts				10.0%	13.0%	45.0%
			FY96	FY97	FY98E	FY98 Target
FG revenue per run rate PC (U.S.)						
Large organizations (including breadth)			\$126	\$147	\$153	\$156
Medium organization			63	71	72	75
Small organization			45	45	48	50
Home			23	30	25	28
	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
Word processing share (blended, U.S., one month lag)						
Retail revenue share	71.6%	76.0%	84.6%	82.1%	82.7%	83.0%
Outbound revenue share *	89.1%	91.5%	93.7%	91.9%	93.5%	94.0%
32-bit applications % of FG revenues	61.0%	68.0%	77.0%	79.0%	83.0%	85.0%
FG License mix by user type (non-academic versions)						
Standard	50.0%	47.0%	41.0%	47.0%	43.0%	
Upgrade	27.0%	30.0%	39.0%	32.0%	35.0%	
Maint/Custom	22.0%	23.0%	21.0%	21.0%	22.0%	
FG License mix by pricing level (including maint.)						
Packaged product/MLP	31.0%	35.5%	32.6%	21.9%	24.8%	
Select/Custom agreement	36.2%	35.5%	39.3%	40.4%	35.9%	
Open	7.9%	10.6%	9.8%	12.1%	15.8%	
Academic	20.1%	12.9%	13.9%	18.5%	18.5%	
Other	4.8%	5.5%	4.4%	7.1%	5.0%	
Office Pro % total Office FG (non AE)	40.6%	43.0%	50.0%	48.9%	49.0%	
	May-97	Jun-97	Jul-97	Aug-97	Sep-97	
Avg # of daily page views of Office Web (thousands)	339	396	362	468	476	

* Outbound = resellers to large organizations

COMPETITION**Corel**

- In August, Corel announced plans to abandon its release of Office for Java (COJ). Instead, Corel will incorporate technology from COJ into CorelCentral, a personal information manager including Netscape Communicator, on the assumption users will spend most of their workdays using email and groupware, booting Office apps infrequently as needed for special documents. In addition, Corel announced that work on its Citrix like product, Remagen, would be incorporated into future versions of CorelOffice, to enable multi-platform client access to Windows applications. Corel has hinted it will make these

technologies available in its network computer currently in development.

- In August, Corel released WordPerfect Suite 8 Professional which includes standard Office applications plus Paradox, Corel Timeline and Corel WebSite builder. Corel announced the CY97-4 product releases of Draw 8, PrintHouse 3 and increased European localization efforts for WordPerfect. The proposed localized languages include Finnish, Swedish, Norwegian, German, Danish, Italian, Spanish and Portuguese. WordPerfect is currently available in French, French-Canadian and Dutch.

Lotus (IBM)

- Lotus announced plans to ship Kona WorkPlace, a Java-based applets suite by the end of this calendar year. The applets will include a client e-mail program, calendar/address book, word processor, spreadsheet, presentation graphics program, project scheduler, file manager, Web browser, and terminal emulation.
- Lotus announced the availability of an updated version of its Lotus Connection product for SAP R/3. Lotus Connection provides a link for users of

Other

- JustSystems completed an initial public offering on October 16 and plans to use the additional capital generated from the offering for acquisitions of new technologies. In September, JustSystems released an updated version of Ichitaro Office with the JustSystems' Intelligent Interface (JIIF). JIIF translates vague expressions into a list of appropriate Kanji characters.

**BUSINESS SYSTEMS****INVESTMENTS & PRODUCT HIGHLIGHTS**

- Internet Information Server (IIS) 4.0 beta 3 released to more than 300,000 customers in September, with final product availability scheduled for Q98-2. IIS 4.0 features support for transaction processing, content replication and process isolation within a web application environment.
- MS announced Proxy Server 2.0 in September, featuring enhanced network performance, firewall security, and hierarchical web caching services for networks of all sizes.
- Windows NT Server 5.0 Beta 1 was distributed to over 6,200 developers at the annual Professional Developers Conference in September, with final product availability expected in the second half of CY1998. Windows NT Server 5.0 provides for better management of networks via TCO initiatives like Zero Administration Windows (ZAW) and Intellimirror technology, enhanced applications scalability, and more robust security.
- MS outlined the Windows Distributed internet Applications Architecture (Windows DNA), which defines a unified approach for building distributed and scalable multi-tier applications to be delivered over any network.
- SAP business applications to access and leverage SmartSuite 97 applications in their day-to-day operations.
- In August, Lotus released Organizer 97 Group Scheduling for the Macintosh, a product providing users with time and contact management, World Wide Web integration, and full group scheduling and calendar replication capabilities through Lotus Notes and Domino.
- In September, Star Division announced a joint licensing agreement that will bundle its StarOffice software suite with NCI's NC Server software. Star Division also released a StarOffice 4.0 beta, which incorporates spreadsheet, word processor and presentation capabilities in one application. StarOffice 4.0 is scheduled to launch in January 1998.
- MS and Cisco Systems announced an industry-wide initiative to integrate directory services and networks, making it easier to develop network applications compatible with a variety of network and directory vendors.
- Windows NT Server, Enterprise Edition 4.0 was released to manufacturing in September, extending application memory support and fault tolerant capabilities over the base version.
- Small Business Server was also released in September, providing start-up organizations with a complete network operating environment (NT Server) integrated with email (Exchange), web (IIS, Proxy), and database (SQL) services.
- MS announced the acquisition of VXtreme, a developer of audio and video streaming services delivered via the Internet. MS also licensed media streaming technologies from Progressive Networks for inclusion in the NetShow 2.0 media server.
- MS and Computer Associates (CA) announced plans to integrate CA's Jasmine database/multimedia authoring environment with MS's OLE DB Component Object Model (COM), enabling the seamless delivery of multimedia objects across networks.

BUSINESS METRICS

	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
Revenue per server (a)						
Windows NT Server	\$645	\$656	\$754	\$771	\$765	\$785
SQL Server	\$1,286	\$1,719	\$1,572	\$2,262	\$1,730	\$1,532
Exchange Server	\$1,420	\$2,723	\$2,419	\$3,231	\$2,863	\$2,044
Revenue per user (a)						
Windows NT Server	\$60	\$48	\$50	\$42	\$45	\$50
SQL Server	\$123	\$98	\$110	\$99	\$108	\$115
Exchange Server	\$60	\$47	\$46	\$46	\$48	\$52
Attach Rate to FG Windows NT Server						
SQL Server	21%	17%	20%	14%	22%	22%
Exchange Server	14%	10%	11%	13%	17%	22%
New Windows NT Server licenses	86,834	84,478	95,900	92,864	99,311	454,121

(a) Revenue = Server + CAL revenue

COMPETITION

- Netscape and Digital announced an agreement to bundle Netscape Enterprise Server 3.0 and FastTrack Server 3.0 on Digital Alpha systems running Digital Unix and Open VMS.
- Dell Computer and Oracle announced an alliance for the delivery of Oracle based information management software products on Dell PowerEdge server hardware, targeted to enterprise customers.
- Novell announced GroupWise 5.2, the next version of its groupware product, featuring expanded support for Internet standards, intranet based collaboration and network administration.
- IBM agreed to acquire Unison Software for \$182 million, or \$15 a share, enhancing its software portfolio that allows companies to centrally manage computer networks.
- Lotus released Domino for the IBM S/390 system, a multi-processor hardware platform featuring expanded capacity, availability, and security. Domino provides email and web application services for internets and intranets.
- Lotus launched the following upgrades: Notes 4.6 Client, Domino Mail 4.6 server, and Notes Designer for Domino 4.6. The products provide client-server, Internet, email/groupware, and tools for delivering and administering collaborative Web applications.
- Sybase signed an agreement with PeopleSoft allowing the resale of Sybase Adaptive Server Enterprise and other Sybase products with PeopleSoft's line-of-business client/server applications.
- Oracle launched Express Server 6.1, an On-Line Analytical Processing (OLAP) product for corporate intranets, for Sun's Ultra Enterprise hardware platform.
- Netscape announced SuiteSpot Hosting Edition, a version of its server suite designed to enable Telcos and corporate entities to host Internet and Intranet services for individuals and enterprises.
- Sun shipped the Enterprise 450 line of servers, aimed at competing with Windows-based Intel products. Featuring a Web server, Java-based browser, Internet Mail, and administration tools, the servers are priced starting at \$12,000.



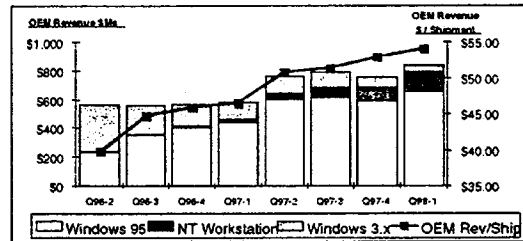
PERSONAL SYSTEMS

INVESTMENTS & PRODUCT HIGHLIGHTS

- Windows NT Workstation (NTW) 5.0 beta one was delivered at the Professional Developers Conference to key corporate customers and to 200,000 MSDN developers. Windows NTW 5.0 will extend the reliability, security, performance, and networking capabilities of earlier versions, while offering the lowest total cost of ownership of any Windows-based desktop. In addition, it will include some key ease-of-use features such as full Internet integration and Plug and Play.
- Work continued on Windows 98, which will be fully integrated with IE4. Windows 98 will provide support for new entertainment platforms such as digital television and digital videodisks. For home user upgrades, Windows 98 will make computing more reliable with new tune-up utilities and provides better communication via the new e-mail client. For corporations, Windows 98 will make computers less costly to manage with MS Zero Administration Initiative and new troubleshooting utilities.
- Windows 98 product launch slipped from Q98-3 to Q98-4. Originally, a staggered release strategy was planned, providing an easy upgrade path for Windows 95 users first, then after additional development and testing, an upgrade path for Windows 3.1 customers. A release combining the two upgrades will simplify the product roll out to the MS channel, and address valuable market feedback.
- An updated Windows 95 retail version featuring IE4 was released to manufacturing, and will appear on store shelves by the end of November, in an effort to sustain Windows 95 sales through the

holiday season. A similar retail promotion of Windows NTW 4.0 and IE4 will be available in stores by February 1998.

- The U.S. Department of Defense has adopted the Windows Logo Program technical requirements as the standard for NT applications purchased or internally developed. This covers all branches of the U.S. armed forces and intelligence community.
- The installed base of computers running a Windows 32-bit operating system now exceeds 100 million.
- Windows NTW continued its strong revenue growth during Q98-1, increasing 25% over Q97-4, and 120% over the year ago quarter.



- Personal Operating Systems OEM revenue per PC increased slightly during Q98-1, due to mix shift to Windows 95 and Windows NTW from 16-bit operating systems (see chart).

BUSINESS METRICS

	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
Win NTW OEM mix	1%	3%	4%	5%	8%	15%
Win NTW FG mix	22%	28%	28%	40%	20%	20%
PC shipment growth	19%	5%	22%	16%	26%	15%
OEM OS Revenue per PC	\$ 48	\$ 51	\$ 52	\$ 53	\$ 53	\$ 55
ICG Revenue per license	\$ 78	\$ 82	\$ 80	\$ 76	\$ 87	\$ 73

COMPETITION

- A number of vendors are shipping Network Computers (NCs) based on proprietary, non-Windows operating systems. The NCs shipping during the past year have been primarily from terminal vendors, including Wyse, NCD, Tektronix, and Boundless. These vendors adhere to the NC specification by adding a Java Virtual Machine to existing products. Of the major NC champions, IBM is the only company with a commercially available product. IBM expanded its line of NCs to three different devices late this summer. Sun will ship its first NC, the Javastation, this winter, followed by a second version in the spring. Oracle's NCI subsidiary has recently begun shipping a set-top box via RCA and is expected to begin shipping NCs for corporate accounts this winter.
- Apple released the Mac Operating System version 8 at an estimated retail price of \$99, declaring it the most significant release since 1984. Mac OS 8 offers an improved user experience, simplified Internet access, new multimedia capabilities, and enhanced performance and stability.
- Apple's next generation operating system, Rhapsody, is planned for release sometime in CY98. Interim CEO Steve Jobs announced his decision to launch Rhapsody primarily as a server operating system, followed by a gradual deployment over to Macintosh desktop computers over the next several years.

**INTERNET CLIENT AND COLLABORATION****INVESTMENTS & PRODUCT HIGHLIGHTS**

- Internet Explorer 4.0 for Windows95/ WindowsNT was released September 30. Key new features include the Active Desktop integration and Active Channels push technology, which delivers web information directly to a user's desktop. IE4 for the Macintosh, Windows 3.X, and Unix platforms will follow in subsequent months.
- Internet Explorer Administration Kit 4.0 (IEAK) released on September 30 in conjunction with the IE4 launch. IEAK allows for highly customized installations and automatic synchronization of software versions with the Microsoft download site.
- IE continued to gain market share in Q1, despite the release of Netscape's new Communicator suite. According to random digit call down data and hits from popular web sites, IE browser share is at 35% (up from 32% from last quarter). Netscape Navigator browser share is at 47% (down from 50% last quarter).
- All of the top ten computer manufacturers, including Compaq, Dell, and Gateway, have agreed to create push channels to give customers access to up-to-date product support information. Additionally, Apple Computer has agreed to pre-install IE with its Macintosh operating system.
- Several leading Internet Service Providers (ISPs) will provide IE4 as their default browser, including AT&T WorldNet, Concentric Network, EarthLink Network, Erol's Internet, GTE Internetworking, internetMCI, MindSpring, the Microsoft Network, Netcom, Prodigy, and Sprynet. AOL will use IE4 technology in its next browser update.
- MS introduced support for scriptlets in IE4. Scriptlets represent web-based components that allow developers to write simple, reusable user interface applications. Scriptlets are written in HTML in combination with a scripting language. Developer tools scriptlet support will be included in Visual InterDev98 and FrontPage.
- MS and Lotus announced IE4 will become more tightly integrated with Lotus products. Lotus plans to distribute IE4 with the Lotus Notes 4.6 client and the forthcoming release of SmartSuite. Lotus will also support Microsoft's Component Object Model (COM), enabling a more integrated environment for tasks to be performed across different product applications.
- MS and Marimba agreed on a standard format for delivering software upgrades over computer networks. The Open Software Description format is also endorsed by Netscape and Lotus.

BUSINESS METRICS

	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
Browser share from call-downs	8%	12%	27%	31%	35%	40%
Browser share from top 100 sites		22%	26%	31%	37%	40%
Browser share by platform:						40%
32-bit					43%	
16-bit					29%	
Macintosh					9%	
Email share					16%	30%

COMPETITION

- Netscape previewed a new technology, Aurora, which will be offered as a free component of Communicator. Aurora is positioned against IE 4's Active Desktop, and uses the browser as a means of viewing files and information on the desktop. However, the Active Desktop is more tightly integrated with the operating system, where Aurora is positioned as a separate layer on top of the operating system.
- In late August, Netscape posted a stand-alone version of Navigator 4.0, responding to pressure from IBM (Lotus), Oracle, and others to unbundle the browser component from the Communicator software suite.
- In mid-August, Netscape released the Netcaster feature as a component of the Communicator suite. Netcaster uses push technology to deliver web pages to the desktop via subscription channels. Several companies have signed up to become
- Sun Microsystems filed suit against MS for breach of contract, trademark infringement, false advertising, and unfair competition over MS's use of licensed Java technology. Sun contends that MS broke its agreement to provide compatible Java implementations in MS products.
- In September, Novell and Lotus released new versions of their respective groupware client products, GroupWise 5.2 and Notes 4.6. Both products have extended Internet collaboration features and support Internet mail standards. Notes 4.6 is integrated with IE4 for enhanced Web navigation and information.



TOOLS DIVISION

INVESTMENTS & PRODUCT HIGHLIGHTS

- MS and Informix will co-market Visual Basic and Data Director for creating Windows NT solutions. MS will provide Data Director co-marketing and advertising support, while Informix's worldwide sales force will market Data Director as part of a Visual Basic-based solution.
- MS announced the availability of new apartment-threaded ActiveX Control creation capabilities for the MS Visual Basic 5.0 programming system. The new apartment-model-threading capabilities allow developers to create high-performance controls for Web-based applications that take full advantage of multithreaded clients, such as IE4.
- Over 100 of the leading independent software vendors (ISVs), representing 23 different industries, plan to integrate the MS Visual Basic programming system Application Edition (VBA) version 5.0 into future versions of their applications.
- MS will deliver an interim update to its Visual C++ development tool in November to add support for IE4 control development, dynamic HTML, Active Data Objects, and OLE DB, the company's universal data access API.
- MS outlined the features of the next two versions of the Visual Studio development tool suite at the Professional Developers Conference. The next version of Visual Studio, code-named Aspen, will add support for IE4 controls, dynamic HTML, and Windows NT 5.0-specific features, such as the upcoming MS Message Queue server, Active Directory services, and MS's Zero Administration technologies. Aspen will be delivered in stages, with final delivery in the first half of next year. The version following Aspen, code-named Rainier, will support COM+, and the Windows Distributed interNet Applications (DNA) architecture.

BUSINESS METRICS

	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
Windows Platform Targeting (a)	84%	90%	90%	91%	92%	100%
VB Language Usage (b)	40%	50%	53%	53%	51%	51%
Java Native Calls (c)					40%	51%
MS Secure Customer Index (d)					29%	35%
Visual Studio Penetration (e)			7%	14%	23%	20%
Enterprise Edition Upsell (f)	14%	13%	17%	32%	36%	40%
	FY94	FY95	FY96	FY97	Q98-1	FY98 Target
Revenue per License	\$ 145	\$ 163	\$ 218	\$ 229	\$ 334	\$ 293
(a) % of US developers writing applications that target Windows						
(b) % of US developers using MS Visual Basic language						
(c) % of US Java developers making calls to the operating system						
(d) Measurement of satisfaction, willingness to recommend and to repurchase MS products						
(e) % of Visual Studio licenses sold as a % of total Professional and Enterprise licenses						
(f) % of Enterprise licenses sold as a % of total Professional and Enterprise licenses						

COMPETITION

- Oracle's planned development tool Sedona, postponed earlier this year, has been cancelled. Oracle plans to use Sedona technologies in its Developer/2000 and Designer/2000 tools. Oracle outlined a new Java and JavaBeans development tool project, code-named Valhalla, built using technology licensed from Borland. Valhalla will target Java and CORBA application development, which is where Sedona fell short.
- Oracle shipped an upgrade to its Developer/2000 suite. Version 1.5 extends the thin-client deployment capabilities of Developer/2000 to include enterprise-class reporting, charting and data visualization.
- Sun posted the latest version of its Java Workshop, which enables developers to build portable JavaBean components.
- Sun Test, Sun's new business division, launched a suite of tools for testing Java applications and applets. The three new products, JavaStar, JavaSpec, and JavaScope, were written in Java and are designed to work on all Java-compatible platforms.
- Symantec created new versions of Visual Café, the Web Development Edition, the Professional Development Edition, and the Database Development Edition. Each version supports Sun's JDK 1.1, JavaBeans and Java Foundation Classes.
- Borland released JBuilder Professional and JBuilder Standard. The JBuilder product family features JavaBean component creation, a scalable database architecture, and the ability to produce "100% Pure Java" platform-independent applications, applets and JavaBeans.
- Borland launched a new Internet Solutions Program for corporate intranet and Java applications.
- Netscape announced two new support options for developers creating solutions for the Netscape ONE open network environment. The first option, the Netscape SupportEdge technical support program, is aimed at in-house developers within Enterprise customers. The second option is a new membership level for ISV's within the Netscape DevEdge developer program which provides development and test copies of all Netscape products.
- Sybase introduced PowerBuilder 6.0, which includes the ability to package the PowerBuilder client run-time software as an ActiveX component, allowing it to be distributed across the Internet and intranets.
- IBM expanded its Java support with the release of the Enterprise Edition of its VisualAge for Java development tool.

SOFTIMAGE

INVESTMENTS & PRODUCT HIGHLIGHTS

- SOFTIMAGEIDS 1.0 (former Digital Studio) was launched in September at the IBC trade show in Amsterdam. DS is a complete non linear editing, compositing, audio, and paint system priced at \$100,000 including hardware. It is currently in final beta testing at 30 sites, with shipment scheduled for late Q98-2.
- Sony is in advanced negotiations to license SOFTIMAGEIDS for its upcoming video-editing platform based on an OEM version of Intergraph hardware.
- The port of DS 1.0 to the Silicon Graphics (SGI) platform has begun. Release date is anticipated to be Q98-4.
- SOFTIMAGE3D 3.7 SP1 shipped in October.
- Twister, Softimage's new rendering product based on the next generation of Mental Ray, is now expected to be released in Q98-4.
- Sumatra, the next generation of SOFTIMAGE3D, was demonstrated in August at Softimage's annual user meeting, held during Siggraph. The product was well received by both the industry and the press, and is scheduled to ship in Q99-2.

BUSINESS METRICS

	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
3D revenue per license	\$ 7,387	\$ 7,309	\$ 6,864	\$ 6,420	\$ 8,290	\$ 7,848
Revenue per employee	\$ 26,480	\$ 30,996	\$ 37,659	\$ 31,809	\$ 28,283	\$ 160,121
3D licenses as % of 3D Win NT licenses	38%	46%	37%	30%	46%	46%
3D maint. licenses % of total maint.	55%	48%	49%	45%	62%	56%

COMPETITION

- Kinetix, Autodesk's media tools subsidiary, released Max 2.0 with over 1,000 new features including support for OGL and NURBs modeling. Kinetix also announced a strategic partnership with Mental Images, the supplier of Softimage's Mental Ray rendering technology.
- Two companies are readying non linear editors which will compete with SOFTIMAGEIDS. Avid Technology's Jaguar, at an estimated target price of \$100,000, will ship in February 1998. Discreet Logic's Smoke, priced at \$330,000, has no announced release date.
- AliasWavefront (AIW) promoted Penny Wilson to President, after Brian Alum left the company to join Macromedia. A port of Maya, its next generation 3D software, to the Windows NT platform has been announced, with release expected in the first half of CY98. AIW is a wholly owned subsidiary of Silicon Graphics (SGI).
- SGI confirmed it will launch a low-end workstation line in the second half of 1998 based on Intel's processors and Windows NT.



INVESTMENTS & PRODUCT HIGHLIGHTS

- Windows CE 2.0 was released during the quarter. This embedded OS platform was developed from the ground up to empower the development of a new range of emerging computing appliances. OEMs can use this new version of the OS in a wide array of products, from embedded applications such as point of sale devices, to multimedia applications such as TV set-top boxes.
- Four new development tools for the Windows CE 2.0 platform were announced: The Windows CE Toolkit for the Visual Basic 5.0, the Windows CE Toolkit for the Visual C++ 5.0, the Windows CE Embedded Toolkit for Visual C++, and the Windows CE Toolkit for Visual J++ 1.1. Each toolkit is an add-in to the corresponding MS development system. Beta versions are

downloadable for free from the Internet, with final releases available in the retail channel early in 1998.

- Sharp Electronics Corporation announced plans to introduce a Handheld PC running Microsoft Windows CE before the end of the year. Sharp's support for Windows CE is significant due to its

COMPETITION

- Sun Microsystems acquired Diba, Inc. which will become a new Sun business unit, the Consumer Technologies Group, within Sun's Microelectronics division. This group will work with major consumer electronics companies to provide technologies for building internet-enabled TVs, set top and satellite boxes, and smart phones.
- Sun also entered into an agreement to acquire Chorus Systems S.A., a supplier of operating systems for telecommunications networks and intelligent devices. Upon the closing, Chorus will

leadership position in the handheld category with its Zaurus and Wizard products.

- Less than a year after introduction of Windows CE- based Handheld PC's, over 100 leading ISV's, IHV's, and shareware vendors are demonstrating support for Windows CE by developing more than 250 applications and peripherals.

join the JavaOS development and marketing team to create a new group called Embedded Systems Software group. This group will focus on open system software solutions for the embedded market.

- Sun delayed announcement of the EmbeddedJava platform, which was expected at September's Embedded Systems Conference West, in order to complete development. It hopes to unveil the technology by the end of the year.



WEBTV NETWORKS

INVESTMENTS & PRODUCT HIGHLIGHTS

- The WebTV Plus platform and network service were launched during a major press event in New York in September. Key new features include: the integration of the TV with the Internet, an electronic program guide, a tuner digitizer, and a hard disk drive.
- The next generation of WebTV boxes due out in CY98 will be based on the Windows CE platform.
- WebTV lowered the retail MSRP of the WebTV Classic platform from \$249 to \$199; plus offered a \$100 rebate that enables consumers to buy WebTV for less than \$100. The retail MSRP of the WebTV Plus platform was lowered from \$349 to \$299.
- The Fujitsu-WebTV joint venture is expected to close in Q98-2. The joint venture will introduce the WebTV platform and network service into Japan, with product available by the end of CY97.
- WebTV signed a letter of intent with MCI to provide a co-branded MCI WebTV network

service. Under the agreement, MCI will offer WebTV network service at \$14.95 per month to MCI long distance customers and pay WebTV a fixed monthly fee for each subscriber. MCI will assume all network access and first-tier customer care costs.

- WebTV now has seven platform and technology licensees. Agreements are final with Sony, Philips, Pace and Mitsubishi and letters of intent have been executed with Fujitsu, Hitachi and Compaq.
- WebTV has signed up more than 100 partners to provide content and services for the WebTV Network. The most significant are E!, Discovery, PBS, TV Guide, USA Today, Excite, Yahoo and Barnes & Noble.
- WebTV has booked its first orders for Internet advertising, including leading consumer advertisers such as General Motors, Honda and Charles Schwab.

BUSINESS METRICS

	Q97-2	Q97-3	Q97-4	Q98-1	FY98 Target
# of subscribers	28,445	55,589	86,552	136,648	537,000
Revenue per subscriber	\$ 16	\$ 20	\$ 19	\$ 19	\$ 22
Gross margin per subscriber	\$ (66)	\$ (32)	\$ (17)	\$ (8)	\$ 5

COMPETITION

- RCA introduced two models of Oracle's NC which will be available in Q98-2. The NC units currently retail for \$299 and \$349. Upcoming price reductions and rebates are expected to result in pricing of \$149 and \$199. RCA has achieved very limited distribution in major retailers, and is expected to announce a product recall due to an electrical problem.
- Navio (NCI) has teamed up with AOL to aggressively pursue major consumer electronics manufacturers such as Matsushita and cable MSOs. Note AOL is only a strategic advantage in the US market.
- Walt Mossberg, technology editor for the Wall Street Journal, wrote an article about WebTV and the RCA NC which was very favorable toward WebTV.
- Curtis Mathes introduced the Uniview 210 at an MSRP of \$399. The product is a very weak offering and has achieved almost no distribution.

INTERACTIVE MEDIA GROUP

Q98-1 P&L SUMMARY

	Learn & Enter		Inter-Svc Media		Desktop Finance		News & Publish		Inter-Media Grp		Hardware		MSN		TOTAL IMG	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
<i>(\$ in millions, except cost per head, variance to plan)</i>																
Net revenue	\$96.3	30%	\$11.7	(12)%	\$9.2	92%	\$0.1	18%	\$-	nm	\$150.3	50%	\$85.4	6%	\$352.9	29%
Cost of revenue	18.1	14%	5.8	146%	7.6	(7)%	1.1	nm	0%	nm	81.8	(27)%	18.7	16%	158.4	(6)%
% of net revenue	19.0%		49.7%		26.8%		nm		nm		54.4%		21.9%		44.9%	
Gross margin	77.9	47%	5.9	(37)%	1.6	171%	(1.3)	nm	(0.0)	nm	68.5	9%	66.7	60%	194.4	58%
% of net revenue	81%		50%		73%		nm		nm	46%		43%		55%		
Operating expenses																
People	7.2	31%	11.7	17%	4.3	11%	0.7	1%	4.8	18%	4.5	6%	11.1	5%	44.5	15%
Infrastructure	3.9	15%	5.7	8%	1.4	(12)%	0.3	(2)%	3.4	1%	2.0	2%	4.8	13%	21.6	8%
Contingent staff	6.6	(38)%	6.2	(12)%	1.2	(53)%	0.2	(12)%	2.5	(16)%	3.1	(9)%	6.2	(7)%	25.9	(18)%
Product development	12.0	11%	3.4	50%	2.0	5%	0.3	(1)%	(2.0)	(2)%	2.4	61%	18.8	16%	36.9	25%
Other	2.7	(24)%	0.2	(71)%	(0.0)	101%	24.4	12%	0.1	52%	0.0	na	0.4	(35)%	27.8	6%
Product marketing	5.5	6%	4.0	38%	1.8	(9)%	0.1	66%	0.1	45%	1.2	32%	4.6	36%	23.6	27%
Direct controllable oper expenses	37.2	5%	21.0	21%	12.8	(25)%	26.0	11%	8.0	9%	13.7	25%	51.0	16%	180.7	14%
PG customer unit	4.1	26%	0.1	na	0.3	(9)%	0.0	nm	0.0	nm	3.0	6%	0.0	nm	7.5	14%
PG non-customer unit	2.1	7%	0.0	na	0.0	0%	0.0	nm	0.0	nm	0.8	57%	0.0	35%	3.0	32%
Channel and iM marketing	0.0	na	0.0	na	0.0	nm	0.0	nm	0.0	nm	0.0	nm	5.0	42%	5.0	42%
Taxes, insurance, & settlements	0.4	(12)%	0.1	(28)%	0.1	(23)%	0.0	nm	0.0	(96)%	1.1	(25)%	0.8	49%	2.4	17%
Product support services	2.2	27%	0.3	20%	0.4	32%	0.0	nm	0.0	nm	1.0	12%	24.1	15%	28.1	16%
Bad debt expense	0.6	(6)%	0.0	(9)%	0.1	(33)%	0.0	nm	0.0	nm	0.6	7%	6.0	(28)%	7.3	(22)%
R&D shared resources	5.4	12%	1.0	(17)%	0.0	0%	0.8	9%	(8.0)	(2)%	0.8	(7)%	0.1	164%	1.0	28%
Product-related oper expenses	14.8	15%	2.6	(12)%	1.7	12%	0.8	9%	(8.0)	(2)%	7.3	14%	36.2	17%	54.2	17%
Total operating expenses	52.7	8%	34.3	19%	12.6	(9)%	26.8	11%	0.0	90%	21.1	22%	87.2	16%	234.7	15%
Responsibility margin	25.2	(67)%	(23.5)	(14)%	(5.8)	(42)%	(28.1)	(7)%	(0.0)	(98)%	47.4	42%	(51.5)	(39)%	(60.3)	(74)%
% of net revenue	26%		(244)%		(65)%		nm		nm		32%		(59)%		(17)%	
Corporate allocations	10.6	18%	8.4	16%	2.3	17%	0.2	17%	0.1	53%	7.2	17%	3.1	38%	20.2	5%
Contribution margin	\$14.6	185%	\$133.0	14%	\$18.1	37%	\$138.4	7%	\$11.1	92%	\$47.3	nm	\$53.8	39%	\$509.3	63%
% of net revenue	15%		(291)%		(18)%		nm		nm		27%		(63)%		(20)%	
Headcount	296	18%	434	13%	165	5%	51	(114)%	220	9%	144	0%	461	9%	1,765	6%
People costs per head	\$121,599	17%	\$134,047	6%	\$125,996	7%	\$161,185	(39)%	\$142,668	4%	\$156,969	5%	\$96,750	(24)%	\$145,619	3%
Contingent cost per head	\$96,369	(14)%	\$11,979	6%	\$119,579	(9)%	\$78,390	7%	\$45,129	(4)%	\$122,100	-	\$135,641	-	\$72,927	(13)%
Infrastructure costs per head	\$9,486	22%	\$13,624	16%	\$9,797	(22)%	\$11,467	38%	\$12,876	(15)%	\$15,605	2%	\$10,453	(24)%	\$12,982	7%

BUSINESS RESULTS

- IMG net revenue of \$353 million was \$80 million, 29% over plan in Q98-1. Hardware was the biggest contributor to the positive variance, contributing nearly \$50 million on the strength of Mouse and Gaming Devices. Learning and Entertainment Division (LED) added \$24 million to the variance with the release of Encarta 98, Flight Sim 98 and strong back to school sales. Catch-up of MSN billings contributed \$5 million to the positive variance. Q98-1 responsibility margin was a loss of \$40 million, a \$112 million smaller loss than planned. Higher sales across several divisions accompanied with lower than planned direct controllable operating expenses drove the strong quarter.
- LED net revenue for the quarter was \$96 million, 30% above plan and 119% above the same period a year ago. The increase over prior year was due, in part, to an earlier start on the holiday sell-in than last year. Operating expenses were 8% favorable to plan due to lower headcount-related costs, product development, and marketing spending offset by higher contingent staff expenses. A portion of Q98-1 contingent staff costs will shift to regular employee expense as contingent staff positions are converted to regular

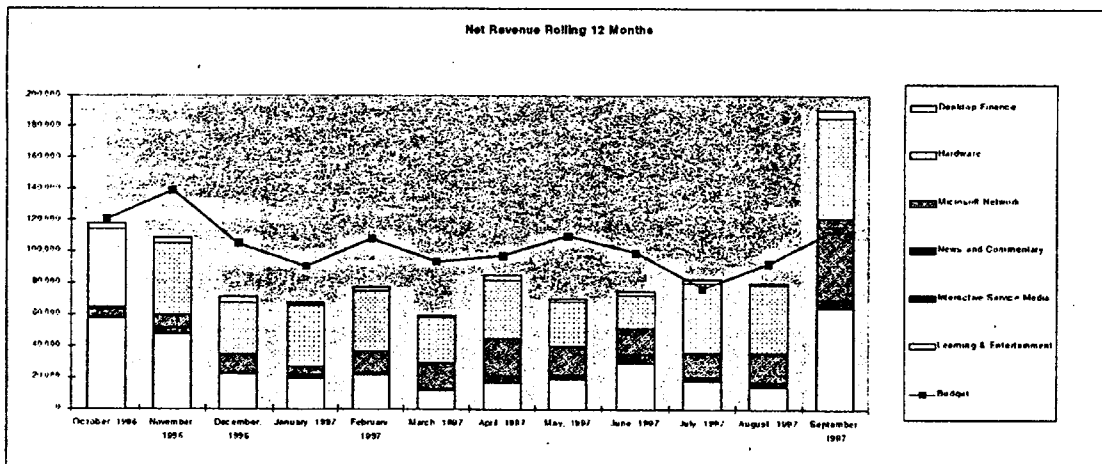
employees. LED responsibility margin for the quarter of \$25 million compares to a plan loss of \$4 million. Each of the business units, Reference, Entertainment and Kids was profitable for the quarter.

- The Q98-1 Interactive Service Media Division responsibility margin loss was \$5 million lower than the planned loss of \$33 million, mostly due to lower operating spending. Specifically, Sidewalk's loss of \$21 million was 79% of the planned loss for the quarter due to slow ramp up of city teams. For Q98-1, FG & OEM revenue was \$3 million over plan primarily due to the Auto Route Express (Europe & Great Britain) and unplanned Cinemania products. Online revenue fell short of plan by \$3.5 million (49%) due to product delays on American Express Leisure and CarPoint.
- Net revenue for Desktop Finance in Q98-1 was \$9 million, 92% above plan and 260% over Q97-1 as a result of strong FG and OEM sales for Money 98, which was released within the quarter. Operating expenses were on plan in Q98-1, despite higher than planned marketing expense due to the Money 98 launch.

- News and Publishing Division responsibility margin loss for the quarter was \$28 million, 7% under plan, resulting from higher cable advertising revenue from improved ratings coupled with lower cable programming expenses (\$2 million below plan).
- Hardware reported strong revenue of \$150 million for Q98-1, double the same quarter a year ago and 50% over plan. Operating expenses were 22% under plan due to slow expansion of product development and marketing expenses, which should eventually reach planned levels. The resulting responsibility margin for the quarter was \$47 million, 32% of net revenue and a 160% increase from prior year.
- MSN positive net revenue variance of \$5 million was primarily due to FY97 billing backlog catch up offset by lower than planned subscriber counts. The worldwide subscriber base is under plan by 21%, due to the magnitude of locked accounts. The decrease in cost of revenue was from renegotiated intellectual property rates (\$6 million) and lower-subscriber based usage. Operating expenses were \$17 million under plan as a result of delayed marketing spend (\$9 million under plan) from the slipped Metro release. Also, PSS costs were below planned levels (\$4 million) due to lower subscriber counts, fewer incidents, and a favorable new vendor contract in Europe. The MSN Division exceeded plan in Q98-1 by 39% (\$32 million) at the responsibility margin level.

OUTLOOK

- IMG expects continued strong momentum in Hardware and is cautiously optimistic about Consumer Software. The latter group is well positioned for the holiday season, with earlier market sell-in than last year and new releases that have garnered a number of impressive reviews. However, a significant channel reserve has been established and sell-through patterns will be watched.
- In the online businesses, revenue momentum in MSN is under pressure as the number of new trials is less than the losses in subscribers due to cancellations and locked accounts (subscribers that are restricted from the network due to non-payment). Revenue in MSN will not meet plan in Q98-2, but expenses will be down due to lower network usage and lower spending for international activities.
- The growth in Expedia is expected to continue as registered users and transaction levels per registrant increase. Other IMG online businesses are basing their growth on overall increases in Internet use by consumers and continued growth in distribution through new alliances, advertising and better leverage of the MSN portal. Ad revenue, which has recently lagged the growth in page views, is building their customer base through sponsorship sales, but may be at risk of achieving FY98 growth targets.





LEARNING & ENTERTAINMENT

INVESTMENTS & PRODUCT HIGHLIGHTS

- Both standard and deluxe versions of Encarta 98 were released this quarter. The strategy is to position the competition against the standard version and to differentiate with the deluxe version.
- Encarta Reference Suite 98 was recently announced and includes Encarta Deluxe, Virtual Globe and Bookshelf. This suite contains more than 20 million words of text in more than 50 thousand articles is expected to match the best-of-breed products.
- My Personal Tutor, a new offering in the children's skills market, provides instruction in math, reading, alphabet and preschool skills that adapts to the child's strengths and weaknesses. The skills market is the principal strategy of the Kids business unit in FY98.
- The Entertainment business unit's releases include two new versions of hit products and two new titles. Flight Simulator 98 has been updated and expanded to include new aircraft options, more detailed scenery and more accurate flight models in order to maintain the forefront of civil aviation simulation. Close Combat: A Bridge Too Far, the sequel to last year's award winning Close Combat, allows the gamer to fight the battles of WWII Operation Market Garden. Age of Empires and CART Precision Racing are new entrants into the strategy and auto racing segments.

BUSINESS METRICS

	Average FG selling price		
	Q98-1	Q97-1	Growth %
Reference	\$ 53.79	\$ 41.77	29%
% Int'l	69%	22%	
Entertainment	\$ 35.23	\$ 31.94	10%
% Int'l	52%	36%	
Kids	\$ 24.97	\$ 22.97	9%
% Int'l	27%	54%	
	Cost per head		
	Actual	Plan	Var %
Regular	\$ 121,599	\$ 147,041	17%
Contingent	\$ 96,368	\$ 84,799	(14%)

- Average selling prices have increased from prior year levels due to new product introductions, which in the competitive software market is key to warding off the natural tendency for falling prices.
- The international percentage mix of Reference declined from a year ago due to high sales of newly released localized versions of Encarta last year. Kids business unit international sales mix fell as a result of recent domestic focus of My Personal Tutor.
- Reference sales growth was fueled by strong back to school sales and growth in international sales.
- Cost per head for regular employees was better than plan primarily due to lower recruiting costs as hiring levels fall behind plan, with an offset in contingent staff cost per head due to the mix of higher-level contingent staff personnel.

COMPETITION

- The field for CD-ROM encyclopedias continues to become more crowded with new products from Compton, Grolier, Britannica, and Funk & Wagnall (which is the core content of Encarta) in addition to IBM/World Book. In a recent review in the San Jose Mercury News, the products were judged to be essentially the same. The review also noted that Britannica and Collier's CD-ROM encyclopedias were adult focused and Encarta and World Book's were youth focus.
- A three-way battle for game console hardware among Sony, Nintendo and Sega will generate significant advertising spending this holiday season. The ads promote both the proprietary

platforms relative to PC and non-MS titles published for game systems and the PC platforms. Price pressure remains with Virgin Interactive's announcement of its "White Label" line, which will feature older titles at \$10 to \$15 retail price points.

- The Kid's skills market is increasingly focused on branding. Disney's "Ready for Math with Pooh", The Learning Company's "Reader Rabbit" and GTI/Humongous' "Freddie Fish" are examples of the established titles and characters against which My Personal Tutor's "Professor Presto" will compete.

INTERACTIVE SERVICE MEDIA**INVESTMENTS & PRODUCT HIGHLIGHTS**

- Local Sidewalk sites for Boston and Twin Cities were launched on July 1 and July 8, respectively, bringing the total number of city sites to four. Seattle and New York had launched in Q97-4. Over 700 thousand users have come to these sites since launch in April, an increase of 70% over Q97-4. The Sidewalk 2.0 platform was successfully deployed in all 4 live cities on September 18. New version enhancements include a cleaner user interface, simplified navigation making it easier to browse and search and "My Page" which lets the user set up personal links to favorite local entities.
- San Francisco, Denver, and Houston launched in early October to be followed by San Diego and Washington D.C. in November.
- Total committed advertising revenue has reached \$6 million in signed one-year contracts with 4,884 merchants participating across the 9 initial US markets.
- Expedia registrants were just over 1 million at the end of Q98-1, a 42% growth over Q97-4. The combined products, Expedia, Northwest, and Continental claimed 1.5 million registrants. In June, American Express and the MS Travel

Business unit publicly announced their corporate travel reservation system, American Express Interactive (AXI). AXI will allow business travelers to make reservations from their computer, a cost savings for companies. AXI is in beta testing in nine companies, including Monsanto, Chrysler and Johnson & Johnson.

- In July, Geography released new versions of their mapping products – Expedia Streets 98, Expedia Streets 98 Deluxe, Expedia Trip Planner 98, Auto Route Express Europe, and Auto Route Express Great Britain. Sales to date have exceeded expectations, \$8 million versus a plan of \$6 million.
- CarPoint's New Car Buying Service (NCBS) continues to grow, with 762 franchises receiving over 500 referrals per day. In September, the Used Car Classifieds service was announced. There are currently 810 dealers under pilot contracts for this service, which adds another dimension to car buying on the Internet. Unique users hit an all-time high in September averaging 23 thousand per day.

BUSINESS METRICS

	Jul-97	Aug-97	Sep-97
Geography			
Revenue per license	\$ 3.64	\$ 11.27	\$ 11.41
Sidewalk			
# of local merchants	1,262	1,364	1,747
Annualized \$ per local merchant	\$ 1,375	\$ 1,927	\$ 1,224
Avg daily guides	9,575	9,591	9,626
Expedia			
# of air tickets sold	23,948	25,803	23,859
Air revenue per air ticket	\$ 20	\$ 20	\$ 20
Retail value of air, car, hotel sales (million)	\$ 8.38	\$ 8.48	\$ 7.82
Cumulative registrants (thousand)	876	980	1,081
CarPoint			
# of referrals	14,079	17,197	15,508
# of new/used dealers active	351	432	1,248
\$ per dealer	-	-	\$ 35
Cost per head			
	Actual	Plan	Var %
Regular	\$ 134,047	\$ 142,307	6%
Contingent	\$ 81,979	\$ 87,535	6%

- Cost per head was lower than planned primarily because low recruiting spending and hiring levels. Contingent staff cost per head was down primarily because of the lower hourly rates.
- Geography revenue per license was low in July because new product versions releases and returns of older versions.
- The Sidewalk merchant base continues to grow due to more cities online as well as continued selling in existing cities.
- The decline from August of dollar per local merchant occurred because higher priced ads are

staged first, then as the rest of the sold inventory comes online the price normalizes. Metrics for July and August reflect 4 weeks of sales versus 5 weeks in September. Normalized for the fiscal month, air tickets sold grew 16% over August.

- The number of CarPoint referrals grew 13% over August, normalized. Dealers increased due to the addition of 810 pilot used car dealers announced in September. Dollar per dealer amounts are low as most of the dealers listed are under pilot contracts which are considerably lower than marketing pricing.

COMPETITION

- Significant competitive threats to Sidewalk are beginning to shift from local arts and entertainment guides like CitySearch and DiveIn toward more compelling offerings from consolidations and partnerships between players. Yahoo announced the acquisition of Four11 Corporation, a privately held online communications and directory company. Zip2 Corporation, whose focus is to provide newspapers a customizable platform of online products including business directories, arts and entertainment guides, community information, auto and home finder guides, point-to-point

directions, and mapping, recently received funding from Softbank Ventures and Knight-Ridder.

- Competition in the online travel market remains intense. Other travel sites include Travelocity (SABRE), Preview Travel (20% owned by AOL), TravelWeb, and Internet Travel Network (ITN). During Q98-1, Preview Travel was named the primary travel provider on AOL.com. Preview Travel also filed for an IPO of 2.5 million shares. SABRE released international versions of Travelocity, allowing users to book reservations outside the U.S.

- The Expedia mapping products won more reviews with the 98 release than with previous versions. Although, Rand McNally continues to dominate in retail through superior marketing efforts. There has been little immediate impact by the October sale of Rand McNally to a private investment group. Additionally, both Rand McNally and Delorme released new versions of their products within the quarter.
- The competitive landscape in the Online Automotive arena is shifting slightly from the previous quarter. While Auto-By-Tel (ABT) is still a significant threat, with 2000 dealers in its network handling 60,000 quote referrals per month, new threats are emerging. Autoweb Interactive, a privately held company, has recently come on to the scene with 1,000 dealers in its network. Perhaps more worrisome than ABT and Autoweb are Automotive channels on search



DESKTOP FINANCE

INVESTMENTS & PRODUCT HIGHLIGHTS

- On September 15, Microsoft announced Microsoft Money 98 Financial Suite, which integrates many households' financial activities into one software product. Money 98 Financial Suite provides consumers with an ability to accomplish financial tasks for day-to-day money management to long-term investment and financial planning.
- MS announced the MS Internet Finance Server (MIFS) toolkit, formerly code-named "Marble", to 70 domestic and international solution providers and financial institutions. These organizations will integrate the MIFS toolkit with their existing

engines. Search engines such as Yahoo! or Excite are partnering with information providers (e.g. Kelley Blue Book, Automotive Information Systems, etc.) to offer similar services for shop and compare. Once ready to purchase the consumer is pointed to sites like CarPoint or ABT to place a referral. Relationships with these search engines are quickly becoming critical to the success of an automotive service. The user base for this kind of service continues to expand. Two percent of car purchases were made through Web referrals last year and 20% of new car buyers did online research. Chrysler Corp. has publicly stated that it gets 1.5% of its sales through the Web now, and expects to get more than 25% within four years.

legacy systems and enable their customers to execute transactions over the Web using Open Financial Exchange (OFX)-based clients.

- Just three months after extending MS Investor to include premium subscription-based content and services, the site has registered more than 21,000 paying subscribers. With nearly 100,000 users visiting its no-charge services each day as well, Investor continues to lead the growing trend in online investing. Microsoft also announced that Investor has been selected as a premier Showcase Portal in the Money channel on Snap! Online.

BUSINESS METRICS

Investor	Jul-97	Aug-97	Sep-97
Revenue (millions)	\$ 2.80	\$ 1.15	\$ 4.38
FG revenue per license	\$ 14.71	\$ 11.95	\$ 31.51
Financial Suite mix	-	-	61%
Money			
Revenue (millions)	\$ 0.27	\$ 0.29	\$ 0.66
Subscribers (thousands)	16	20	21
Revenue per subscriber	\$ 8.21	\$ 8.21	\$ 8.22
Avg daily unique users (thousands)	87	94	95
Churn rate	-	0.03	0.10
	Cost per head		
	Actual	Plan	Var %
Regular	\$ 125.099	\$ 134.634	7%
Contingent	\$ 119.579	\$ 113.410	(5%)

- Money 98's successful US launch was reflected in Money's revenue rise in September. The jump in revenue per license to \$32 was the result of the addition of the Financial Suite product to the Money 98 product line. MS realizes revenue of approximately \$38 per license of Financial Suite versus \$19 for the standard version. The 61%

Financial Suite mix is exceeding the planned mix of 50%.

- Investor revenue is growing as subscribers are added. The revenue jump in September was due to quarterly billing of brokerage royalty contracts, which are featured on Investor.

COMPETITION

- Intuit announced Quicken Deluxe 98 on September 15. Quicken Deluxe 98 features Internet integration that provides financial news and information from the World Wide Web. Embedded browser technology in Quicken 98 also enables users to directly retrieve their checking, credit card and investment account data.
- On August 13, CheckFree Corporation announced that total revenue increased 130 percent to \$176 million for the fiscal year ended June 30, 1997 versus \$77 million for the same period last year. CheckFree signed agreements with an additional 29 financial institutions during the quarter and the Company now has 276 financial institutions under

contract to provide banking and bill payment processing services.

- On October 29, Integrion Financial Network and CheckFree Corporation announced a 10-year processing partnership to provide financial institutions with an electronic billing and payment processing service employing Integrion's Gold Message Standard for Electronic Commerce, its Interactive Financial Services platform and CheckFree's processing infrastructure. The two companies will also work with IBM, Integrion's primary technology partner, to fully integrate Integrion's IFS banking platform with electronic billing and payment.

NEWS AND PUBLISHING



INVESTMENTS & PRODUCT HIGHLIGHTS

- MSNBC.com launched a web site redesign in September. The new site received favorable reviews and has contributed to increased traffic to the site. The new user interface translates well to television leading to better cross promotion with MSNBC cable.
- Slate announced a distribution deal with America On Line (AOL) to become an anchor tenant on AOL's Newstand.
- The cable channel made a number of programming changes with an increase in emphasis on timely news. The Site, Edgewise and Remember were

cancelled while The Big Show and Weekend Magazine were added to the lineup. The programming changes should contribute to a reduction in programming expenses.

- Cable channel began official Nielsen metering in July. Ratings for Princess Diana coverage were very high with a peak audience of over 1 million homes (3.0 rating) during funeral coverage. The event seems to have had a permanent effect on viewer habits as channel ratings doubled from .1 prior to the event to .2 well after coverage ended.

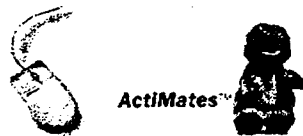
BUSINESS METRICS

Online (MSNBC & Slate)	Jul-97	Aug-97	Sep-97
Advertising Revenue (k)	\$ 359	\$ 415	\$ 298
Page Views (m)	69	112	116
Ad Impressions Sold (m)	8	6	8
Avg Daily Unique Users (k)	139	159	169
MSNBC Cable	Q97-3	Q97-4	Q98-1
Advertising Revenue (m)	\$ 2.40	\$ 4.20	\$ 4.40
Subscriber Revenue (m)	\$ 6.90	\$ 7.70	\$ 8.80
# of Subscribers (m)	28	31	34
Avg Monthly 24 Hr. Ratings	0.12	0.09	0.20
Avg CPM	\$ 2.44	\$ 3.26	\$ 2.30
	Cost per head		
	Actual	Plan	Var %
Regular	\$ 161,185	\$ 156,831	(3%)
Contingent	\$ 78,380	\$ 84,715	7%

- Cable JV year-over-year Q1 total revenue increased from \$6 million to \$13 million, up 106%.
- Online (MSNBC & Slate) Q1 revenue of \$1.1 million was 5% below plan, although a new high for News and Publishing.

COMPETITION

- MSNBC.com reach surveys by PC Meter, a measure of audience at home, matched or exceeded the competition in August. In the most recent measured month, MSNBC measured 3.7, versus the following from competition: USA Today 3.7, CNN 3.6, ABC News 2.2.
- PC meter is beginning to measure business use. Early studies indicate MSNBC.com lags in business use in relation to our competitors.
- Princess Diana coverage resulted in a ratings increase that was significantly higher than CNN and Fox News. MSNBC beat or matched CNN ratings in Chicago and Washington DC during Diana's coverage.
- MSNBC's September 24 hr. competitive rating was .4 with a 134 thousand household (HH) average, versus CNN's .6 rating with 465 thousand (HH), and Fox News's .1 rating with 29 thousand (HH).



HARDWARE

INVESTMENTS & PRODUCT HIGHLIGHTS

- The hardware division had a strong quarter, foreshadowing what is expected to be a good year. Net revenue doubled year over year to \$150 million. The mouse business, which still represents approximately two-thirds of hardware revenue, was up 56% over the prior year. While the mouse is sold primarily through the OEM channel, retail mouse sales are strong, especially in Europe, where sales are up over 200% of plan.
- The other main contributors to the year over year growth are the new force feedback joysticks, which resulted from the Exos acquisition, and Actimates, which resulted from the Dare to Dream acquisition, and the mouse Trackball.
- Keyboard sales have rebounded from an erosion in market share last year following the 25% price cut effective in July. As a result, the unit growth doubled from a year ago and revenue is up 17 %.

BUSINESS METRICS

	Average FG selling price		
	Q97-1	Q98-1	Growth %
Mouse	\$ 21.42	\$ 31.18	46%
%OEM	53%	47%	
Keyboards	\$ 64.37	\$ 48.50	(25%)
%OEM	42%	35%	
Gaming devices	\$ 48.21	\$ 45.40	(6%)
% Int'l	37%	43%	
	Cost per head		
	Actual	Plan	Var %
Regular	\$ 156,900	\$ 165,543	5%
Contingent	\$ 122,100	\$ 121,831	-

- The average selling price for mouse in the FG channel is up from \$21 in Q97-1 to \$31 in Q98-1 on the strength of Intellimouse which was released at holiday time last year. The average selling price on other mouse products are generally down.
- Keyboards average selling prices are down year to year as a result of the 25% price decrease effective in July. The keyboard market is essentially a

commodity market, but profitable because of relatively low investments in product development and marketing.

- The average selling prices of gaming devices are down from a year earlier reflecting the competitive effect of an increased number of quality low-end joysticks and game pads.

COMPETITION

- Logitech has introduced wheeled products in both the OEM and retail markets to compete with Intellimouse. In retail, they have offered a suite of products at various price points with both the low cost and expensive units having wheels. Logitech's low cost unit is already a popular choice for cost-conscious customers. There is additional pricing pressure at the low end of the category with a \$10 unit from Mouse Systems.
- Key Tronic Corp. recently announced its partnership with Northern Telecom to manufacture small-footprint wireless keyboards optimized for Northern Telecom's new line of advanced screen phones and other telephony applications. Key Tronic is also a leader in keyboards that incorporate the Universal Serial Bus (USB)

technology, as well as the latest trackball, touchpad and infrared wireless technology.

- The choice of quality game controllers is increasing rapidly with products that demonstrate more functionality and realism than ever before especially in the \$100 and up price range. CH Products and ThrustMaster are two main players in this market. CH Products has a competitive force-feedback controller, the Force F/X as well as a flight yoke product for PC-based flight simulators. ThrustMaster recently announced the release of the NASCAR Pro, a racing wheel licensed by the legendary stock car sanctioning body. MS will need compelling products, packaging and message to effectively compete.

MSN

MICROSOFT NETWORK The Microsoft Network

INVESTMENTS & PRODUCT HIGHLIGHTS

- Significant focus is directed towards the Portal in an effort to maximize the reach of MS properties. The Portal beta product was released at the end of October. It provides personalized start view, search and information retrieval, member control,

dynamic topical navigation, cross network navigation, and structured member interaction. Plans are to combine the Portal (Microsoft Start) and Home.microsoft.com (HMC) by Q98-4,

whereas the HMC hits will be redirected to Microsoft Start creating a central point of entry.

- Metro MSN 2.5, launched on October 13, is equipped with easier and faster installation. MSN 2.5 is based on Internet Explorer 4.0, and provides a new Outlook Express email client and Internet Standard (POP3 and SMTP) email. New features include new email and friends online notification, instant password reset, MSN Member Directories, automatic access number updates, and a Quick View navigation tool located on the Windows 95 taskbar.
- MSN plans to distribute more than 10 million copies of MSN 2.5, starting with immediate

shipments to current members of MSN who have pre-ordered the CD, and concluding in November 1997 with an automatic upgrade mailing to remaining members.

- During Q98-1 MSN was able to catch up on all subscription charge billings, from six week lag at the end of Q97-4. This catch-up in billings had an estimated impact on net revenue for the quarter of \$26 million. Remaining, however, is a significant backlog of additional hour charges. Efforts to implement a filter that would increase throughput by separating out access events for the flat rate plan subscribers have been unsuccessful. It is projected that the backlog of hour charges will be largely reduced in Q98-2, but not eliminated.

BUSINESS METRICS

	Jul-97	Aug-97	Sen-97
Average # of subscribers (millions)			
US	1.4	1.4	1.4
Japan	0.3	0.3	0.3
Other	0.3	0.3	0.3
Total	2.0	2.0	2.0
Average revenue per subscriber			
US	\$ 10.33	\$ 9.99	\$ 29.05
Japan	\$ 3.35	\$ 9.74	\$ 24.47
Other	\$ 4.47	\$ 11.66	\$ 35.28
Total	\$ 8.39	\$ 9.54	\$ 27.05
Churn rate	5.7%	3.6%	4.3%
PSS calls per subscriber	0.38	0.32	0.32
Unique daily visitors (thousands)			
MSN.com (U.S.)	175.3	172.3	182.2
MSN Premier	146.3	135.9	133.4
Cost per head			
	Actual	Plan	Var %
Regular	\$ 135.641	\$ 136.299	0%
Contingent	\$ 104.653	\$ 102.456	(2%)

- MSN subscribers averaged 2.0 million versus a budget of 2.4 million for Q98-1, 17% below plan due a higher number of locked accounts coupled with fewer new trials (sign-ups) in all locations. Average subscribers in the U.S. for the quarter was 12% below plan, and internationally 26% below plan. The forecasted worldwide subscriber base is expected to grow at an average of 5% per month.
- Average revenue per subscriber exceeded plan for the month of September and the quarter due to the billing catch up. Of the total revenue per subscriber for the month of September, approximately \$17 per subscriber related to the prior period backlog.
- Churn rate for the quarter was on plan at 4%. Minor fluctuations in July and August were due to changes in the cancellation process.
- Support calls per subscriber for the quarter were on plan at .34. Higher July rates were isolated to customer support calls in the US regarding billing and cancellations. This correlated to higher churn figures in the month of July. Calls per subscribers were reduced later in the quarter by the implementation of toll calls for technical support in the U.S.
- Usage on MSN Premier has declined due to the growing number of restricted accounts for non-payment.

COMPETITION

- Distribution agreements, both with ISPs and PC manufacturers, and acquisitions to obtain advertising revenue characterized the competitive environment in the quarter
- AOL acquired CompuServe subscriber's (2.3 million) in a deal with Worldcom. AOL signed an agreement with MS making AOL Preview Channel a pre-configured premier active channel on IE 4.0. AOL and Netscape signed agreements for distribution of AOL content through Netscape Netcaster, a component of Netscape Communicator that enables "push" delivery; and separately to launch a co-branded real-time instant messaging service.
- Netscape launched Netscape Netcenter, a web-based free on-line service.
- C/Net also entered the online services arena with, Snap! Online, primarily an Internet directory service with some original content. C/Net also signed marketing agreements with AT&T, MCI, and Sprint.
- Yahoo acquired Four11, an online communications and directory company that provides free email to its 700 thousand customers for \$100 million in stock. Separately, Yahoo entered into distribution agreements with Compaq and Gateway 2000 that provide prominent desktop placement of Yahoo.

MS RESEARCH**Q98-1 P&L Summary**

(in millions, variance to plan)	Actual	Plan	Var %
Net revenue	\$5.0	\$0.0	-
Controllable expenses			
People	8.7	9.0	4.3%
Contingent staff	0.3	0.8	61.8%
Infrastructure	2.5	2.8	11.2%
Other misc expenses	1.1	3.5	68.6%
	12.5	16.1	22.1%
Marketing	0.3	0.2	(9.4%)
Total controllable expenses	12.8	16.3	21.7%
Responsibility margin	(7.8)	(16.3)	(52.3%)
Corporate allocations	2.4	2.8	14.1%
Contribution margin	(\$10.2)	(\$19.1)	(46.8%)
Headcount	247	254	2.8%
People costs per head	\$140,097	\$142,299	1.5%
Infrastructure costs per head	\$40,097	\$43,906	8.7%

FINANCIAL HIGHLIGHTS

- In August, Research recorded revenue for the first license of the Whisper speech-recognition engine. Research division expense in Q98-1 totaled \$13 million, short of plan by 22% but 57% greater than the prior year.
- The shortfall in spending was primarily a result of lower than expected external research funding and other product development expense.
- Research division expense is expected to increase by 25% to \$17 million during Q98-2 due to the continuing ramp up of headcount and external research funding and evangelism.

INVESTMENTS & PRODUCT HIGHLIGHTS

- Research division employees reached 250 by quarter-end. Hiring has been brisk, with several internal transfers from other groups joining the division this quarter. A key external hire during the quarter was Anoop Gupta, joining MS as a Senior Researcher after 11 years with the Stanford University faculty.
- On September 11, MS and Lernout & Hauspie Speech Products announced a broad strategic alliance designed to accelerate development of the next generation of voice-enabled computing on the Windows platform. MS invested \$45 million in Lernout & Hauspie (L&H) common stock,

representing a minority stake in the speech technology company. While no announcement was made regarding specific future products, MS and L&H have agreed to share technologies and expect to cooperate on future speech technology initiatives. In conjunction with this announcement and reaffirming its commitment to speech technology development, MS also announced it plans to invest \$3 million (U.S.) in the Flanders Language Valley Fund CVA (FLV), a Belgium-based international technology center dedicated to helping companies develop speech-based technologies and applications.

KEY PRODUCTS RELEASE SCHEDULE

Business Unit/Product	Release to market			Release to market	
	Act/Fest	Plan		Act/Fest	Plan
Desktop Finance			Desktop Applications/Web Authoring		
Money 98	Aug-97	Aug-97	Picture It! 2.0	Aug-97	Aug-97
Interactive Media			Greetings Workshop 2.0	Sep-97	Sep-97
Expedia Streets Deluxe 6.0	Jul-97	Jul-97	Project 98	Sep-97	Sep-97
Expedia Streets Plus 6.0	Jul-97	Jul-97	Home Essentials 98	Sep-97	Sep-97
Expedia Trip Planner 6.0	Jul-97	Jul-97	FrontPage 98	Oct-97	Aug-97
Encarta 98	Aug-97	Aug-97	Publisher 98	Jan-98	Dec-97
Age of Empires 1.0	Sep-97	Aug-97	Small Business Edition 98	Jan-98	Dec-97
Baseball 1.0	Feb-98	Aug-97	Mac Office 98	Jan-98	Dec-97
CART Precision Racing 1.0	Oct-97	Aug-97	Outlook 98	Jan-98	Jan-98
Close Combat 2.0	Sep-97	Aug-97	Home Essentials/Springfield	Jun-98	Jul-98
DWJ Goosebumps: Attack of the Mutant	Aug-97	Aug-97	Office 9	Jul-98	Jul-98
Encarta World Atlas 98	Aug-97	Aug-97	FrontPage 99	Oct-98	May-98
Flight Simulator 6.1	Aug-97	Aug-97	Personal & Business Systems		
Personal Tutor 1.0	Aug-97	Aug-97	Windows 98	Jun-98	Dec-97
Golf 4.0	Feb-98	Aug-97	Windows NT 5.0 Beta	Sep-97	Sep-97
DWJ Jurassic Park: Chaos Island	Sep-97	Sep-97	Windows NT 5.0	Sep-98	Feb-98
DWJ Dilbert	Sep-97	Sep-97	SQL 6.5, Enterprise Edition	Nov-97	Aug-97
NBA Full Court Press 2.0	Sep-97	Sep-97	MS Exchange "Osmium" Server	Nov-97	Sep-97
Encarta Deluxe 98	Oct-97	Sep-97	NT Server Enterprise (Granite)	Oct-97	Jun-97
DWJ Jurassic Park: Trespasser	Feb-98	Nov-97	Small Business Server	Oct-97	Aug-97
Outwars	Feb-98	Feb-98	IIS 4.0	Nov-97	Aug-97
Riot	Feb-98	Feb-98	Proxy 2.0	Oct-97	Aug-97
Monster Truck Madness	Apr-98	Apr-98	Site Server 2.0	Jul-97	May-97
Reach for the Stars	Dec-98	Dec-98	Site Server 3.0	Mar-98	Nov-97
Hardware			SNA 4.0	Nov-97	Nov-97
Actimates Barney 1.0	Jul-97	Jul-97	Softimage		
Intellimouse Trackball 1.0	Aug-97	Aug-97	Softimage/DS NT 1.0	Dec-97	Dec-96
Sidewinder Force Feedback Pro	Aug-97	Aug-97	Softimage/DS IRIX 1.0	Apr-98	Apr-98
Sidewinder Precision Pro	Aug-97	Aug-97	Twister	Apr-98	Sep-97
Sidewinder Game Pad: Tilt	Dec-97	Dec-97	Sumatra	Nov-98	Apr-98
Natural Keyboard Elite	Jan-98	Jan-98	Developer Tools		
EasyMouse	Feb-98	Feb-98	Visual Studio 98	Apr-98	Jun-98
Intellimouse Pro	Mar-98	Mar-98	Visual Basic 98	Apr-98	Jun-98
Force Feedback Steering Wheel	Aug-98	Aug-98	Visual C++ 98	Apr-98	Jun-98
Consumer Platforms			Visual J++ 98	Apr-98	Jun-98
Handheld PC 2.0	Sep-97	Sep-97	Visual InterDev 98	Apr-98	Jun-98
Windows CE OAK 2.0	Sep-97	Sep-97	Visual Foxpro 98	Apr-98	Jun-98
Wallet PC 1.0	Nov-97	Oct-97	Internet Platforms		
Windows CE Toolkit for Visual C++ 5.0	Jan-98	Nov-97	Internet Explorer 4.0 for Windows 95	Sep-97	Aug-97
Windows CE Toolkit for Visual Basic 5.0	Jan-98	Nov-97	Internet Explorer 4.0 for Windows 3.1	Nov-97	Nov-97
Windows CE Toolkit for Visual J++ 1.1	Jan-98	Dec-97	Internet Explorer 4.0 for Macintosh	Dec-97	Dec-97
Windows CE Embedded Toolkit for Visual C++	Jan-98	Nov-97	Internet Explorer 4.0 for Unix	Jan-98	Jan-98
Windows CE OAK 3.0	Mar-98	Mar-98	Internet Explorer 5.0	Jul-98	Jul-98
Webphone 1.0	Aug-98	Aug-98			
Web TV					
WebTV Plus Platform	Oct-97	Sep-97			

LOCALIZATION

Platforms & Applications Group - Localized Products							
FG Gross Revenue and Cost by Language - Tiers 1-3							
4 quarters ending Q98-1							
(in millions)	Revenue	Cost	Revenue multiplier	Growth %	% of FG rev		
Tier One	Language						
	Japanese	\$ 1,194.3	\$ 55.1	21.7 x	44%	98%	
	German	649.5	26.2	24.8 x	33%	88%	
	French	415.4	16.0	25.9 x	43%	81%	
	Spanish	218.8	11.4	19.2 x	67%	71%	
	Subtotal	2,478.1	108.8	22.8 x	43%	89%	
Tier Two	Italian	152.1	8.3	18.2 x	3%	80%	
	Swedish	88.9	7.5	11.9 x	32%	71%	
	Brazilian	92.4	6.5	14.1 x	85%	75%	
	Dutch	84.9	6.0	14.2 x	117%	54%	
	Korean	51.2	8.2	6.3 x	46%	79%	
	Danish	48.3	5.7	8.4 x	61%	61%	
	Chinese Trad.	45.1	8.3	5.5 x	95%	86%	
	Norwegian	36.1	5.8	6.3 x	59%	61%	
	Finnish	31.6	4.0	7.9 x	97%	54%	
	Polish	27.3	3.1	8.7 x	49%	80%	
	Czech	23.6	3.3	7.1 x	16%	71%	
	Chinese Simp.	27.1	6.7	4.1 x	132%	42%	
	Russian	10.8	3.3	3.3 x	43%	52%	
		Subtotal	719.4	76.7	9.4 x	53%	68%
Tier Three	Hebrew	11.6	4.2	2.8 x	-46%	56%	
	Portuguese	13.3	2.8	4.8 x	30%	37%	
	Hungarian	12.9	3.2	4.1 x	49%	71%	
	Arabic	9.5	4.3	2.2 x	-34%	31%	
	Thai	7.8	2.3	3.4 x	-21%	52%	
	Slovak	5.8	1.1	5.2 x	51%	60%	
	Turkish	6.2	2.1	3.0 x	360%	35%	
	Slovene	3.2	1.4	2.3 x	52%	54%	
	Greek	2.8	2.8	1.0 x	32%	30%	
		Subtotal	73.2	24.1	3.0 x	-2%	45%
		Total	\$ 3,270.7	\$ 209.6	15.6 x	43%	82%
Division**							
DAD/Web Auth	2,295.6	87.6	26.2 x	39%	88%		
PBSG	814.2	66.5	12.2 x	51%	73%		
Tools	159.6	24.7	6.4 x	69%	63%		
ICCD/CPD	1.3	30.7	nm x	nm	94%		
Total	\$ 3,270.7	\$ 209.6	15.6 x	43%	82%		
Region							
Europe	1,825.4	111.9	16.3 x	41%	76%		
Far East	1,317.8	78.3	16.8 x	48%	94%		
ICON***	127.5	19.4	6.6 x	28%	61%		
Total	\$ 3,270.7	\$ 209.6	15.6 x	43%	82%		

* Each language market may represent several countries with a common language.
 ** International Product Strategy Group localization costs are allocated among revenue producing divisions.
 *** ICON revenue does not include Spanish language revenues from Latin American markets (these are included in Europ

- Localized products represent 40% of total Finished Goods (FG) gross revenue for the Platforms & Applications division.
- Tier 1 languages (Japanese, German, French, and Spanish) account for 76% of localized revenue, generate the highest return on investment (23x cost), and are markets dominated by localized products (89% of revenue in these markets is from localized products).
- Tier 2 languages account for 22% of localized revenue, generate a strong return on investment (9x cost), and most of these markets demonstrated significant annual revenue growth in excess of 36%. As Tier 1 language markets mature and encounter saturation, Tier 2 languages will provide significant growth opportunities - in particular, key investments in Russian, Chinese- Simplified (PRC), and Korean are expected to accelerate growth through the year 2000.
- Tier 3 languages account for only 2% of localized revenues, but still provide a positive return on investment (3x cost). The small size of these markets, the scarcity of localized products, and rapidly changing economic conditions result in volatile growth rates.
- Localized revenue growth of 43% in Q98-1 over Q97-1 is due primarily to below average localized revenue in Q97-1 in most major language markets.
- Localization spending is dependent on the product release cycle - in particular, more offsite localization (vendor) costs are incurred closer to the ship date and these costs typically represent at least one third of the total localization cost. With the upcoming major releases of Windows 98, Windows NT 5.0 and Office 9, we expect spending increases in the latter half of FY98.
- Localization costs including internal costs, contingent staffing, and offsite localization/vendors, for Platforms & Applications were \$46 million in Q98-1, or 19% of the full year FY98 budget. ICCD spent 25% of their annual budget in Q98-1, a larger percentage than any other division due to the release of Internet Explorer 4.0 within the quarter.
- On September 30, Netscape opened its European Software Development and Operations Center in Dublin. This is Netscape's first software development center outside North America. This site will undertake development, localization, telesales, technical support and finance and administration for Europe - with 20 jobs filled currently and plans to create 295 new jobs within three years. Netscape aims to shorten its delivery times for products and services to the European market.
- Office Pro 97 provides significantly more language coverage than competitors (34 localized versions compared to Corel's 24).
- Office 97 achieves more timely product localization - 31 language versions are currently available compared to Corel's three languages for WordPerfect 8.0 and nine languages for WordPerfect 7.0.
- Internet Explorer 4.0 shipped in 8 languages and plans to achieve shorter deltas in all 24 languages versions (compared to Internet Explorer 3.0).
- Netscape covers only 11 languages and just 5 languages of Navigator 4.0 have shipped, even after an earlier U.S. release date than Internet Explorer 4.0.

PRODUCT DEVELOPMENT

C97-4

PC MICROSOFT CONFIDENTIAL

FOR: ROB SONDERMAN (RSONDER)

Sales, Marketing &
Product Support

CONSOLIDATED SALES, MARKETING & SUPPORT

Q98-1 SUMMARY

(in millions, variance to plan)	Net revenue		Cost of revenue		% of net rev	Responsibility margin		% of net rev	Contribution margin		% of net rev
	Actual	Var%	Actual	Var%		Actual	Var%		Actual	Var%	
North America FG	\$1,027.7	15%	\$98.2	(3%)	9.6%	\$679.4	40%	66%	\$480.9	73%	47%
Europe FG	674.6	32%	53.2	(7%)	7.9%	494.4	67%	73%	372.9	151%	55%
ICON FG	232.8	10%	21.6	19%	9.3%	153.8	36%	66%	109.4	78%	47%
Far East FG	338.9	11%	23.7	22%	7.0%	261.5	26%	77%	191.4	54%	56%
Total finished goods	2,274.1	18%	196.7	3%	8.6%	1,589.2	44%	70%	1,154.5	88%	51%
OEM (including Retail OEM)	1,057.9	14%	29.2	15%	0.8%	982.4	16%	28%	828.4	23%	24%
Total business	3,315.7	16%	225.9	5%	6.8%	2,555.3	31%	77%	1,966.6	53%	59%
Softimage	8.6	(4%)	0.6	8%	7.2%	1.3	(352%)	15%	(4.3)	(42%)	(50%)
Press	30.8	10%	10.4	23%	33.8%	15.3	164%	50%	9.5	-	31%
Online	90.5	1%	54.4	12%	60.1%	(13.8)	(65%)	(15%)	(56.4)	(34%)	(62%)
Web TV	7.0	111%	10.5	(9%)	150.5%	(10.3)	(51%)	(147%)	(17.2)	(22%)	(247%)
Other	(2.9)	42%	(0.3)	33%	nm	(49.5)	(10%)	nm	(2.9)	54%	nm
Total channel	\$3,449.8	16%	\$301.6	6%	8.7%	\$2,498.4	36%	72%	\$1,895.3	62%	55%

FINISHED GOODS

Q98-1 P&L SUMMARY

(in millions, except cost per head, variance to plan)	North America		Europe		ICON		Far East		Total WW FG	
	Actual	Var%	Actual	Var%	Actual	Var%	Actual	Var%	Actual	Var%
Net revenue	\$1,027.7	15%	\$674.6	32%	\$232.8	10%	\$338.9	11%	\$2,274.1	18%
Cost of revenue	98.2	(3%)	53.2	(7%)	21.6	19%	23.7	22%	196.7	3%
Gross margin	929.6	16%	621.4	35%	211.2	14%	315.2	15%	2,077.4	21%
% of net revenue	90%		92%		91%		93%		91%	
Controllable expenses										
People	50.4	18%	45.0	12%	20.1	12%	14.2	4%	129.7	14%
Contingent staff	8.4	3%	4.1	21%	1.9	31%	1.4	24%	15.8	14%
Infrastructure	17.5	19%	12.1	15%	8.0	10%	4.9	17%	42.4	16%
Other misc expenses	9.8	(10%)	4.3	28%	3.7	23%	1.6	(5%)	19.5	8%
Sales expense	86.1	14%	65.6	15%	33.7	14%	22.1	8%	207.5	14%
Marketing	108.7	23%	37.0	33%	15.0	37%	19.9	31%	180.7	27%
Product support services (net)	57.5	22%	17.7	25%	4.9	13%	8.8	20%	88.9	22%
MC'S (net)	(2.7)	167%	(1.5)	300%	0.6	(144%)	0.7	9%	(3.0)	534%
General and administrative costs	0.5	-	8.2	12%	3.2	6%	2.3	4%	14.3	6%
Total controllable expenses	250.1	20%	127.0	23%	57.4	21%	53.7	20%	488.2	21%
Responsibility margin	679.4	40%	494.4	67%	153.8	36%	261.5	26%	1,589.2	44%
% of net revenue	66%		73%		66%		77%		70%	
Shared resources	32.4	(54%)	7.5	61%	2.9	45%	5.2	48%	47.9	13%
Corporate allocations	166.2	11%	114.0	11%	41.6	11%	64.9	11%	386.7	11%
Contribution margin	\$480.9	73%	\$372.9	151%	\$109.4	78%	\$191.4	54%	\$1,154.5	88%
% of net revenue	47%		55%		47%		56%		51%	
Headcount	1,845	12%	1,530	4%	869	14%	530	9%	4,774	10%
People costs per head	\$109,278	7%	\$117,728	8%	\$92,365	(2%)	\$106,980	(5%)	\$108,652	5%
Infrastructure costs per head	\$37,844	8%	\$31,639	11%	\$36,903	(4%)	\$36,719	8%	\$35,560	7%

FINISHED GOODS

- Finished goods (FG) net revenue for Q98-1 exceeded \$2.2 billion, an increase of 10% from Q97-4 and 35% over Q97-1. The variance from foreign currency exchange was only \$9 million for the quarter as unfavorable European exchange rates offset favorable rates against the Japanese Yen.
- The top 10 revenue subsidiaries, all of which exceeded plan for the quarter, included the United States, Japan, the United Kingdom, Germany, France, Canada, Australia, the Netherlands, Italy and Brazil. Brazil supplanted Switzerland as the tenth largest subsidiary with revenue growth of 86% over Q97-1 due primarily from strong sales of desktop applications and personal and business systems. The Netherlands, the eighth largest subsidiary, also had an excellent quarter, with net revenue growth exceeding 100% over Q97-1, also due to growth in desktop applications and personal business systems revenue. In aggregate, the top 10 subsidiaries represented 82% of FG net revenue and grew 31% over Q97-1.
- As a result of a continuing poor local economy, Thailand was the only subsidiary significantly below net revenue plan. Q98-1 net revenue was \$6 million (56%) below plan, 6% greater than Q97-4 but 56% lower than Q97-1.
- Q98-1 revenue adjustments were \$59 million (33%) more than plan as increased channel reserves for pre-holiday channel sell-in and a \$15 million unresellable returns provision for packaged product sales offset less than planned unearned revenue from Custom Agreements and Upgrade Advantage (formerly known as Maintenance). Revenue from Custom Agreement Upgrade Advantage was \$90 million in the quarter, \$57 million (18% favorable to plan) of which was unearned on the management P&L.

**Q98-1 Custom Agreement & Upgrade
Advantage Revenue**

(in millions)	Gross		
	revenue	Unearned	Earned
North America	\$55.1	\$29.8	\$25.3
Europe	16.3	12.1	4.1
ICON	2.4	1.9	0.5
Far East	16.6	12.9	3.7
FG Total	\$90.4	\$56.7	\$33.7

- Q98-1 gross margin from finished goods was 91% versus a plan of 90%, equal to Q97-4 and a 2 point improvement over Q97-1. The principal driver was

lower product costs in all geographies due to continued shift toward more licensing and CD-ROM media sales. See Operations section for additional analysis on cost of finished goods revenue.

- Sales expense for Q98-1 was 14% below plan due primarily to lower than planned headcount across all geographies. On a per head basis, people costs were 5% better than plan due primarily to lower than plan travel and entertainment expense.
- Q98-1 marketing expense, net of recovery, was \$181 million and represented 8% of net revenue, 5 points below plan and a 28% increase over Q97-1. Q98-2 marketing spend is expected to ramp up significantly for holiday promotions.
- Product support services (PSS) costs, net of recovery, were 4% of net revenue, slightly below plan and almost flat with Q97-1. PSS revenue was 4% below plan due primarily to below plan Priority and Premier contract revenue but was offset by lower than planned support costs. Gross support costs were 17% below plan due to lower than planned headcount and the delayed start-up of the India Regional Support Center (RSC). Excluding the favorable impact of the India RSC, net PSS costs were 12% less than plan and 7% less than Q97-1. For more analysis, see the PSS section.
- Microsoft Consulting Service (MCS) recorded a net gain of \$3 million versus a planned loss of \$696 thousand. MCS revenue was \$4 million under plan but grew 26% over Q97-1 as consultant revenue shortfalls (16% below plan) offset subcontractor revenue strength (21% over plan). Q98-1 MCS operating expenses were 13% less than plan due primarily to lower than planned people costs. For more analysis, see the MCS section.
- Q98-1 responsibility margin was 70%, 13 points over plan, an 8 point improvement over Q97-4, and a 6 point improvement over Q97-1. All geographic areas' responsibility margins exceeded 65%. The Europe and ICON regions' responsibility margin grew 11 points and 8 points, respectively, over Q97-1.

Q98-1 Subsidiary FG Net Revenue Ranking

(in millions)	Q98-1			Q97-1	% Growth	% of Total
	Actuals	Plan	Var %			
1 United States	\$955.4	\$840.6	14%	\$783.5	22%	42.0%
2 Japan	281.8	266.9	6%	217.4	30%	12.4%
3 United Kingdom	157.3	135.5	16%	102.8	53%	6.9%
4 Germany	140.8	108.0	30%	101.8	38%	6.2%
5 France	90.2	63.8	41%	56.4	60%	4.0%
6 Canada	72.3	53.7	35%	46.1	57%	3.2%
7 Australia	46.5	42.2	10%	36.1	29%	2.0%
8 Netherlands	42.9	26.5	62%	21.4	100%	1.9%
9 Italy	40.3	29.4	37%	32.1	26%	1.8%
10 Brazil	32.0	27.8	15%	17.2	86%	1.4%
11 Switzerland	31.5	19.9	58%	22.9	37%	1.4%
12 Sweden	28.7	23.0	25%	21.9	31%	1.3%
13 Belgium	24.8	16.3	52%	15.2	63%	1.1%
14 Denmark	19.7	13.9	41%	11.2	76%	0.9%
15 South Africa	18.8	18.8	(0%)	12.9	46%	0.8%
16 Mexico	18.1	15.9	13%	9.5	91%	0.8%
17 Taiwan	17.4	10.3	69%	9.3	87%	0.8%
18 Spain	16.7	12.3	36%	12.1	38%	0.7%
19 Korea	16.0	14.3	12%	12.5	28%	0.7%
20 Finland	15.6	10.0	56%	8.6	83%	0.7%
21 Austria	15.5	10.9	43%	9.8	58%	0.7%
22 Hong Kong	14.1	7.7	83%	7.0	101%	0.6%
23 Norway	13.1	10.8	21%	8.9	47%	0.6%
24 Argentina	11.8	9.9	18%	6.6	78%	0.5%
25 Malaysia	10.7	7.3	47%	5.2	108%	0.5%
26 Singapore	10.6	8.9	20%	6.1	74%	0.5%
27 New Zealand	9.8	8.6	13%	7.6	29%	0.4%
28 China	9.6	5.7	68%	4.4	116%	0.4%
29 India	8.9	9.2	(3%)	5.9	50%	0.4%
30 Portugal	8.5	6.0	43%	6.2	39%	0.4%
31 Caribbean	8.1	6.4	26%	3.8	112%	0.4%
32 Poland	6.6	5.0	33%	4.5	48%	0.3%
33 Colombia	6.4	6.1	4%	3.3	95%	0.3%
34 Czech Republic	5.8	5.9	(1%)	5.8	(0%)	0.3%
35 Russia	5.7	5.0	13%	3.0	91%	0.2%
36 Turkey	5.6	3.1	79%	2.2	153%	0.2%
37 Israel	4.9	5.8	(17%)	5.8	(16%)	0.2%
38 Chile	4.1	4.3	(5%)	3.5	17%	0.2%
39 Venezuela	4.0	3.5	12%	2.4	67%	0.2%
40 Gulf	4.0	4.9	(19%)	4.0	(1%)	0.2%
41 Hungary	3.7	3.1	19%	2.3	65%	0.2%
42 Saudi Arabia	3.5	3.9	(12%)	3.1	11%	0.2%
43 Indonesia	3.4	2.5	35%	1.0	234%	0.1%
44 Philippines	3.1	2.2	44%	1.4	133%	0.1%
45 Slovak Republic	2.8	2.3	20%	2.0	36%	0.1%
46 Peru	2.7	3.5	(23%)	2.3	7%	0.1%
47 Thailand	2.5	4.5	(43%)	5.7	(56%)	0.1%
48 Greece	2.3	2.3	2%	1.6	44%	0.1%
49 Uruguay	2.1	1.5	40%	0.7	198%	0.1%
50 Ecuador	1.8	1.3	41%	1.0	77%	0.1%
51 Eastern Europe	1.7	1.1	66%	0.9	86%	0.1%
52 Egypt	1.4	1.9	(25%)	1.9	(26%)	0.1%
53 Ivory Coast	1.4	1.1	25%	0.8	72%	0.1%
54 Kenya	1.2	1.7	(26%)	0.9	33%	0.1%
55 Slovenia	1.2	1.1	12%	0.9	39%	0.1%
56 Morocco	1.2	1.0	13%	1.2	(0%)	0.1%
57 Indian Ocean Islands	1.0	0.7	40%	0.5	125%	-
58 Croatia	0.7	0.6	26%	0.4	101%	-
59 Romania	0.7	0.5	34%	0.7	(10%)	-
60 Other Middle East	0.5	0.7	(34%)	-	nm	-
61 Vietnam	0.3	0.2	29%	0.1	215%	-
FG Total	\$2,274.1	\$1,922.0	18%	\$1,687.4	35%	100.0%

GROSS REVENUE

- Q98-1 FG gross revenue was \$2.5 billion, 20% above plan and grew 19% over Q97-4 and 44% over Q97-1 on the strength of desktop applications, personal and business systems product licensing. Q98-1 Select and Open licensing revenue grew 81% and 126% over Q97-1, respectively, and represented 48% of total gross revenue versus 36% in the year ago quarter.
- All geographic areas exceeded Q98-1 plan, led by especially strong results in Europe, which exceeded plan by 34% and grew 56% over Q97-1. Far East gross revenue was \$377 million, 19% over plan, down 5% from Q97-4 but up 45% over Q98-1. ICON gross revenue was \$258 million, 17% above plan, up 5% over prior quarter and 62% over Q97-1. North America gross revenue was 13% above plan and up 34% over Q97-1.
- Europe Q98-1 gross revenue was \$724 million and included a 2% unfavorable foreign exchange variance. The strength in personal and business systems licensing in addition to pre-holiday sell-in of learning and entertainment and hardware products were the primary reasons for the positive results. Open licensing revenue grew 118% in the quarter over Q97-1 (business systems 213%, personal systems 174%) while Select revenue grew 65% (business systems 181%, personal systems 122%). All European subsidiaries were above plan for the quarter with the exception of the Czech Republic, which was just slightly below plan.
- Q98-1 North America revenue was \$1.1 billion, 13% over plan, 34% over Q97-1 due primarily from licensed sales of Windows 95 and seasonal sell-in of learning and entertainment and hardware products. Windows 95 revenue was 64% over plan in the quarter and grew 46% and 5% over Q97-4 and Q97-1, respectively. Strong sell-in of Actimates Barney and gaming devices drove hardware revenue over 100% of plan in the quarter.
- Far East revenue was \$377 million in Q98-1, 19% over plan, 5% less than Q97-4 and 35% over Q97-1. All Far East subsidiaries were above plan for the quarter, however Taiwan, Hong Kong and China had very positive results due primarily to sales of Office and business systems products. China's gross revenue surpassed the \$10 million mark for the first time. Japan's gross revenue was \$39 million or 14% over plan, including \$22 million of Office replacement product.
- Q98-1 ICON gross revenue was \$258 million, 17% over plan, up 5% over Q97-4, and 62% over Q97-1. Select and Open licensing sales of desktop applications personal and business systems products accounted for 57% of ICON gross revenue and grew 133% over Q97-1. Malaysia, Indonesia, Argentina, Mexico and Brazil collectively were 19% above plan and grew 92% over Q97-1.

Q98-1 FG Gross Revenue
(including Retail OEM revenue)

(in millions)	North America			Europe			ICON			Far East			Worldwide FG		
	Actual	Plan	Var %	Actual	Plan	Var %	Actual	Plan	Var %	Actual	Plan	Var %	Actual	Plan	Var %
Desktop Applications	\$539.8	\$517.7	4%	\$397.0	\$324.8	22%	\$149.8	\$126.5	18%	\$230.0	\$168.4	37%	\$1,316.6	\$1,137.4	16%
Tools	65.0	62.3	4%	26.6	31.7	(16%)	9.2	9.0	2%	42.6	46.3	(8%)	143.5	149.3	(4%)
Internet Content and Collaboration	0.4	0.2	58%	-	0.1	nm	0.1	-	72%	0.5	4.5	(90%)	0.9	4.8	(82%)
Personal Systems	189.3	138.5	37%	86.0	47.9	80%	34.5	23.2	49%	27.9	28.4	(2%)	337.7	238.0	42%
Business Systems	227.8	212.9	7%	143.8	106.3	35%	51.1	49.0	4%	65.6	57.9	13%	488.3	426.0	15%
Consumer Products	0.2	1.9	(90%)	-	-	nm	-	-	nm	0.1	-	nm	0.2	1.9	(82%)
Total Platforms & Applications	1,022.5	913.5	10%	653.5	510.7	28%	244.6	207.7	18%	366.7	305.5	20%	2,287.2	1,957.4	17%
Learning and Entertainment	32.2	32.3	(0%)	36.2	14.7	146%	5.1	5.2	(3%)	2.9	2.2	36%	76.4	54.4	40%
Interactive Service Media	2.8	2.1	30%	3.7	0.8	378%	-	-	29%	-	-	nm	6.5	2.9	122%
Hardware	78.3	38.5	103%	25.3	10.2	148%	5.1	4.9	4%	4.1	5.7	(27%)	112.8	59.3	90%
Desktop Finance	3.4	1.7	104%	0.4	0.5	(30%)	1.5	0.3	400%	-	-	(23%)	5.3	2.5	110%
Total Interactive Media Group	116.6	74.6	56%	65.6	26.2	180%	11.7	10.4	12%	7.1	7.9	(10%)	200.9	119.1	69%
Other	11.9	11.5	4%	5.1	5.2	(2%)	1.3	1.5	(10%)	3.6	4.6	(21%)	21.9	22.7	(4%)
Total FG Gross Revenue	\$1,150.9	\$1,019.5	13%	\$724.1	\$442.1	34%	\$257.6	\$219.7	17%	\$377.4	\$217.9	19%	\$2,510.1	\$2,099.2	20%

NORTH AMERICA

- The Enterprise Customer Unit (ECU) announced co-funded strategic alliances with Arthur Andersen (AA) and KPMG Peat Marwick. AA will market and support the deployment of mid-market solutions on MS platforms. The first initiatives involve AA's endorsement of Windows NT and SQL Server as the preferred platform for their SAP R/3 solutions practice and the establishment of an MS-based SAP Solution Center. KPMG will form a 500-person consulting practice based on MS's enterprise platform, and will standardize on MS Exchange Server for its 20,000 U.S. employees. Windows NT Server will also provide KPMG's computing infrastructure, and Internet Explorer will be deployed as the standard web browser.
- ECU continues to build long term commitments with customers through the Custom Agreement (CA) program, which is designed to increase customer satisfaction and secure increased long-term revenue per desktop. Significant new agreements were closed with Xerox, Aluminum Company of America, KPMG and Software House Ltd., with an additional 87 agreements in the pipeline at the end of the quarter. Billed agreements average a 3.4 year term and \$177 per desktop per year. A simplified revenue-per-desktop pricing approach is expected to increase the pace of closing custom agreements in future months.
- In FY98, ECU will grow its direct sales and support infrastructure and expand its account coverage in an effort to be more competitive with IBM and Oracle. Over 170 additional ECU sales representatives will focus on an account base that will more than double to 10,800 accounts.
- In August, the Organization Customer Unit (OCU) launched the Direct Access program in the U.S., targeting 150,000 value-added providers. The program will provide seminars, subsidized training, web-based content, an email newsletter, trial packs, and special offers including beta releases and a dedicated telesales contact.
- The OCU VAR Summit for Sun's elite partners was held in July and produced 41 letters of intent for joint sales engagements, technical training and cooperative marketing programs. Similar summits for key Lotus partners (MS Collaboration Summit in October) and Oracle partners (MS Database Solutions Summit in November) have been scheduled and are expected to attract more than 60 key partners each.
- The End User Customer Unit (EUCU) began their holiday initiative by introducing more than 30 new products to the retail channel. Strategic holiday products include Money 98, My Personal Tutor, Encarta Reference Suite 98, Flight Simulator 98, Internet Explorer Plus 4.0, and the Sidewinder Force Feedback joystick. Promotional displays have already been implemented at key resellers.
- During August and September, EUCU ran the New PC/Microsoft Rebate promotion, offering customers a 50% rebate on MS products if purchased at the same time as a qualifying PC system.
- Retail outlet inventory management audits were increased in frequency from quarterly to monthly, with results showing a strong 80% average in-stock rate for September. The purpose of these audits is to increase on-shelf presence of the top 80% revenue generating titles at key retailers.
- The Application Developer Customer Unit (ADCU), in partnership with NT Magazine, created the Industry Solutions Directory, an internet based reference tool for third party line of business applications shipping on Windows NT, SQL Server and BackOffice. Over 1,200 applications have been posted to date, and over 20,000 page views by customers are recorded weekly.
- The Education Customer Unit (EdCU) launched the MS Office Academic Upgrade Pilot program in September, allowing college students to purchase Office 97 Professional bundled with guaranteed upgrades for 2 years. It will be available through campus resellers at an estimated reseller price of \$299 and is positioned as an inexpensive and easy way for students to stay up-to-date on MS technologies.
- In 1998, EdCU will partner with more than 350 State Department of Education and College of Education teacher training sites via the Professional Development Partnership Program. These partners provide development training for teachers who will be implementing technology in their classrooms. MS supports their training efforts through annual software donations for teacher training lab sites and preview/demonstration sites.
- The Internet Customer Unit (ICU) hosted an event at the ITU Telecom Interactive in Geneva, where Siemens Public Communications Networks announced they would port their INXpress SS7 enhanced telecommunications software to the NT Server platform.
- On July 16, an alliance of Microsoft, British Telecom, MCI, and several other service providers announced

the launch of "Intranet Complete". This service provides managed Intranets to customers who prefer to rent a complete service as an alternative to managing their own. The service is based on the MS Commercial Internet System and BackOffice, and every end-user will generate revenue to MS. British Telecom and MCI will use their private networks to guarantee high levels of performance and security.

- On September 30, ICU helped launch MS Internet Explorer 4.0 in conjunction with the top 11 U.S. internet service providers (ISPs). The ISP Services were branded and custom-configured for IE 4.0 and included AT&T Worldnet, EarthLink Network, GTE Internetworking, IBM Global Services, MCI, NETCOM, and SpryNet among others.

EUROPE

- The U.S. dollar's strengthening slowed against key European currencies in Q98-1. Average exchange rates for French Francs, Deutsche Marks and British Pounds were almost unchanged compared to Q97-4 average exchange rates. Compared to Q97-1, the currency fluctuations had a negative impact of 16% on European FG revenue.
- The overall economic situation in Europe is mixed. Germany's unemployment rate rose to 11.7% in September, very similar to France at 12.5%, and Italy at 12.4%. Spain is at 21 %, while the United Kingdom's unemployment rate dropped to 5.3% and the Netherlands to 5.8%. Increases in Industrial Production and Retail Sales volume ratios for the main European countries led to a significant GDP increase over the last three months.
- According to the latest economic data, the European Economic and Monetary Union will commence in 1999 with 11 members. Every country except Greece has a realistic chance of qualifying for the EMU before next spring. The UK, Sweden and Denmark as well as Switzerland are unlikely to join the first wave of the EMU. The potential impact of the EMU on Microsoft revenue and pricing strategy is currently under review with no major issues foreseen.
- According to International Data Corporation, (IDC) Western Europe PC unit sales rose to almost 4 million units during first quarter of FY98 compared to 3.6 million units in same quarter of the previous fiscal year. Eighty percent of these PCs were shipped with Windows 95 or Windows NT Workstation pre-installed compared to 60% in Q97-1. The percentage of installed base PCs with a Windows 32-bit operating system has increased from 23% in Q97-1 to 46% in Q98-1.
- European gross revenue for Q98-1 was \$724 million, 73% over Q97-1 (in constant dollars) due to strong

desktop applications, business and personal systems product licensing, and pre-holiday sell-in of IMG packaged product. Licensed products represented 61% of total finished goods revenue in the current quarter compared to 56% in Q97-1, led by 118% growth in Open license sales targeted at small and medium organizations. Western European countries saw very high year over year quarterly growth in gross revenue with the Benelux region at 116%, France at 98%, Nordic at 86% and Germany at 68% (in constant dollars) compared to East European countries that saw lower growth in gross revenue.

- Based on the September 1997 Netcraft Web Server Survey, IE browser share in Europe was 44%, up 2% from the Q97-4 survey. Spain, Portugal, Belgium and Denmark each had over 50% market share. Netscape's market share in Europe is still 52%.
- Anti-piracy activities continue to be successful across the region. The UK, Nordic countries, Poland and Italy implemented aggressive end-user campaigns in association with the Business Software Association. This program is targeted at small and medium sized business, based on a "best practice" SMORG campaign developed in France in FY97.
- In September, Netscape announced the start-up of its European Software Development and Operations Center in Dublin and the creation of 295 new jobs within the next three years. This will enable them to shorten delivery times for products and services to the European market. The range of activities undertaken will include software development, localization, telesales, distribution, technical support, administration and finance.

FAR EAST

- The US dollar continued to strengthen relative to the Japanese Yen. The average exchange rate for the Yen in Q98-1 was 116 up from 106 in Q97-1. The budgeted rate for FY98 was 119. Late in Q98-1, MS Japan shipped a service release for Office 97, increasing gross FG revenue by \$22 million. A channel reserve for expected returns relating to outdated Office 97 products was recorded in MS Japan's Q98-1 P&L.
- Gross revenue from the Office 97 products released in Q97-4 continue to drive the Q98-1 results for the Far East. Revenue from desktop application products in Q98-1 was \$230 million, \$62 million over plan. This revenue represents 61% of the total revenue for the region and nearly all of the favorable revenue variance for the quarter.
- MS Japan faces strong local competition for the word processing market from Just Systems. Just Systems' Ichitaro for Windows is the leading word processing program in Japan, with an estimated 46% market share (based upon primary usage). In September 1997, Just Systems released an updated version of their office suite and announced that they plan to raise capital by offering 3.5 million shares of their stock to the public in mid-October. In late October, MS Japan plans to release a professional business edition and family package of Office 97.
- WebTV, Inc. is in the process of forming a joint venture with Fujitsu for the sales, distribution and support of a localized version of WebTV in the Japanese market. The current proposal is that WebTV, Inc. will be a 75% partner in the joint venture and Fujitsu a 25% partner. The initial capitalization of \$35 million is planned.
- MS Japan is continuing its expansion efforts in Tokyo. Currently, MS Japan has an office in Sasuzuka, with a 630 person capacity, and an office in Chofu, with a 760 person capacity. MS Japan is currently seeking space for a third office in the Shinjuku area, to hold approximately 1,000 people.
- The growth rate of PC shipments in Japan is slowing in comparison with previous years. In FY97, the PC shipments (Intel and Mac) in Japan were 8.13 million units, representing 23% growth over FY96. In June 1997, management's estimate of PC shipments in FY98 was 9.6 million units, 18% growth over FY97. Management's current estimate for FY98 is 9.5 million units, 16% growth over FY97. For the other Far East subsidiaries, strong PC growth in FY98 is still forecasted. PC shipments in Korea are expected to grow 19% in FY98; Taiwan, 31%; Hong Kong, 24%; and PRC, 48%. For the Far East in the aggregate, PC shipments in FY98 are expected to grow at 23% in FY98, which is well above the worldwide growth rate of 13%.
- Hong Kong Q98-1 FG revenue grew 112% over Q97-1. Slowing demand from the government sector prior to the conversion to Chinese rule depressed sales in Q97-4. FY98 economic forecasts for Hong Kong are more optimistic than those of FY97.
- China continued to take measures to increase local customer satisfaction. In Q98-1, China committed to a new 2,500 square meter office facility. The site will also provide support services to Hong Kong and Taiwan.

ICON

- South East Asian (SEA) economies were hard hit during Q98-1 by recurring currency speculation. This was driven by underlying inflationary pressures in several currencies, principally Thailand, where governments pegged local currency to baskets of foreign exchange in an effort to maintain stability. Most reactions came about from currencies being freed from these bands. This factor has driven several key currencies to devalue by approximately 25% over Q98-1. The Thai Baht, Indonesian Rupiah and Malaysian Ringgitt have been especially impacted.
- MS's competitors in these markets, except Compaq, have chosen historically to bill in local currencies. Strong PR for these companies and a fear of weakened market share as a consequence led MS to announce fixed local currency pricing in these four countries. MS will continue to bill in US dollars, but will grant a rebate to distributors based on a benchmark exchange rate published monthly by MS.
- Revenue in the SEA region has so far suffered little impact from currency weaknesses. Net revenue incorporates \$3 million of reserves to meet the

anticipated cost of rebates to protect distributors against exchange rate movements. Despite a general currency devaluation of 25% across the region, only Thailand's revenue has suffered noticeably.

- Thailand's economic problems led the speculative drive on SEA currencies during Q98-1. While the corrections in many economies seem temporary, Thailand's economy has underlying issues, which may take a significant period of time to resolve. Allied to these economic issues are well-publicized political problems including allegations of widespread corruption in the government. A protracted debate of no confidence in the government during September highlighted many of these allegations and included claims of misdeeds by the minister of education with regard to purchases made by his department from MS in 1996. Several former MS Thailand managers were named as complicit in certain irregularities regarding these deals. We believe the allegations against MS employees are unfounded. However, one former employee is pursuing legal action against MS for unfair dismissal.
- Blas Garcia Moros was appointed regional director for South East Asia, succeeding John Lauer. Moros was subsequently general manager in Singapore, Philippines and Thailand. Mike Hard was promoted from GM, Philippines to Director, Latin America Developing Markets.
- Following a tour of two years, Gulf GM Ahmed Chami has returned to Morocco to become GM of North West Africa, based in Casablanca. His position in Dubai has been filled by Emre Berkin, GM of Turkey, who retains overall responsibility for Turkey and adds management responsibilities for MS subsidiaries in Egypt, Saudi Arabia and the Gulf.
- A key distributor in ICON, CHS Promark, has continued to extend coverage through acquisition in several markets in the region. They have added to their already extensive list of purchases by acquiring distributors in Turkey and several Latin American locations while continuing negotiations with potential partners in India, South Africa, Singapore, Australia and Colombia. While CHS is believed to be fundamentally financially sound, they have funded much of their recent acquisitions from large public offerings estimated at \$400 million during 1997.
- Brazil enjoyed an outstanding quarter, climbing into the group of the 10 largest net revenue subsidiaries. Growth of 86% over Q97-1 with revenue of \$32 million contributed to a responsibility margin 13 points better than plan. A recovering Australian economy contributed to substantial growth in the South Pacific region and included the signing of a large Custom Deal with Telstra, the Australian telecommunications provider, for \$15 million.

OEM

Q98-1 P&L Summary

<i>(in millions, except cost per head, variance to plan)</i>	Actual	Plan	Var %
Net revenue	\$1,057.9	\$941.8	12%
Cost of revenue	29.2	34.6	16%
Gross margin	1,028.7	907.2	13%
<i>% of net revenue</i>	97%	96%	
Controllable expenses			
People	8.8	9.9	11%
Contingent staff	0.3	0.3	13%
Infrastructure	2.2	2.4	9%
Other miscellaneous expenses	23.2	18.4	(26%)
Sales expense	34.4	30.9	(11%)
Marketing	9.9	12.2	18%
Product support services (net)	1.9	2.0	5%
General and administrative costs	-	-	-
Total controllable expenses	46.3	45.1	(3%)
Responsibility margin	982.4	862.1	14%
<i>% of net revenue</i>	93%	92%	
Shared resources	0.7	1.0	27%
Corporate allocations	153.3	170.2	10%
Contribution margin	\$828.4	\$690.9	20%
<i>% of net revenue</i>	78%	73%	
Headcount	297	319	7%
People costs per head	\$118.592	\$124.397	5%
Infrastructure costs per head	\$29.017	\$29.526	2%

BUSINESS HIGHLIGHTS

- At \$1.06 billion in gross revenue, Q98-1 OEM was essentially flat from the prior quarter, and 42% higher than Q97-1. North American multinational OEMs accounted for 74% of the positive revenue variance. This quarter was the fourth consecutive \$1 billion quarter.
- Japan revenue was lower than in the two prior quarters and only 1% more than one year ago, suggesting that prior years' high growth rates are moderating as the PC market becomes more saturated and prices increase in response to the introduction of high-end Intel processors. Growth may be spurred in Q98-2 by Compaq's introduction of a sub-\$1,000 PC.
- Highly volatile foreign exchange rates in Southeast Asia slowed local DSP sales. Beginning in October, OEM will guarantee a monthly FX rate for Southeast Asian countries other than Singapore, allowing the OEMs to plan sales strategy based on a known product cost.
- Dell's distribution success has inspired several OEMs, including Compaq, Hewlett Packard, and IBM, to move toward more direct distribution models. Implementation of these JIT models by large OEMs is likely to put more pressure on mid-tier OEMs by limiting their access to suppliers.

- About 35% of the Q98-1 consumer retail PC sales in the U.S. were for sub-\$1,000 PCs, a departure from the consumer trend of technology being more important than price. Intended to broaden the consumer market, these PCs appear to be cannibalizing some sales of more expensive PCs. IBM will announce restructuring of its consumer division as a result of recent disappointing sales of its higher-priced Aptiva consumer PC.
- In January, the OEM division will form Microsoft Licensing, Inc. (MSLI), a fully owned MS facility based in Reno, Nevada. OEM Operations will be physically located in Reno while other corporate functions such as Sales, Marketing and Treasury will be contracted from MS by MSLI. Implementation of this transition is on schedule.

SIGNIFICANT OEM CUSTOMERS

OEM Revenue by Customer

(in millions)	Q98-1			Growth from Q97-1	
	Actual	Plan	Variance	\$	%
Gateway 2000	\$98.1	\$62.6	\$35.5	\$56.9	138%
IBM	90.3	108.2	(17.8)	25.6	40%
Hewlett Packard	89.2	45.0	44.2	54.3	156%
Dell	79.7	67.6	12.1	34.9	78%
Compaq	65.4	58.6	6.8	18.3	39%
Toshiba	36.5	41.5	(5.0)	8.4	30%
Packard Bell NEC	32.5	30.9	1.6	16.1	99%
Fujitsu	32.4	28.8	3.5	7.7	31%
NEC	26.4	27.9	(1.5)	5.6	27%
Siemens Nixdorf	22.8	14.2	8.6	10.0	79%
Other multinationals	55.0	55.8	(0.8)	8.5	18%
Total Multinationals	628.2	540.9	87.3	246.5	65%
Named accounts	255.6	214.2	41.4	32.4	15%
System Builders	180.2	190.8	(10.6)	40.5	29%
Total OEM Gross revenue	1,064.0	945.9	118.2	319.4	43%
Revenue adjustments	(6.1)	(4.1)	(2.0)	(5.1)	529%
Total OEM Net revenue	\$1,057.9	\$941.8	\$116.2	\$314.3	42%

- Gateway 2000 was the top revenue producer for the quarter due to \$34 million from out-of-period reports. Gateway is shipping Office SBE on its consumer models, however on its corporate line, Gateway will act as a pre-installer for Select customers or will work with VARs to supply Office.
- IBM's failure to respond to the consumer market's shift to the sub-\$1,000 PC has caused its reported consumer PC shipments to plummet 42% from Q97-4. Compaq introduced a line of sub-\$1,000 PCs in July. By August its share of the U.S. consumer retail market jumped 13 points to capture the No. 1 position with a 36% market share.
- Hewlett Packard's quarterly revenue was inflated by \$34 million in out-of-period reports.
- Dell passed Compaq to become the No. 1 desktop shipper to corporate America. Unit shipments reported by Dell in Q98-1 were 64% over last year, the largest unit growth experienced by an OEM this quarter.
- Dell's success in the corporate market has fueled their NT penetration to 15.5%.
- Both Compaq and NEC have begun to sell direct through the Internet and via telemarketing. In an effort to reduce conflict with the VAR channel, Compaq is only offering this on its consumer line. With significant consumer retail sales through Packard Bell NEC, NEC has limited its direct selling to business.
- Packard Bell NEC, facing increased competition in the sub-\$1,000 market, and NEC, experiencing slower growth in the Japan market, continue to lose market share. OS shipments for the combined companies grew only 7% over last year.
- NT penetration for multinationals was 10.4%, up from 6.2% last quarter. The multinationals with the greatest NT penetration were Digital (22.3%), Siemens Nixdorf (21.3%) and Dell (15.5%). Budgeted NT penetration for total multinationals was 8.8%.

MARKETING EXPENSE

Q98-1 and FY98 Marketing spend

(in millions)	Q98-1			Total FY98	
	Actual	Plan	% Plan spent	Plan	% Plan spent
	North America	\$108.7	\$141.2	77%	\$570.3
Europe	37.0	55.0	67%	287.2	13%
ICON	15.0	23.7	63%	92.3	16%
Far East	10.0	29.0	60%	120.7	16%
FG Total	\$180.7	\$248.0	73%	\$1,070.5	17%
WW Broad Reach	\$19.4	\$26.9	72%	\$128.5	15%

Marketing spend quarterly trend

(in millions)	Q96-1	Q96-2	Q96-3	Q96-4	Q97-1	Q97-2	Q97-3	Q97-4	Q98-1
North America	\$86.4	\$96.2	\$74.3	\$146.6	\$85.7	\$117.5	\$134.7	\$142.3	\$108.7
Europe	49.6	69.7	44.3	61.8	33.2	76.1	64.4	78.2	37.0
ICON	16.4	11.6	9.8	15.3	10.6	17.5	14.4	24.1	15.0
Far East	11.3	24.7	10.9	31.4	11.6	21.6	18.6	39.7	19.9
FG Total	\$163.7	\$202.1	\$139.4	\$255.0	\$141.1	\$232.8	\$232.0	\$284.3	\$180.7
<i>Growth over same quarter, prior year</i>	99%	82%	3%	37%	(14%)	15%	66%	11%	28%
<i>Spend as a percent of net revenue</i>	11%	12%	9%	15%	8%	12%	11%	15%	8%
WW Broad Reach	\$54.7	\$54.9	\$18.7	\$47.2	\$23.2	\$28.9	\$25.1	\$32.2	\$19.4

- Net FG marketing expense for Q98-1 was \$181 million, 7.9% of net revenue compared to plan of 13.0%. This variance was caused by a combination of higher revenue volume and below plan marketing spend.
- Marketing spend for the quarter was 27% below plan and represented 17% of the year's budget.
- Relatively low spend during the first quarter is typical as new programs ramp up.
- Q98-1 marketing spend was up 28% compared to Q97-1, which reflects the expected year over year increase in total marketing.

MICROSOFT CONSULTING SERVICES (MCS)**Q98-1 P&L Summary**

<i>(in millions, except cost per head,) variance to plan)</i>			
	Actual	Plan	Var %
Consultant	\$39.0	\$46.6	(16%)
Subcontractors	18.4	15.3	21%
Revenue	57.4	61.8	(7%)
People	34.9	40.0	13%
Contingent staff	15.8	12.7	(25%)
Infrastructure	9.6	10.8	12%
Other	(5.9)	(1.0)	nm
Expenses	54.4	62.5	13%
Responsibility margin	3.0	(0.7)	nm
Headquarter allocations	2.0	3.4	39%
Estimated general and administrative	2.0	2.0	-
Contribution margin	(\$1.0)	(\$6.1)	83%
MCS Practice average headcount	1,328	1,426	7%
MCS Headquarters average headcount	31	45	31%
Subcontractor margin	\$4.1	\$3.0	37%
Consultant revenue per head	\$138,593	\$137,000	1%
People costs per head	\$105,012	\$112,306	6%
Infrastructure expenses per head	\$28,849	\$30,414	5%

BUSINESS INITIATIVES

- MCS as a part of its "service readiness" effort is working with the Product groups on a Rapid Deployment Program (RDP). RDP is designed to accelerate the deployment of new products to early adopter customers in order to provide product feedback, early references and capture deployment information for incorporation into Service Guides and Information assets such as TechNet. The program kicked off with Compaq, KPMG, Boeing and Texaco on Windows NT 5.0 and will focus on 7 other new product releases in FY98.
- MCS Portugal partnered with Unisys on a project for BPI Group, a financial institution, covering the planning and architecture of NT, SMS and Exchange for 500 branches. Orient Overseas

Container Line (OOCL), a leader in the containerized transportation industry, worked with MCS to replace Novell with an enterprise-wide Back Office network including more than 200 servers and 2,500 desktops running Windows 95 and Microsoft Office and deployed Exchange in all 140 OOCL offices worldwide.

- The Worldwide Business Desk's functions were expanded to provide a single focal point for coordinating the integration of product and services into multi-year Custom Agreements.

BUSINESS RESULTS

- Q98-1 revenue was \$4 million below plan. Below plan consultant revenue was partially offset by above plan subcontractor revenue.
- Expenses were 13% below plan primarily due to lower than people expense related to lower than planned headcount. Other expense includes \$7

million for relief services MCS performs for other groups within MS.

- Q98-1 contribution margin was \$5 million favorable to plan. Subcontractor revenue contributed \$4 million to the margin.

PRODUCT SUPPORT SERVICES (PSS)

Q98-1 Product Support Cost and Revenue

(in millions)	Actual				Plan			
	Costs	Revenue	Net	Recov %	Costs	Revenue	Net	Recov %
North America	\$79.8	\$25.7	\$54.1	32%	\$92.3	\$25.8	\$66.5	28%
Europe	30.4	11.6	18.9	38%	37.8	10.8	27.0	29%
ICON	7.8	2.1	5.7	27%	10.6	3.4	7.2	32%
Far East	12.9	2.8	10.1	21%	17.0	3.5	13.5	20%
FG Total	131.0	42.1	88.9	32%	157.8	43.5	114.3	28%
OEM	2.8	0.9	1.9	32%	3.1	1.1	2.0	35%
Total Business	\$133.7	\$43.0	\$90.8	32%	\$160.8	\$44.6	\$116.2	28%

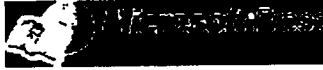
BUSINESS RESULTS

- Q98-1 net support costs totaled \$91 million, 22% below plan. Net costs were 3.9% of net FG revenue compared to a plan of 5.9%. Q98-1 support revenue totaled \$43 million, 4% below plan due to lower than expected sales of Premier contracts, Priority contracts, and single incidents. Premier contracts accounted for 60% of total Support Revenue. Q98-1 support revenue increased 38% over Q97-1.
- Q98-1 support gross expenses totaled \$133 million and were 17% below plan. The favorable \$27 million was mostly due to the delayed start-up of the India Support Center and below plan contingent staffing, and depreciation expenses. The contingent staff variance is driven by fewer support incidents.

BUSINESS HIGHLIGHTS

- Three significant pieces of support technology code were completed for inclusion in Windows 98. Included are thirteen troubleshooters, the Microsoft Systems Information utility and the Windows reporting interface for Web Response. The expected results are an enhanced customer experience with the product and a decrease in support incident length.
- MS launched an upgrade to its Support Online web site. The new and improved site features natural language searching, site customization, sign-up for proactive support alerts via email and the ability to add Support Online to the Internet Explorer 4.0 Active Desktop. Also included is a new interface that makes searching easier and provides a mechanism for registration. Registration information will be linked to the regbase and increase our understanding of our customer base.
- A new support offering, Microsoft Authorized Support, is being launched in North America and Europe. This offering which is based on the Premier model, is targeted to reach a greater number of enterprise customers. It will focus on organizations with typically 1,000-2,500 PCs and will combine MS's direct support resources with the multi-vendor services offered by Digital or Hewlett-Packard.
- Critical Problem Resolution and Quick Fix Engineering (QFE) policies were implemented to provide for quicker resolution to customer's critical bugs reported with Developer, Office, and IE products. In addition, a QFE council of managers across the company has been established to improve quality and execution of the QFE process for customers.
- Hewlett Packard, with assistance from Microsoft Enterprise Support, introduced 6 new services aimed at Enterprise Customers with mission critical NT server-based applications. These services, which ensure high availability, include Priority recovery, Proactive prevention, Managed change, Performance optimization, Expert technical advice and a guaranteed 6 hour fix on server hardware calls.
- Forty ISVs have already signed up for the Premier for Developers (PFD) offering which was recently introduced. In addition, a major application benchmarking study for the HBO & Company, a solution developer who sells hospital software that runs on Windows NT and SQL Server, is underway in the PFD lab.

PRESS



(in millions, variance to plan)	Q98-1			FY98	Q98-1
	Actuals	Var %	% net rev	Plan	as % of FY98
Net revenue	\$ 33.2	118%	100%	\$ 147.1	23%
Cost of revenue	12.1	90%	36%	60.6	20%
Gross margin	21.1	144%	64%	86.5	24%
Operating expenses					
People	5.2	92%	16%	22.7	23%
Infrastructure	1.7	88%	5%	7.8	22%
Product development	0.9	36%	3%	8.8	10%
Other miscellaneous expenses	0.0	3%	0%	1.9	1%
Marketing	2.7	92%	8%	14.5	19%
General and administrative costs	0.1	67%	0%	0.4	17%
Operating expenses	10.6	77%	32%	56.1	19%
Responsibility margin	10.5	nm	32%	30.4	34%
Corporate allocations	0.8	86%	2%	3.9	21%
Contribution margin	\$ 9.7	nm	29%	\$ 26.5	37%

- Net revenue for Q98-1 was \$33 million, \$5 million (18%) above plan. As a percentage of net revenue, cost of revenue was 11% under plan due to gains realized on paper and kit box prices and lower than anticipated royalty payments. Operating expenses were under plan with a significant positive variance from Product Development. Product development spend was 36% under budget primarily due to the product delays of Windows 98, Visual Studio products and Windows NT 5.

- As the table below illustrates, the top selling English titles for Q98-1 were based on Windows NT and Windows 95. The top 10 English titles (out of approx. 260 active titles) were responsible for 43% of the English language revenue for Q98-1. Standard margin (SM) for the top ten titles has remained consistent with the FY97 average of \$39 per unit. Seven of the 10 English titles since the beginning of FY96 remained in the top 10 of Q98-1.

Top 10 English Language Titles for Q98-1 and Since 7/1/95							
(\$ in thousands)							
No.	Title	Shipping Months	Net Rev	% Rev	Units	Rev/Unit	SM/Unit
1	Microsoft Windows NT Server 4.0 Resource Kit	12	\$2,015	8%	27,599	\$73.02	\$60.09
2	Networking Essentials	18	1,760	7%	39,618	44.42	35.97
3	Microsoft Windows NT Technical Support Training	6	1,311	5%	26,131	50.16	40.24
4	Microsoft Windows NT Network Administration Training	6	967	4%	23,415	41.29	33.23
5	Microsoft TCP/IP Training	3	961	4%	17,385	54.65	47.76
6	Microsoft Windows NT Workstation 4.0 Resource Kit	12	794	3%	25,571	31.04	25.31
7	Microsoft Windows 95 Resource Kit	6	783	3%	36,534	21.43	16.82
8	Microsoft Windows 95 Training Kit	6	743	3%	7,857	94.62	86.94
9	Microsoft SQL Server Training	12	589	2%	5,545	106.14	93.36
10	Microsoft Visual Basic, Deluxe Learning Edition	6	556	2%	9,270	59.97	45.48
Q98-1 Top 10 English Titles:			\$10,478	43%	219,125	\$47.82	\$39.42
1	Microsoft Windows 95 Resource Kit	27	\$18,120	10%	749,530	\$24.18	\$17.09
2	Microsoft Windows NT Server 4.0 Resource Kit	12	13,742	7%	185,699	74.00	59.84
3	Microsoft Windows 95 Training Kit	6	8,737	5%	93,468	93.48	80.91
4	Microsoft Windows NT Resource Kit, version 3.51	23	8,384	5%	84,572	99.13	79.77
5	Networking Essentials	18	8,070	4%	171,961	46.93	36.37
6	Microsoft Windows NT Workstation 4.0 Resource Kit	11	6,404	3%	193,982	33.01	26.87
7	Microsoft Windows NT Training Kit Version 3.51	30	5,845	3%	57,114	102.35	83.80
8	Microsoft SQL Server Training	11	3,576	2%	33,272	107.48	94.05
9	Running Microsoft Windows 95	25	2,884	2%	197,707	14.59	9.89
10	Microsoft Windows NT Technical Support Training	6	2,194	1%	39,984	54.88	44.99
Top 10 English Titles Cumulative Since 7/1/95:			\$77,956	42%	1,807,389	\$43.13	\$33.95

General &
Administrative

GENERAL AND ADMINISTRATIVE

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

(in millions, variance to plan)	Actual		Plan		Var	Var %
Allocated expenses						
HR/Admin services	\$ 16.5	0.5%	\$ 18.6	0.6%	\$ 2.1	11%
IT	12.6	0.4%	16.1	0.5%	3.5	22%
Law and corporate affairs	25.5	0.7%	31.1	1.0%	5.7	18%
Finance	16.8	0.5%	23.0	0.8%	6.2	27%
Other	5.3	0.2%	4.9	0.2%	(0.3)	(7%)
	76.7	2.2%	93.8	3.2%	17.1	18%
Distributed expenses						
HR/Admin services						
Recruiting	7.7	0.2%	10.4	0.3%	2.7	26%
Benefits	35.0	1.0%	35.1	1.2%	0.1	0%
Services	10.1	0.3%	13.1	0.4%	3.0	23%
Facilities	36.8	1.1%	36.0	1.2%	(0.8)	(2%)
IT	35.4	1.0%	38.0	1.3%	2.7	7%
	124.9	3.6%	132.6	4.5%	7.7	6%
Distributed	(125.9)	(3.7%)	(138.4)	(4.7%)	(12.5)	9%
Under/(over) distributed expenses	(1.1)	(0.0%)	(5.8)	(0.2%)	(4.8)	82%
Net general & administrative	\$ 75.6	2.2%	\$ 87.9	3.0%	\$ 12.3	14%

- Allocated G&A - Human resources and administrative services were under plan in Q98-1 primarily due to lower than planned headcount and related people and infrastructure costs. Finance costs were \$6 million under plan in Q98-1 as the result of differences in the timing of certain expenditures. IT was under plan in Q98-1 as the result of lower than planned headcount and related people and infrastructure costs as well as differences in the timing of certain expenditures. Legal costs were \$6 million under plan in Q98-1 as the result primarily of lower than anticipated professional fees and settlements during the quarter.
- Distributed G&A - IT infrastructure costs were under plan in Q98-1 as the result of differences in the timing of expenditure periods. Depreciation was \$1 million over plan due to the accelerated North American WAN upgrade. Employee services costs were under plan by \$3 million in Q98-1 due primarily to higher than anticipated company store sales and increased charge backs of mail costs to the cost centers. Facilities costs were over plan for the quarter primarily due to unanticipated janitorial and property taxes as well as accelerated timing of certain lease related expenses.

BENEFITS

	Basis	Actual	Plan	Var	Var %
Healthcare prmts and fees	Per employee	\$ 1,274	\$ 1,220	\$ (54)	(4%)
401(k) employer match	Per participant	528	476	(52)	(11%)
Health club	Per participant	239	241	2	1%

- Costs of employee benefits, including health coverage, 401(k) plan and health club dues are captured centrally and allocated monthly to domestic departments. Total employee benefit costs are on plan for Q98-1, but slightly over on a per head basis because of timing of expenditures and under estimating the impact of August performance bonuses on the 401(k) match. However, there should be little to no effect on an annual basis.
- The MS Healthcare plan is self-insured through a tax-exempt trust and administered through several healthcare providers.
- Health club fees represent costs for employee and dependent memberships at the Pro Club and Columbia Athletic centers in the Puget Sound area. Costs for other club memberships are paid directly by the benefiting cost center through their fringe accounts and are not included above.

RECRUITING

<i>(in million, except new hires, variance to plan)</i>	GSA/Ops/CA			Sales & Support			PG & Research			Total		
	Actual	Plan	Var %	Actual	Plan	Var %	Actual	Plan	Var %	Actual	Plan	Var %
Recruiting costs	\$ 1.0	\$ 0.6	(67%)	\$ 1.8	\$ 2.7	33%	\$ 4.1	\$ 7.0	41%	\$ 6.9	\$ 10.3	33%
New hires (salaried)	148	115	(29%)	346	299	(16%)	557	457	(22%)	1,051	871	(21%)

- Human resources provides recruiting support to the rest of the company. Costs of recruiting, which are distributed to the customer divisions based on number of new hires, include employment advertising and agency fees, candidate travel, and people and infrastructure costs of the staff.
- The recruiting staff hired 1,051 salaried employees in Q98-1 and surpassed the hiring target by 180 heads or 21%. Over half of the new hires were for the product groups and research, mostly from within the industry or from contingent staff conversions.

FACILITIES & CAPITAL SPENDING

<i>(\$ in millions, square feet in thousands)</i>	Q98-1 Capital Spend				
	Square feet	Mix	Actual	Plan	Variance
Puget Sound	4,661	57%	\$ 45.8	\$ 79.7	\$ 33.9
Other domestic	1,381	17%	1.5	9.7	8.2
International	2,187	27%	17.6	8.9	(8.7)
	<u>8,229</u>	<u>100%</u>	<u>\$ 64.9</u>	<u>\$ 98.3</u>	<u>\$ 33.4</u>

- Construction on the Augusta project, located between Building 22 adjacent to SR 520 and the southwest section of the main campus, continued during the quarter. By Q98-3, this \$184 million dollar project will add 566,000 square feet to the portfolio and capacity for 2,300 people.
- Excavation and foundation work on the Troon project commenced during the quarter. Troon is located south of Augusta. By Q99-3, this \$128 million dollar project will add 415,000 square feet to the portfolio and capacity for 1,700 people.
- Building 28, adjacent to Buildings 26 and 27 in the southwest section of the main campus, was completed during the quarter at a total cost of approximately \$27 million, adding approximately 100,000 square feet to the portfolio and capacity for 470 people.
- Construction of the Thames Valley Park project in the UK continued during the quarter. Building 1 was occupied in August 1997. Buildings 2 and 3 will be occupied in Q98-2. Total construction cost at completion is estimated to be \$49 million. Although a proper CER was authorized, there is no FY98 capital budget for this project, which drives an unfavorable variance in International Capital Spending for FY98.

PUGET SOUND CAPITAL SPENDING

(in millions)	Q98-1		
	Actual	Plan	Variance
Committed projects	\$ 39.5	\$ 51.6	\$ 12.1
Tenant improvements	3.1	16.0	12.9
New construction	0.4	2.1	1.7
All other	2.8	10.0	7.2
Total	\$ 45.8	\$ 79.7	\$ 33.9

- Committed projects include Augusta, Building 28 and Troon. Capital spend on tenant improvements represents work on existing buildings and new construction represents campus projects expected to occur through FY99. The variance in spending for committed projects versus plan is primarily due to timing of payments on Augusta and a delayed start on Troon. The variance in tenant improvements is primarily due to less activity occurring in Q98-1 than anticipated. All other is largely comprised of payments to the City of Redmond for construction mitigation and property acquisitions that will occur later in FY98.

CORPORATE PROCUREMENT

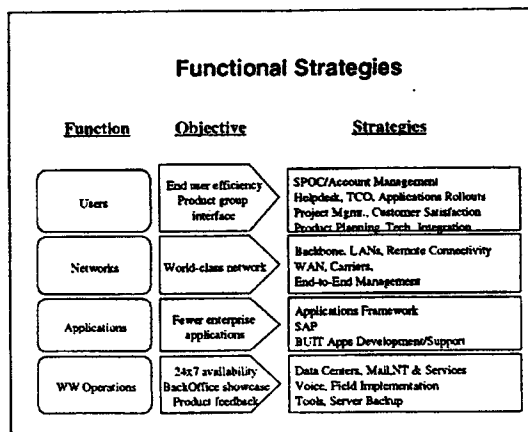
Metric	Q97-1	Q98-1
Number of transactions	261,464	406,597
Cost per transaction	\$ 2.88	\$ 2.20
Trans paid within std terms*	80%	85%
Problem invoices	6%	7%

* Standard Terms- Payment within 30 days of invoice date.

- Transaction volumes increased 56% in Q98-1 over Q97-1 due primarily to the growth rate of MS and expansion into new businesses. Consistent with expectations, the number of consultants, contractors, and marketing vendors used for transaction processing has increased.
- Cost per transaction decreased 24% from Q97-1. Gross expenses rose 5%, but with the increase in transactions, cost per transaction decreased.
- Additionally, the amount of transactions processed by Electronic Invoicing increased from 72% of all vendor transactions in Q97-4, to 80% in Q98-1.
- Percentage of problem invoices increased from 6% during Q97-1 to 7% during Q98-1. For the first quarter in North America, there were 2,451 new vendor set-ups, an average of 175 per week. Of these, 58% were contractor and consultant vendors.

INFORMATION TECHNOLOGY

- ITG set aggressive spending control targets for FY98, allowing less than 7% expense growth while still accomplishing a complete upgrade of the North American Wide Area Network (WAN). This upgrade was completed in 50% of all Puget Sound sites during Q98-1.
- Internet datacenters are now operational in Tokyo and London, as well as Redmond. These datacenters are the hosting sites for all Internet based products such as MSN, Expedia, Investor, and MSNBC, as well as our corporate site, Microsoft.com.
- The following chart describes the key strategies for each of the ITG organizational areas in FY98:



Worldwide IT Spending

(in millions)	Corporate IT			Non-Corporate IT			Total		
	FY97	FY98	Change	FY97	FY98	Change	FY97	FY98	Change
Backoffice - Datacenter	\$ 56	\$ 46	\$ 10	\$ 14	\$ 14	\$ -	\$ 70	\$ 60	\$ 10
Backoffice - Network	68	72	(4)	83	113	(30)	151	185	(34)
Applications	32	42	(10)	82	95	(13)	114	137	(23)
End user services	38	45	(7)	35	30	5	73	75	(2)
IT administration	1	2	(1)	-	-	-	1	2	(1)
Total	\$ 195	\$ 207	\$ (12)	\$ 214	\$ 252	\$ (38)	\$ 409	\$ 459	\$ (50)

Key Corporate IT Metrics

	Q97-1	Q98-1	Chg in headct	Change %
Corp IT to MS headcount (U.S.)	1:27	1:31	4	15%
	Q97-3	Q97-4	Q98-1	Rolling average
Cost per call to helpdesk (U.S.)	\$ 29.96	\$ 32.72	\$ 29.68	\$ 30.79

BUSINESS UNIT IT (BUII) – SIGNIFICANT PROJECT UPDATES**OPERATIONAL BUSINESS SYSTEMS (OBS)**

- IE 4.0, Domestic and International Development- Internet Explorer 4.0 has played a critical role by driving over 200,000 units in sales of IE4 on CD-ROM due to the web-order sites created by OBS. In addition, this project has laid the infrastructure for international fulfillment of IE across more than 40 countries. The availability of the product directly via CD-ROM has been viewed as a distribution competitive advantage over Netscape in press reviews.
- HOPS Manu project - The Hardware Operations Manugistics system and datamart were completed by OBS in August. This effort included a business re-engineering of the planning process for the production and transportation of hardware

products for Microsoft worldwide and replaced an often outdated Excel based tool.

- MOET 97 (Microsoft Order Entry Tool) is MS's own Internet based electronic commerce system that supports the order process between MS business partners and operations. Many of the largest business partners use EDI (Electronic Data Interchange), however most of the channel partners are limited to error prone manual order processing. MOET 97 utilizes the Worldwide Web as its transport layer and is more accessible, cheaper, and easier to use than EDI. MOET 97 is the electronic ordering alternative to EDI for channel partners.

FINANCE IT

- Headcount reporting will be released in Q98-2, complete with key organizational reporting attributes such as contingent staff and vendor details. Daily feeds from the SAP HR Reporting database and leveraging the MARS reporting infrastructure will result in streamlined processes and more efficient reconciliation. Improved reporting granularity for all headcount types will assist business analysis of cost per head calculations and contingent staff spending. This level of information will ensure consistent HR accounting in both OnTARGET and SAP.
- Gibraltar is a re-engineering of Treasury systems for an integrated cash management, equity, equity derivatives and F/X transactions, risk management and decision support system. Gibraltar will improve cash controls, reduce opportunity for

errors, create systematic audit controls, increase data consistency, and perform compliance reporting

- During Q98-1, IT began development of the systems infrastructure for the data warehouse (MST), sourced portfolio data into MST, provided high level training, and created standard suite of reports. Currently two vendor finalists are under evaluation for a Treasury Transaction System (TTS). In Q98-2, TTS implementation will begin and additional data elements to be sourced into the warehouse will be analyzed. The search for a Financial Risk System (FRS) product has yielded 3 potential candidates with selection and implementation expected in Q98-2. Overall Gibraltar integration (MST, TTS, FRS) is scheduled to be complete during Q98-4.

ADMINISTRATIVE BUSINESS SYSTEMS (ABS)

- In July, SAP/HR Phase 2 was implemented in the international subsidiaries eliminating many disparate HR systems including 17 HR Vantage systems and providing more timely, accurate and consistent headcount information. Several new web tools including The Online PSR, CS Request, and Personal Data were also introduced eliminating more than 50,000 paper transactions per year.
- ABS completed the GEMS (Grant Exercise Management System) project, which included; conversion of our legacy stock system to the Equity Edge package, installation of the Valuation

module for Finance, and creation of Stock Option Exercise Confirmation via the Intranet. In October, this new web site was released to all MS employees. The web site shows a history of their exercises, and replaces the hardcopy confirmation statement that employees currently receive via interoffice.

- The Restrac system, a recruiting system, was implemented in US field sites in July. In addition, the CAT (Campus Applicant Tracking) system was converted to Restrac.

CORPORATE PROCUREMENT IT

- MS Market is MS's web based worldwide requisitioning tool used to order goods and services. In August an upgrade for MS Market was released. Thirteen subsidiaries are live, with eight more to come on in FY98. Corporate Procurement Group (CPG) eliminated 12 headcount positions from the process and now the tool is supported by just 1.5 people. MS Market is regularly used as a showcase for MS technology in marketing to large accounts and will ship as a starter site in Site Server Enterprise Edition 3.0.
- MS Expense, a new web based employee expense reimbursement tool, was released July 28. MS Expense simplifies employee expense reporting and reduces the timing of reimbursement to the employees. The application will allow the CPG to save 4 headcount. MS Expense will ship as a sample application in BackOffice 4.0.
- MS Invoice, initiated in July, allows vendors to enter invoices directly into our accounts payable system, eliminating manual data entry and paper handling by MS. By targeting most of the 10,000 paper invoices currently received each month, MS Invoice will allow CPG to improve payment cycle times, give more control to approving managers, and significantly reduce data entry headcount. Version 1.0 will be released in December.

Treasury &
Investor Relations

CAPITAL MARKET ACTIVITIES

PORTFOLIO MANAGEMENT

FAMILY OF FUNDS PORTFOLIO SUMMARY

(in millions)	Cash & Money Mkt	Enhanced Money Market	Short Term	Intermediate	Opportunity	Total
Portfolio allocation						
Q97-4	37%	28%	16%	16%	3%	100%
Q98-1	31%	33%	17%	18%	2%	100%
Cash balances *						
Q97-4	\$ 3,187	\$ 2,383	\$ 1,426	\$ 1,415	\$ 242	\$ 8,653
Q98-1	\$ 2,889	\$ 3,031	\$ 1,586	\$ 1,634	\$ 158	\$ 9,298
Annualized rate of return (pre-tax)						
Q97-4	5.8%	6.3%	10.1%	13.6%	15.5%	8.0%
Q98-1	6.1%	6.3%	8.4%	11.0%	8.0%	7.3%

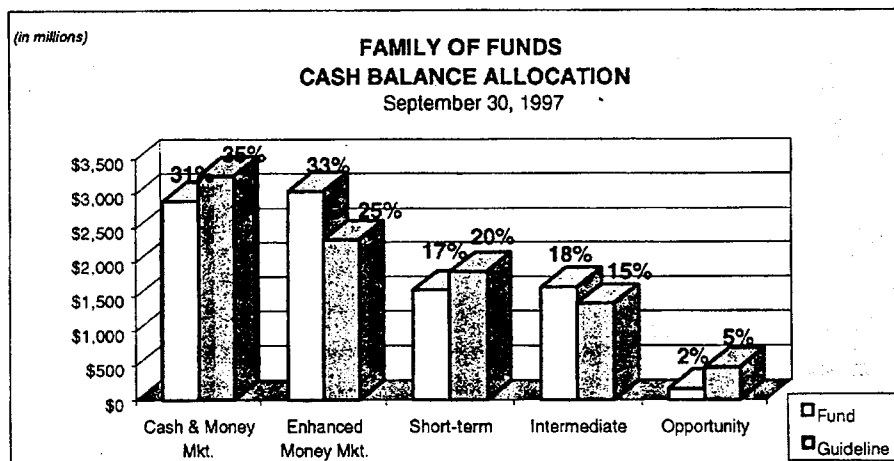
* Net asset value of the Treasury-managed portfolio, including certain securities classified as other assets on the balance sheet, but excluding certain foreign currency operating balances

- Q98-1 portfolio *economic income* corresponded to \$.09 per share on an after-tax basis. This contribution represents accounting cash flow of \$142 million, plus the value of tax-related and unrealized net gains in market value of \$31 million. Unrealized gains and losses are reflected in equity and do not flow through the P&L until realization.
- Q98-1 Family of Funds allocations (cash balances) exhibited an increased emphasis on longer

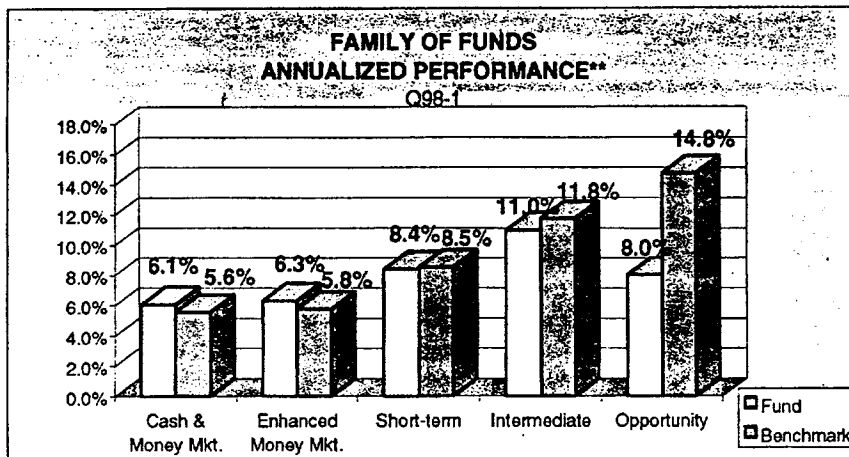
duration funds as shown in the Allocation table above and graph below.

- Although the fixed income market rallied in Q98-1, it did not match the rally experienced in Q97-4. The Q98-1 annualized rate of return vs. Q97-4 decreased 72 basis points to 7.3%. Annualized performance compared to benchmarks is depicted in the performance chart on the next page.

CASH BALANCE ALLOCATION



FUNDS PERFORMANCE



- During the quarter, moderation in measures of broad based inflation and dove-ish sentiment from the Federal Reserve Chairman led capital market participants to continue to remove much of the bias toward more restrictive monetary conditions that had been factored into the market.
- As a result, market interest rates matching the maturities of the MS Family of Funds fell during the quarter. Three month US Treasury Bill yields fell 8 basis points to 5.1%, one year US T-Note yields fell 21 basis points to 5.4%, three year US T-Note yields fell 36 basis points to 5.8%, and five year US T-Note yields fell 39 basis points to 6.0%.
- Portfolio durations were held slightly shorter than equivalent fund benchmark durations. The Short-

term fund and the Intermediate fund were both at 99% of their respective benchmarks, on average, during the quarter.

- The four main Family of Funds portfolio returns exceeded their respective benchmarks for the quarter by a weighted-average of 18 basis points (on an annualized basis). Portfolio returns above benchmarks were primarily generated via security sector and issue selection.
- The Strategic Opportunity Portfolio, which represents about 2% of the total portfolio, delivered an annualized return of 8.0% during the quarter.

ACCOUNTS RECEIVABLE

(in millions)	DSO				Aging Summary				
	Q97-2	Q97-3	Q97-4	Q98-1	Total	Current	1-30	31-60	60+
Finished goods									
North America	48	38	41	35	\$425	\$388	\$10	\$21	\$5
Europe	43	43	40	37	264	240	10	10	4
Far East	69	57	58	58	209	181	21	3	4
AM/ME	71	73	85	93	46	38	6	1	1
Brazil	135	115	143	131	40	33	6	(2)	3
Indian Sub Continent	133	146	147	122	11	9	1	-	-
Southeast Asia	98	96	84	73	27	23	1	1	2
South Pacific	139	106	87	74	42	34	5	1	2
Spanish America	102	96	99	103	65	48	9	3	5
Total finished goods	54	49	55	46	1,128	994	69	40	26
OEM	29	25	28	27	337	272	41	11	12
Other					134	62	28	14	29
Total accounts receivable	47	43	43	40	\$1,599	\$1,328	\$138	\$66	\$68
						83%	9%	4%	4%
Clearing accounts					(46)				
Reserves for sales returns					(707)				
Allowance for doubtful accounts					(412)				
Other reserves					(64)				
Earned but unbilled revenue					419				
Accounts receivable-net					\$788				

- Worldwide gross accounts receivable slightly decreased, from \$1.604 billion at the end of Q97-4 to \$1.599 billion. Aging improved from 81% current to 83% but "over 60 day" delinquency increased from 3% to 4%.
- Worldwide days sales outstanding (DSO) decreased from 43 days in Q97-4 to 40 days in the

current quarter with the greatest improvement coming from South East Asia and North America.

- Higher channel inventory resulted in reserves for sales returns to increase from \$628 million at Q97-4 to \$707 million for the first quarter. The allowance for doubtful accounts increased from \$372 million at Q97-4 to \$412 million at the end of Q98-1.

ACCOUNTS RECEIVABLE OF THE TEN LARGEST CUSTOMERS WORLDWIDE

(in millions)	Total		Aging Summary			
	Balance	Percent	Current	1-30	31-60	Over 60
Ingram Micro	\$208	13%	\$201	\$5	\$-	\$1
R.R. Donnelley & Sons	65	4%	46	6	9	3
Merisel	59	4%	58	1	-	-
Tech Data	51	3%	50	-	-	1
Gateway 2000	48	3%	38	10	-	-
Fujitsu	48	3%	42	4	-	2
CHS	42	3%	40	2	(1)	1
Computer 2000	39	2%	37	-	1	-
Soft Bank	36	2%	34	3	-	-
Tech Pacific	34	2%	30	2	-	1
Top ten largest	629	39%	577	33	10	9
Other	970	61%	751	105	56	\$9
Total Q98-1	\$1,599	100%	\$1,328	\$138	\$66	\$68
Total Q97-4	\$1,604		\$1,303	\$196	\$53	\$51

Aging mix:				
Q98-1 Top ten largest	92%	5%	2%	1%
Q98-1 Total	83%	9%	4%	4%
Q97-4 Total	82%	12%	3%	3%

- Total accounts receivable for the top ten worldwide customers accounted for 39% of the total at the end of Q98-1, up from 31% at the end of Q97-4.
- As part of their plan to expand globally, CHS completed its secondary offering within the quarter. CHS sold 13 million shares at a market price of \$31 ³/₄, raising \$412 million in capital. In addition, a group of underwriters exercised the green shoe to purchase additional shares totaling \$35 million. Capital from the offering will go

toward paying down suppliers and funding future acquisitions.

- Merisel continues to show signs of improving financial health with funding from Stonington Partners, a \$152 million investment. Merisel previously contracted with their note holders in April, but subsequently received a better offer from Stonington, that the board ultimately approved. As a result, the note holders are suing Merisel for breach of contract. We feel the lawsuit will be settled amicably out of court and will not upset day to day operation of the business.

EQUITY INVESTMENTS & OTHER ASSETS

(in millions)	Cost			Market Value if public		
	Q98-1	Q97-4	Change	Q98-1	Q97-4	Change
Equity investments						
Comcast	\$1,000	\$1,000	\$-	\$1,135	\$1,027	\$108
Apple	150	-	150	\$197	\$0	197
Wang	73	74	(1)	0	0	-
Lemout & Hauspie	45	-	45	63	0	63
Stac Inc.	21	38	(17)	12	16	(4)
Mtel	30	30	-	28 (a)	25 (a)	3
RealNetworks	30	-	30	0	0	-
Santa Cruz Operation	20	20	-	23	15	8
WorldCom (hedged)	16	16	-	452	438	14
MicroUnity	15	15	-	-	-	-
Dreamworks SKG	15	12	3	-	-	-
Lightspan	13	13	-	-	-	-
Individual	11	11	-	6	4	2
CMG	7	7	-	12	6	5
Verisign	7	7	-	-	-	-
Metricom	6	6	-	2	1	1
Tandem/Compaq	6	6	-	-	-	-
Academic Systems	6	5	1	-	-	-
Digital Anvil	5	5	-	-	-	-
Single Trac	5	5	-	-	-	-
VDO.Net	5	5	-	-	-	-
Wildfire	5	5	-	-	-	-
Flanders Language Valley	3	-	3	-	-	-
E-Stamp	3	-	3	-	-	-
Navitel	3	3	-	-	-	-
Dreamworks JV	3	4	(1)	-	-	-
eFusion	3	3	-	-	-	-
Trados	3	-	3	-	-	-
KPMG/EIS	2	-	2	-	-	-
Proginet	2	2	-	-	-	-
Citrix Systems	2	2	-	82	71	11
Enterplay	2	2	-	-	-	-
Helicon	1	1	-	2	-	2
ASCII NT	1	1	-	-	-	-
WebTV	-	5	(5)	-	-	-
Monotype	-	-	-	-	-	-
Vanstar	-	-	-	24	22	2
	<u>1,517</u>	<u>1,302</u>	<u>216</u>	<u>\$2,038</u>	<u>\$1,625</u>	<u>\$413</u>
ABN AMRO fund	407	381	26			
Quadramics	350	350	-			
Other equity investments	222	113	109			
Mark-to-market (net of taxes)	338	295	43			
Valuation allowance	(101)	(95)	(6)			
Total	<u>\$2,733</u>	<u>\$2,346</u>	<u>\$388</u>			
Other assets						
Intellectual property rights	434	272	162			
Accumulated amortization	(312)	(177)	(135)			
L/T Loans & Other	189	108	81			
Total other assets	<u>\$311</u>	<u>\$203</u>	<u>\$108</u>			

- Six new minority investments were made in Q98-1 in Apple, Lernout & Hauspie, RealNetworks, Flanders Language Valley, E-Stamp and Trados. In addition, dividends of \$1 million were received from Wang in Q98-1.
- Other equity investments increased \$109 million, including an additional \$15 million in Affordable Housing, a Risk mitigation investment ("Tracers") of \$100 million, offset by reserves for MSNBC and other JVs.
- Total market value of investments in public companies increased \$413 million during the quarter, primarily due to the Apple and Lernout & Hauspie investments and an increase in the Comcast stock price.
- Intellectual property rights, net of accumulated amortization, increased \$27 million during the quarter, due to the acquisition of DimensionX (\$18 million - see last quarter report) and VXtreme (IPR of \$51 million), the Apple patent cross-license agreement (\$93 million), offset by write-offs.
- Long-term loans and other increased \$81 million, primarily due to the WebTV goodwill (\$117 million), an additional loan to TechData (\$1.4 million), and the offset by the pay-off of the UUNet loan (\$23 million) and the partial pay-off of the DEC loan (\$12 million, leaving a balance of \$41 million).

NEW DEALS

- Apple Computer, Inc. - On August 6, MS and Apple announced a broad series of agreements, including MS's purchase of \$150 million of non-voting convertible preferred stock. Under the arrangement, MS paid an undisclosed amount (\$100 million) in exchange for a patent cross-license and committed to develop and ship future versions of Office for the Mac. Apple agreed to preinstall Internet Explorer on every Macintosh computer. The companies will also collaborate to provide more compatible implementation of Java Virtual Machines for Windows and Macintosh platforms.
- Progressive Networks/RealNetworks - On July 21, MS and Progressive Networks (PN) announced that MS acquired a source and distribution license to RealAudio and RealVideo technology, licensed certain PN trademarks, and that the companies would cooperate to define future versions of MS's Active Streaming Format (ASF). MS paid \$30 million for the license.
- MS also acquired a 10% stake in PN for an additional \$30 million or \$8.99 per share, as well as a warrant to acquire an additional 10% of PN.
- On September 26, PN filed an S-1 registration statement with the SEC for an IPO of PN stock. At the same time, PN changed its name to RealNetworks. The S-1 discloses neither the number of shares to be sold, nor the expected price per share. MS has been told by RealNetworks that the expected filing range is \$9 to \$11 per share.
- VXtreme Inc. - On August 5, MS announced the acquisition of VXtreme Inc., the Sunnyvale-based developer of streaming media solutions. VXtreme technology will be integrated into the NetShow product line. The purchase price, which was not publicly disclosed, was \$68 million. MS hired 51 of VXtreme's 90 employees.
- Shortly after this announcement, the Department of Justice informed MS that it was investigating MS's acquisition of VXtreme as well as earlier investments in Progressive Networks and VDOnet.
- Lernout & Hauspie Speech Products - On September 11, MS announced a \$45 million investment in Belgium-based Lernout & Hauspie, a leader in the development of advanced speech technology for various commercial applications and products. MS purchased 1,450,210 shares of common stock for \$31.03, representing 7% of outstanding shares.
- The companies also announced a broad alliance designed to accelerate development of the next generation of voice-enabled computing on the MS Windows platform. Further, MS announced it plans to invest \$3 million in the Flanders Language Valley Fund, a Belgium-based international technology center dedicated to helping companies develop speech-based technologies and applications.
- Trados - In September, MS paid \$2.5 million for a 20 percent stake in Trados GmbH, of Stuttgart, Germany. Standardizing on its high-end translation tools will enable MS to realize significant cost savings and increase the quality of localized products. As part of the investment, Trados agreed to customize and extend their

software in a direction favorable to MS. MS received a source code escrow and the right to veto any change of control.

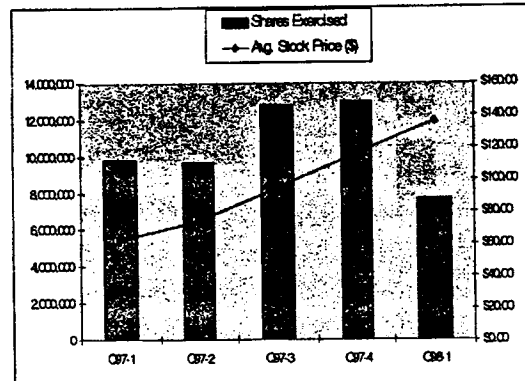
- Walkabout Software - On October 6, MS acquired Walkabout Software, a developer of HTML browsing engine technology, which extends HTML to deliver multimedia experiences over the Internet in a way that can easily be authored. The purchase price was \$2.75 million in stock. MS hired 4 employees, who relocated to Redmond to work in the Trident group.
- E-Stamp Corporation - MS invested \$3 million in preferred shares at a pre-money valuation of \$30

HIGHLIGHTS OF CURRENT INVESTMENTS

- On September 11, Stac concluded its Dutch Auction tender offer. The company repurchased 3,663,156 of its shares for \$5.50 each or \$20.1 million. MS tendered 2 million of its Stac shares, but continues to hold nearly 2.5 million Stac shares, which represents about 9% of the total outstanding.
- Santa Cruz Operations (SCO) signed a marketing development alliance with Compaq, to promote Unix solutions on Compaq's products. Tarantella (SCO's future "universal application server") is now installed on several beta sites.
- Lightspan has raised approximately \$26 million at \$3.76 per share in its Series D Preferred Stock financing. The company hopes to raise an additional \$9 million in this round by the end of 1997. The issuance of the Series D Preferred Stock triggered the conversion of MS's \$770,000 convertible note into 209,458 Series D Preferred Shares. MS currently owns just over 9% of the company.
- On September 17, Individual and Netscape announced "Netscape Industry Watch by Individual," a content service for Netscape Netcenter. Individual's stock price increased to \$5.00 per share from below \$3.00 for most of August and September.
- On October 10, Paul Allen, through Vulcan Ventures, announced its plan to increase its ownership of Metricom to 49.9%. Vulcan will buy 4.65 million shares of Metricom for \$56 million, and will assume leadership of Metricom's board. Metricom has chosen to defer its pending \$125 million bond offering because of the ownership changes. The market has reacted positively to the investment: the stock is currently at \$17 1/2, up 190% in the last month.
- Tandem was acquired by Compaq in September. MS now owns a warrant to acquire 525,000 shares of Compaq common stock. The warrant has an in-the-money value of about \$27 million dollars.
- On September 10, Academic Systems closed its Series F Convertible Preferred Stock round of financing after issuing a total of 14.8 million shares at \$1.08 per share for total proceeds of \$16 million. MS invested \$1 million during this issue for 925,925 shares of Series F Preferred. MS owns a total of 2,727,351 shares, or 7% of the company.
- On September 11, SingleTrac's board of directors approved the terms of the sale of the company to GT Interactive Software for \$16 million. On October 6, stockholders approved the transaction. The transaction should close shortly. MS's \$4.9 million investment in SingleTrac will be worth \$6.1 million as a result of the acquisition.
- VDOnet's viability has been threatened by its inability to raise additional financing. The company believes this situation arose from investors' perception of MS's purchase of VXtreme and investment in Progressive Networks.
- Helicon completed its initial public offering (IPO) on July 17 at a price of £1.25 per share, or a 120% premium over the price paid at the time of MS's initial investment. At the IPO price, Helicon has a market capitalization of £7.4 million, or US\$11.0 million. MS's ownership was diluted to approximately 20% ownership from 40% as a result of the offering.
- ASCII Network Technology, in which MS Japan has a 20% stake, achieved revenue of Y1.1 billion and operating profit of Y10 million for the six months ending September 1997. The forecast for the second half of the fiscal year is Y2 billion of revenue and Y180 million of profit. The NT Related publishing business at ASCII will be moved to ASCII Network Technology.

OTHER TREASURY ACTIVITIES

STOCK OPTIONS GRANTS AND EXERCISES



- MS stock traded at an average price of \$136.50 during Q98-1. The highest closing price was \$149.50 and the lowest closing price during the quarter was \$124.94.
- In Q98-1, the number of stock option exercises was 10,044, an increase of less than 1% over the same period in Q97-1. The number of shares exercised was 7.7 million, a 21.5% decrease from Q97-1. During Q98-1, 19,828 stock option grants were issued, totaling 28.9 million shares. Of this total, 28.2 million shares were dated in Q98-1,

with the balance dated in prior quarters due to overlapping window periods.

- Cumulative outstanding options on September 30, 1997 were 258.5 million with an average price of \$41.8871. Authorized but unissued options totaled 520.9 million.
- Under the ESPP program, a total of 151,595 shares for the period ending 6/30/97 were issued to 4,668 international employees at a purchase price of \$69.38 per share. Domestic ESPP is reported in even numbered quarters.

STOCK REPURCHASES

	Shares Adjusted for all Splits	Amount (millions)	Average Cost
FY90	7,141,500	\$47	\$6.53
FY91	21,879,000	197	8.99
FY92	7,919,310	135	17.04
FY93	12,514,000	250	19.98
FY94	17,278,000	348	20.12
FY95	23,338,000	698	29.89
FY96	27,000,000	1,384	51.26
FY97	37,025,000	3,101	83.75
Q98-1	8,133,781	1,082	132.98
LTD	162,228,591	\$7,240	\$44.63

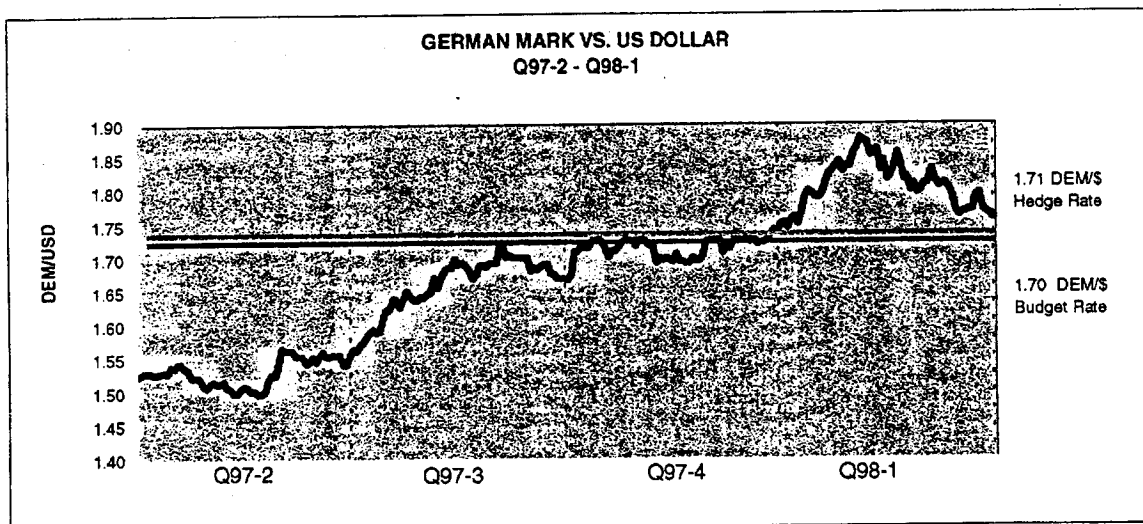
- During Q98-1, MS repurchased 8.1 million shares at an average cost of \$132.98. A total of 162.2 million shares have been purchased life-to-date at an average price of \$44.63.
- A large portion of the shares repurchased in Q98-1 were acquired in a block trade on September 16 via a structured deal. MS spent \$600 million to buy 5.8 million shares at an initial price of \$102.75, when MS was trading at \$131. The 21.6% discount allows MS to derive an economic benefit tantamount to an annual return of 7.8% on the

\$600 million over 5 years. The final price will be set within the next 5 years. Regardless of what the stock price does over the next 5 years, we are always economically better off under this structure when compared to investing the same money and buying shares in the future. The 21.6% discount is not reflected in the quoted average quarterly repurchase price. Rather, the \$132.89 average assumes MS paid \$131 for these 5.8 million shares. Including the discount would result in a quarterly average cost of \$112.31/share and a LTD cost of \$43.54/share.

PUT WARRANTS

- At quarter end, 23 million put options were outstanding, with a strikes ranging from \$123 to \$129 and maturities of 8 months to 2 years. During Q98-1, MS took in additional premium of \$280 million. Life-to-date program proceeds are now \$554 million, of which \$286 million represents put options that have expired or been closed out. Total put warrant authorization is now 50 million puts, with a maximum maturity of 2 years.
- This program has enhanced the buyback program by reducing the life-to-date stock buyback cost per share by \$3.41, from \$44.56 to \$41.15.
- The net share settlement feature of the put warrant contracts results in MS no longer being required to reflect a put warrant liability on the balance sheet. Without this contract settlement method, a liability of \$2.9 billion would have been required as a reclassification of retained earnings.
- MS did not sell any incremental cash-only settled puts in Q98-1. MS took in \$5.9 million in tax-free interest from this program in FY97.

FOREIGN EXCHANGE HEDGING



- The dollar remained strong against the Deutsche Mark during Q98-1. This domestic strength was driven by the combination of a strong economy and low inflation, together with continued monetary union uncertainty in Europe.
- MS realized a gain of \$14 million (net of the cost of the hedges) on the Q98-1 foreign currency-denominated net revenue hedges. This represents a return of 150% over the premium spent for the hedge contracts.
- Foreign currency put options were purchased systematically during FY97 to hedge the FY98 exposure of \$2.0 billion. During Q98-2, Treasury will begin layering in hedges for FY99. The total premium for unexpired FY98 hedges was \$30 million. The current value of these positions is \$49 million, representing a \$19 million mark-to-market gain.
- Treasury also has a continuing program to actively hedge MS's monthly exposure to foreign currency-denominated accounts receivable on a short-term rolling 30 day basis.

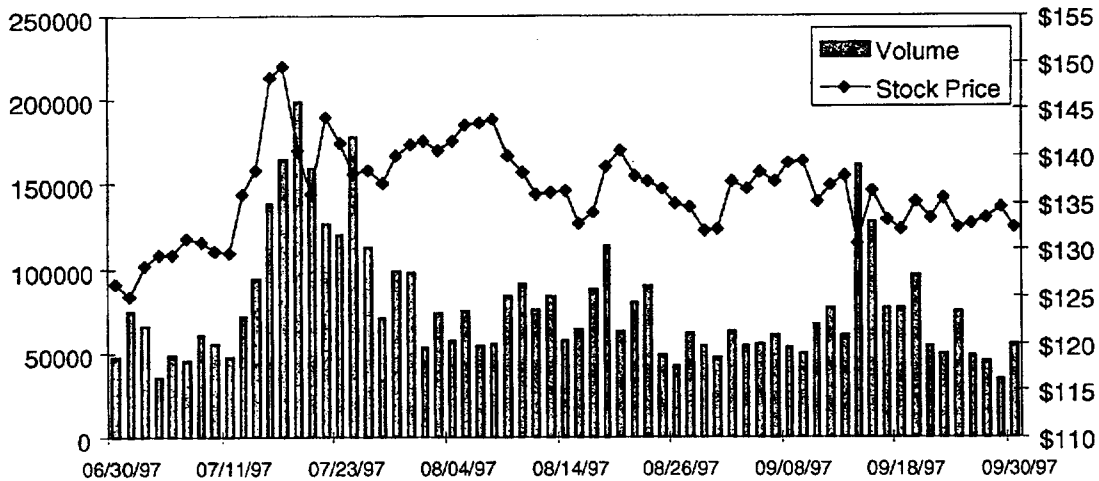
INVESTOR RELATIONS

MARKET OVERVIEW

- While the S&P 500 and the DJIA recorded modest growth of 6% and 3%, respectively, the Nasdaq composite rose 17% in the quarter.
- In a couple of high volume trading days, MSFT traded 19.3 million shares on October 20, the release date of Q98-1 earnings and the DOJ announcement, and 14.5 million shares the following day. MSFT closed up 3/8 to \$132 5/8 on the 20th after up \$3 per share in early trading and down \$4 3/4 a share following the DOJ announcement. On the 21st, MSFT closed up \$5 7/8 after beating consensus estimates by \$0.02 and providing optimistic guidance for Q98-2.
- MSFT experienced growth of 4.4% during the quarter, generally trading in a range between \$130 and \$145. Sun performed well this quarter with 28% growth, while Oracle and Netscape growth slowed to 12% and 2% respectively.

MICROSOFT COMMON STOCK

MSFT QUARTERLY STOCK PRICE AND VOLUME



MSFT ANALYST RATINGS

Firm	Analyst	Rating	Firm	Analyst	Rating
BT Alex Brown	Mary McCaffrey	Strong Buy	Montgomery Securities	David Readerman	Strong Buy
Cowen	Drew Brosseau	Strong Buy	Morgan Stanley	Mary Meeker	Buy
DMG	Michael Kwatinetz	Strong Buy	Paine Webber	Walter Winnitzski	Buy
Donaldson, Lufkin & Jenrette	Alex Kotylar	Buy	Piper Jaffray	Tom Berquist	Hold
First Boston	Esther Schreiber	Buy	Ragen MacKenzie	Scott McAdams	Buy
Furman Selz	Sanjiv Hingorani	Hold	Robertson, Stephens	Marshall Senk	Strong Buy
Goldman Sachs	Rick Sherlund	Buy	Salomon Brothers	Neil Herman	Buy
Hambrecht & Quist	Danny Rimer	Buy	UBS Securities	Jonathan Cohen	Strong Buy
Lehman Brothers	Michael Stanek	Strong Buy	William Blair	Laura Lederman	Buy
Merrill Lynch	Lucianne Painter	Strong Buy			

- There were no analyst upgrades or downgrades during the quarter.
- Jonathan Cohen, UBS Securities, initiated coverage with a Strong Buy and a 12-month target price of \$185, which is the highest target price among our analysts. Neil Herman initiated coverage at the Salomon Technology Conference with a Buy and a 12-month price target of \$160.
- In July Internet analyst and opinion leader, Bill Gurley, left Deutsche Morgan Grenfell to become a partner at Hummer Winblad & Co., a venture capital firm in San Francisco. Lise Buyer, an analyst who covered MS for T. Rowe Price, replaced him.
- Current consensus earnings per share estimates for FY98 are \$3.24, reflecting a 20% growth in revenue over FY97.

INSTITUTIONAL BUYERS AND SELLERS

Top 5 Buyers Q98-1				
Institution	Investment Style	Turnover Rate	Change Since June	September Position
Independent Investment Associates	Core Value	Mod	2,376,800	5,053,600
Lincoln Capital Management	Growth	Mod	1,626,500	5,126,700
Fidelity Management & Research	GARP	Mod	1,617,571	24,820,876
RCM Capital Management	Growth	Mod	823,408	4,699,000
Barclays Global Investors	Index	Low	580,000	31,105,000
Total			7,024,279	

Top 5 Sellers Q98-1				
Institution	Investment Style	Turnover Rate	Change Since June	September Position
W.P. Stewart & Co.	Growth	Mod	(792,727)	2,885,000
Morgan Stanley Asset Management Inc.	GARP	High	(570,000)	2,435,000
American Century Investment Mgmt.	Momentum	High	(565,000)	3,535,000
Montag & Caldwell Inc.	Growth	High	(561,467)	3,749,466
Texas Teachers' Retirement System	GARP	Mod	(535,000)	4,525,000
Total			(3,024,194)	

GARP (Growth at a Reasonable Price) - This style favors investments that will grow at a higher rate than the market average

- A trend toward a more neutral view regarding the stock price and the fairly tight trading range is evidenced in the Buy and Sell activity in the chart above.
- Lincoln began buying back into the stock in April, consistently adding to their position each month. Fidelity continued to add to their position. Internal analysts believe holdings of MS are underweighted relative to MS's weighting in the S&P.
- Continuing their trend from last quarter, WP Stewart took profits on MSFT at the height of the stock run. Recently it appears they are stabilizing their position.

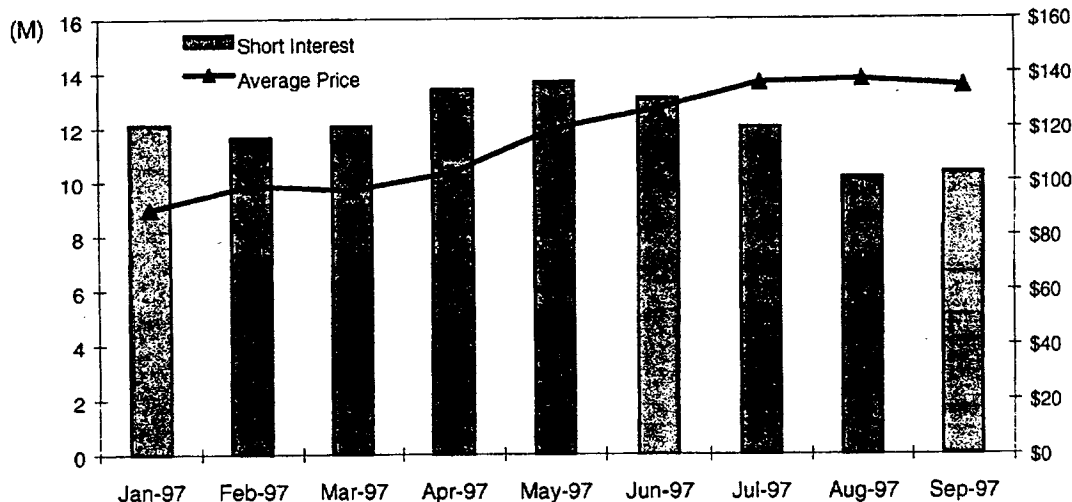
TOP INSTITUTIONAL HOLDERS

Top 15 Institutional Holders		Investment	Turnover	Change Since	September
Institution (Last Quarter's Rank)		Style	Rate	June	Position
1	Barclays Global Investors (1)	Index	Low	580,000	31,105,000
2	Fidelity Management & Research (2)	GARP	Mod	1,617,571	24,820,876
3	Alliance Capital Management L.P. (3)	Core Growth	Mod	100,000	15,724,609
4	Bankers Trust Company (4)	Index	Low	100,000	15,566,000
5	State Street Global Advisors (5)	Index	Low	325,000	12,635,000
6	Vanguard Group (6)	Index	Low	(48,761)	11,743,469
7	Provident Investment Counsel (7)	Growth	Mod	(250,000)	8,129,496
8	Mellon Bank (Private Asset Management) (8)	Index	Low	350,000	7,437,000
9	College Retirement Equities Fund (9)	Index	Low	(355,300)	7,305,200
10	New Jersey Division of Investment (10)	GARP	Low	375,000	6,875,000
11	California Public Employees' Retirement System (11)	Index	Low	0	6,019,400
12	Putnam Investment Management, Inc. (12)	Core Growth	Mod	3,237	5,853,237
13	Prudential Money Management Group (13)	Deep Value	Mod	0	5,590,278
14	Massachusetts Financial Services (15)	Core Growth	Mod	45,000	5,345,000
15	Northern Trust Company(14)	Core Growth	Low	(350,000)	5,135,000

GARP (Growth at a Reasonable Price) - This style favors investments that will grow at a higher rate than the market average.
 Core Growth - Investments favor blue chips that perform at or near the S&P Index.
 Deep Value - Contrarian investors, favoring stocks with low valuation and/or out of favor industries.

- A quiet quarter for most top institutional shareholders; only three of the eight non-Index funds added significantly to their position.
- MS's top 15 institutional shareholders remains steady, while owning 12.8% of the common shares and 37% of shares held by institutions.

SHORT POSITIONS



- Short position in MSFT is very modest compared to the broad market, down somewhat this quarter from last quarter (19% on average lower).
- Days to cover remained stable from quarter to quarter at about 1.5 days which is comparable with our competitors.

MSFTP MICROSOFT PREFERRED STOCK

Top 15 Institutional Holders		Investment	Turnover	Change Since	September
Institution (Last Quarter's Rank)		Style	Rate	June	Position
1	Federated Department Stores (1)	Corporate	Low	0	1,251,957
2	Intel Corp. (2)	Corporate	Moderate	0	1,250,000
3	GE Investment Management (3)	Core Growth	Low	(157,000)	755,000
4	Mackay Shields Financial (4)	GARP	Moderate	0	525,000
5	Suntrust Bank (5)	Core Growth	Moderate	27,000	438,000
6	Van Kampen American Capital (6)	Growth	High	0	264,000
7	TransAmerica Corp. (7)	Core Growth	Moderate	0	240,000
8	New York Life Insurance (21)	Core Growth	High	195,000	235,000
9	TCW Asset Management (9)	Growth	Moderate	0	200,000
10	Swiss Bank Corp. (22)	Growth	High	190,000	200,000
11	Hellman Jordan Management Co. (10)	GARP	High	0	195,000
12	National Life Investment Management (8)	Core Value	Low	(19,000)	191,000
13	Oppenheimer Funds (11)	GARP	Moderate	0	185,000
14	Oaktree Capital Management LLC (13)	Specialty	High	15,000	140,000
15	Firststar Management (14)	Core Growth	Moderate	(19,000)	129,000

- MS's Preferred Shares trade on NASDAQ under the symbol MSFTP. Originally issued at \$79.875 in mid-December, MSFTP rose 11/16 to close the quarter at 87 11/16.
- The third quarterly dividend was declared on August 19 for shareholders of record as of September 1. The \$0.549 per share quarterly

dividend was distributed to shareholders on September 15, for a total cash distribution of \$7 million.

- New York Life Insurance and Swiss Bank Corp. added substantially to their positions over the quarter.

INVESTOR RELATIONS SIGNIFICANT EVENTS

- Investor Relations hosted the annual Financial Analyst Meeting in conjunction with the Windows Platform Briefing on July 24. Bill Gates, Steve Ballmer, Paul Maritz, Bob Herbold, Pete Higgins, Mike Brown and Greg Maffei presented MS product strategy and financial information to a packed house.
- IR and executives presented at five conferences in September. Greg Maffei presented at the Salomon Technology conference; Laura Jennings presented at the Merrill Lynch Media Conference; Steve Ballmer presented at a Robinson-Humphries/Computer Reseller News conference; Bob McDowell presented at both Cowen's Technology Conference and Montgomery's Investment Conference.
- Nearly a million copies of the 1997 Annual Report were printed and distributed to shareholders. Simultaneously, a new and updated on-line version went live on the MSFT website. We are showcasing analysis tools on the Annual Report Website which allow investor access to historical numbers and ratios. <http://www.microsoft.com/msft/ar97/default.htm>
- In a first within the IR profession, all MS employee shareholders were allowed to vote their proxies on-line through the use of MS technology. The day following the electronic publication of the proxy, more employees voted than historically have during the entire proxy period.

Industry Watch

COMPETITOR HIGHLIGHTS

(Prices as of November 4, 1997)

ORACLE (\$36 11/16)

- Once again, first quarter revenue fell short of analyst expectations. August quarter revenue of \$1.37 billion (30% growth) was below analyst expectations of \$1.4 billion. However, earnings grew 33% to \$149.8 million, or 15 cents a share, excluding special acquisition charges, meeting expectations. Database software grew just 6% from the year-earlier period, compared with analysts' expectations of about 20% growth as the company began a transition to its new database product, Oracle8. Some analysts believe the database industry's growth will slow as the market matures, and profitability will decline as Microsoft and others force prices down. However, application programs grew 96% above the 1996 period, compared with analysts' projections for about a 75% increase.
- The August earnings announcement, combined with a downgrade by two analysts, caused the stock price to fall 9% to \$36 1/16 the day after the announcement.
- Oracle disclosed plans to integrate television programming with information from the World Wide Web. Entering the "enhanced television" market, Oracle will compete with Microsoft's WebTV. Oracle's new approach involves retrieving information from Web sites using vertical blanking interval, a space between TV signals that can be adapted for sending data. But that transmission technique will require Oracle to sign deals with broadcasters, and it hasn't announced any to date.
- Inso Corp announced that Oracle has licensed Inso's Outside In HTML Export 1.0 for integration in Oracle's new Oracle InterOffice database messaging software. HTML Export will enable Oracle InterOffice to automatically convert proprietary document formats into HTML.

SUN MICROSYSTEMS (\$36 7/8)

- Sun's September quarter revenue was \$2.1 billion, up 13% over a year ago. Earnings per share, excluding one-time charges related to acquisitions, was \$0.41, versus consensus estimates of \$0.44. Revenue growth of 13% was below expectations of 21% due to foreign exchange impacts, a soft European market, and a strong year ago quarter, which launched a new product line. Sun traded down \$4 down the day following the announcement. One-time charges for the acquisitions of Diba, Inc. and Integrity Arts, Inc amounted to \$0.27 per share
- Sun filed a lawsuit against MS's use of Java technology. Although previously undisclosed, the contracts signed in March of 1996 were publicly released with agreement from both companies. Sun commented with "we believe the contracts will speak for themselves." On October 27, MS filed a countersuit against Sun for breach of contract, breach of "the covenant of good faith and fair dealing," and unfair competition.
- U.S. representatives to an international-standards body voted against Sun's application to become a "publicly available specification submitter" for the Java Internet-programming language. Sun has received six votes for its application and one against. Twenty countries have not yet voted. In July, the International Standards Organization (ISO) turned down Sun's preliminary proposal for Java to become an official standard. The company had until September 24 to address comments and modify its proposal, and representatives have until November 14 to vote once again. Sun is reluctant to turn its Java programming language over to an international standards board in response to a letter from Microsoft, Intel, Compaq, and Digital. Later, Sun lashed out and contended that Microsoft was trying to cripple Java because it was a threat to the popularity of Microsoft's Windows software.
- In an expansion effort, Sun created an Embedded Systems Software Group and entered into an agreement to acquire the assets of Chorus Systems, a supplier of operating systems for telecommunications networks and intelligent devices. The new business group will produce open system software solutions for the embedded market. These announcements and the recent acquisitions of Diba, a developer of appliance-style products to help consumers access the Internet, and Integrity Arts, a developer of operating system technologies for smart cards using Java, are centered around Sun's plans to provide solutions for non-traditional computing environments.
- GlobeSet and Sun announced a two-year joint marketing agreement in which GlobeSet will offer a line of secure electronic transactions (SET)

based solutions for the Sun Solaris platform. Sun will provide engineering expertise to GlobeSet. The SET protocol includes key backers like IBM, Microsoft, Netscape, GTE, and others.

- At the Financial Technology Expo, Sun demonstrated web-based solutions for financial services organizations. Sun highlighted applications and services from third-party vendors,

IBM (\$101 15/16)

- IBM's September quarterly earnings were \$1.38 per share, above last year's quarter of \$1.23. However, the company's tax rate was 31.5% in the third quarter compared with 35.1% in the prior year quarter. Earnings before taxes were essentially flat year over year. Revenue increased 3% year over year to \$18.6 billion. Service revenue increased 20% year over year, but hardware sales were flat year at \$8.3 billion and software revenue actually declined 2%. IBM's stock soared \$10 1/4 to \$85 after the company announced a \$3.5 million stock buyback on October 28, but the company said it has no current plans to increase its ongoing share buyback program. Two analysts upgraded IBM during the quarter.
- IBM agreed to acquire Unison Software Inc. for approximately \$182 million to enhance the company's "systems-management" software, which provides companies the ability to centrally manage computer networks. IBM's Tivoli subsidiary competes with Computer Associates in "systems-management" software market for corporations. Unison, which reported revenue of \$40 million, sells software that allows companies to manage the distribution of work across a vast computer network, handle payroll and inventory systems, control paper flow and document printing, and manage storage of critical data.
- Just three months after demonstrating a prototype, IBM decided it will not sell NetPCs, stripped-down desktop machines, citing lack of customer demand. The NetPC uses an Intel microprocessor and its own Microsoft operating system. Compaq, HP and others are still expected to release their NetPCs in

which provide solutions for the banking capital markets and insurance industries.

- Sun announced a new server line to run Solaris for Intranets (codenamed Tasmio) and intended to compete with PC servers and Windows NT Server. The server is high-priced at \$15,000-\$20,000, versus Compaq's Proliant 6000 at \$12,000, and does not present much over existing solutions.

coming months. Apple also plans to introduce a version of network computers that run Macintosh software in January.

- In a move to try and create an industry standard, IBM will offer competitors the software its uses to link network stations to servers. A new model of IBM's network station, which uses code written in Java, is slated for release later this year.
- Lotus shipped cc:Mail Release 8.1, featuring stronger Internet connectivity to Domino and Notes messaging products, and Domino Intranet Starter Pack for web collaboration for small and mid-sized businesses.
- Lotus's eSuite, former code-named Kona, a Java-based software to be released in January, will also incorporate a new Webtop user interface for the NC market. The Kona strategy was originally a set of applets and a development kit for use on a NC.
- ViaVoice Chinese, a Chinese speech recognition system, was launched in September. It is said to be able to input about 150 Chinese spoken characters a minute and recognize an average of 95% of them. IBM executives acknowledged ViaVoice Chinese has trouble picking up some non-standard Mandarin words. Some native speakers complained the system didn't recognize half of what they said. The system now sold in China is bundled with personal computers, which retail for about \$2,000. IBM plans to put the software on China's retail shelves at a later date, but copyright and patent piracy is a concern.

NOVELL (\$8 3/8)

- In a continuing battle to reduce excess inventory and restructure its business, Novell announced a large July quarter loss of \$121.7 million. Shipments decreased 75% to \$90.1 million, while Novell's channel inventory was worked. Analysts noted the lack of upgrades from NetWare to IntranetWare as customers wait for the next version of NetWare (Moab) due to ship in 1H98.
- Novonyx, a joint venture between Novell and Netscape, plans to ship three of Netscape's Internet servers for use on NetWare 4.0 by the end of the year. The servers would allow companies to set up intranets or networks based on Internet standards. Novell hopes that the availability of Netscape's servers will encourage customers to upgrade to NetWare 4.0.
- Rumors swirled again that IBM is interested in buying Novell. If the acquisition panned out, IBM could enhance its network services offerings while Novell could obtain solid financial footing. The rumors sent the stock trading as high as \$10.50 and later closed at \$9 31/32, up 31/32 or 10.76 %.
- Groupwise 5.2, the latest version of Novell's collaboration product for corporate networks and intranets, shipped in mid-September. GroupWise provides a gateway for Microsoft Mail allowing users to exchange messages. The company also announced the availability of ActiveX Controls for developers.

NETSCAPE (\$32 15/16)

- Netscape reported quarterly earnings per share of \$0.13 for the September quarter versus a consensus estimate of \$0.12. Revenue of \$150 million, growth of 50% over a year ago also exceeded consensus with server revenue up 100% and client revenue down 4%.
- In an effort to keep up with Microsoft, Netscape plans to demonstrate a new technology, code-named Aurora, which can integrate personal computer files, e-mail and new "channels" automatically to subscribers over the Internet. Last year, Netscape made many of the same claims for a product then code-named Constellation, but the features were not included in the subsequent release of Communicator. The announcement coincided with Microsoft's launch of IE 4.0.
- Novell and Oracle selected Netscape Navigator client software as their preferred browser. Both companies will include Netscape Navigator with selected desktop and network computer hardware and software platforms and products.
- Three new bundles were announced Labor Day weekend including Netscape Communicator Internet Access edition for retail users; Netscape Communicator Deluxe edition for power users; and Netscape Publishing Suite for Web site creation. In addition, Netscape announced a retail-marketing program with several super stores in order to address the retail customer.
- FastTrack Server 3.0 software, the next generation of Web server software for individuals and small workgroups, was released for download and beta testing. OEM customers, including Digital, HP, NCR, Silicon Graphics, and others, set the software with their hardware solutions.

COREL (\$3 3/32)

- Corel posted a loss for its August quarter of \$0.52 a share, two cents below the First Call estimate and versus a year-ago loss of \$0.05 a share. Corel also indicated its November quarter results would be "materially less" than analysts' estimates causing Midland Walwyn to downgrade the company from "reduce" to "sell". Corel's revenue of \$56 million, versus an analyst consensus estimate of \$125 million, was net of a \$40 million channel inventory reserve, primarily for WordPerfect Suite 8, which was released during the quarter.
- Corel is re-examining its Java strategy after scrapping plans to sell Corel Office for Java, which was expected to be the first application christened "100 Percent Pure Java" by Sun. Corel claims it is not retreating from Java rather that it will spend up to 50% of its C\$80 million annual research and development budget on Java. Analysts remain confused about the implications of Corel's new strategy.
- As part of its new Java strategy, Corel is developing two new products. CorelCentral, the successor to Corel Office for Java, is a family of products for network computers built around the web-browser design. Remagen, also referred to as WordPerfect Enterprise, is "bridging" technology

that allows servers to distribute Windows programs to Java-capable network computers.

- Corel WordPerfect Suite 8 Professional appeared on store shelves in mid-September. The suite contains CorelCentral 8, which provides calendaring and scheduling capabilities as well as integration with Netscape Communicator.
- Corel Computer Corp., a separate unit of Corel, says it will be ready to unveil its network computer hardware by October, with general availability by November or December.

CONSORTIUM

- Oracle, Sun, and IBM with Lotus announced plans to develop an open Internet standard for network computing. A team of software developers from each company will create this desktop standard with an environment to build and deploy applications for Java-based network computers.
- IBM, Netscape, and Sun announced the Java Porting and Tuning Center, where they will work to speed Java performance and ensure timely,

- Corel shares advanced to C\$8.90, or approximately 9%, over three days in mid-August as RBC Dominion Securities Inc. rated Corel a "buy" with a 12-month price target of C\$12.00.
- Corel launched CorelDraw 8, a graphics and image-editing suite for Windows 95 and NT operating systems.

consistent distribution of Java implementations to the industry.

- Netscape and Sun unveiled plans for a 100% Pure Java version of Netscape Navigator in early 1998. As part of that announcement, Sun revealed plans to include Netscape's HTML component with the JDK and to standardize on the 100% Pure Java version of Navigator expected in Q1-98.

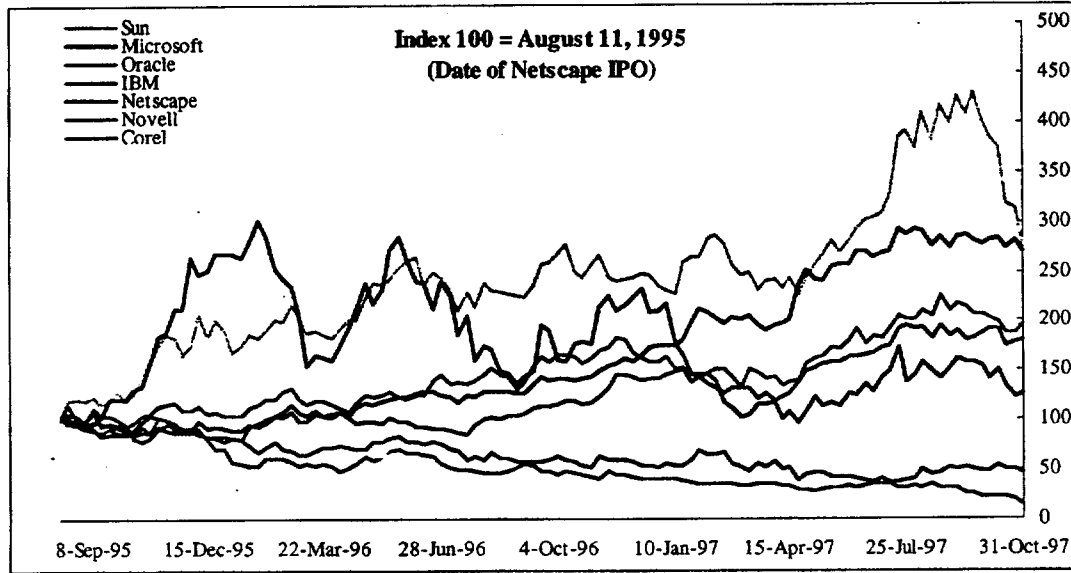
OTHERS

- The FTC has launched another inquiry into Intel's practices in the PC chip industry. The investigation follows allegations that Intel was bullying customers and competitors through its licensing practices and by threatening to limit customers' supplies of chips, or their access to key technical information needed to keep pace with new generations of chips. Intel was accused of selectively allocating new chips to favored customers, and tying the sale of one product to others.
- WorldCom announced it would acquire CompuServe in a stock for stock transaction valued at the time of the announcement at approximately \$1.2 billion. WorldCom will retain CompuServe's 1,200 corporate customers but will give America Online \$175 million in cash and CompuServe's 3 million consumer customers in exchange for AOL's high-speed Internet access division, ANS Communications. WorldCom and AOL also entered into a five-year plan for AOL to lease much of its infrastructure needs from WorldCom while AOL's chairman, Steve Case, obtains a seat on WorldCom's board.
- Broderbund Software completed its acquisition of Intuit's Parsons Technology unit for \$30 million in early August. Intuit will retain Parsons' line of tax preparation software.

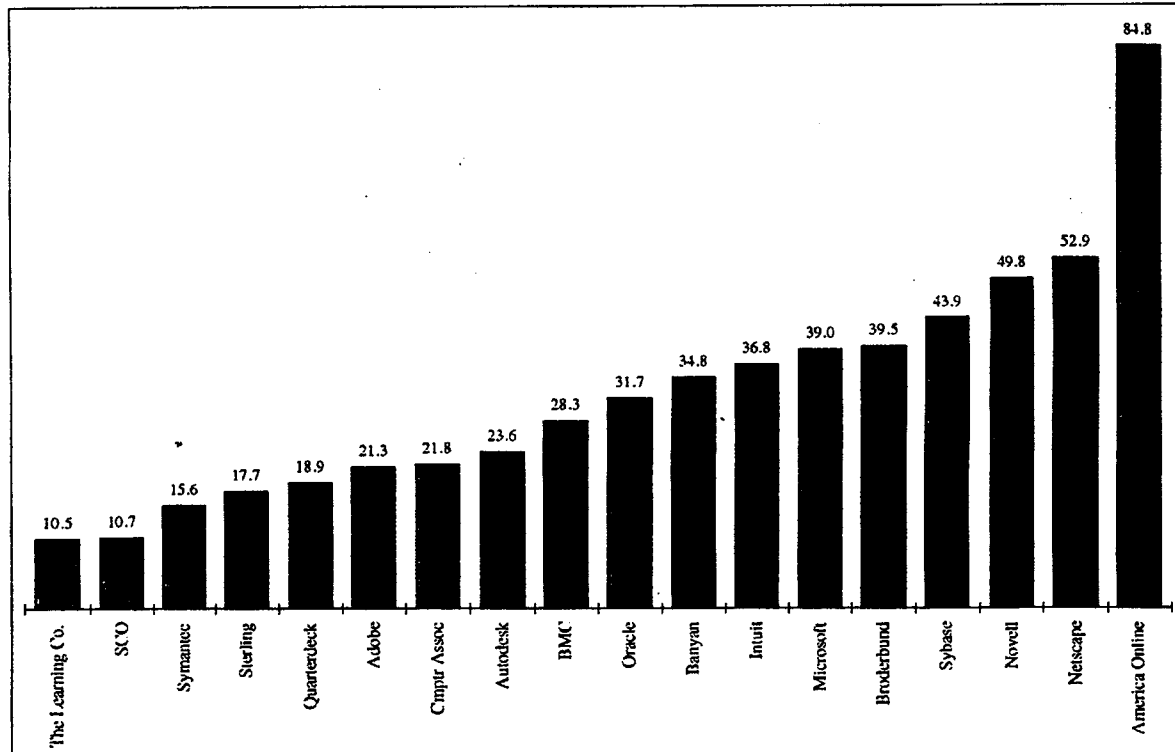
- Informix reported a second quarter loss of \$121 million, or 79 cents a share, versus a projected 25 cents a share loss by First Call analysts. Losses included a restructuring charge of \$62 million and plans for additional layoffs of 10% to 15%. The company faces criticism regarding accounting practices of revenue recognition and will restate 1996 and 1995 earnings downward due to revenue-statement errors. After noting that Informix was the best-performing software stock between 1990 and 1995, one analyst commented that Informix is struggling to produce a business model for the rest of the year. Informix shares closed at \$10.31, down 37.5 cents, well below its high last year of \$35.
- Digital agreed to sell its semiconductor production operations to Intel for \$700 million. Digital will withdraw its patent infringement litigation against Intel. The agreement provides for a ten-year cross licensing of Alpha architecture elements to Intel and Intel guarantees Digital a supply of both Intel architecture and Alpha processors.
- NEC will launch a new line of PCs, PC 98-NEX Series, in October based on hardware specifications established by Microsoft and Intel. The line is not expected to replace PCs in the 9800 series based on its proprietary architecture, but rather will meet the demand for PCs with the new global standards and will be able to operate Windows 98.

INDUSTRY REVIEW

KEY COMPETITOR STOCK PRICES



SOFTWARE FORWARD P/E RATIOS



a) Forward P/E ratios are calculated based upon September 30, 1997 stock prices and analyst's consensus estimates for the next four quarters.

SOFTWARE COMPANIES

(in millions)	AMERICA				
	Adobe	Online	Autodesk	BMC	Banyan
	8/29/97	6/30/97	7/31/97	9/30/97	9/30/97
Income statement					
Most recent quarter					
Revenue	\$230	\$476	\$154	\$163	\$19
Net income (loss)	53 (a)	(12) (c)	18	45	1 (g)
EPS	0.72	(0.12)	0.34	0.41	0.04
Trailing twelve months					
Revenue	\$892	\$1,691	\$505	\$632	\$73
Net income (loss)	208 (b)	(518) (d)	(23) (e)	136 (f)	(46) (h)
EPS	2.80	(5.18)	(0.48)	1.26	(2.66)
Net income (loss) as a % of net revenue	23%	(31%)	(5%)	22%	(63%)
Balance sheet					
Cash	\$687	\$125	\$225	\$105	\$11
Other current assets	166	196	147	117	16
Other assets	253	509	206	677	12
	<u>\$1,106</u>	<u>\$830</u>	<u>\$578</u>	<u>\$899</u>	<u>\$39</u>
Liabilities	\$234	\$718	\$224	\$325	\$37
Put Warrants	0	0	65	0	0
Equity	872	112	289	574	2
	<u>\$1,106</u>	<u>\$830</u>	<u>\$578</u>	<u>\$899</u>	<u>\$39</u>
Other data					
Closing stock price (September 30, 1997)	\$50.38	\$75.47	\$45.38	\$64.75	\$2.44
Common shares outstanding	75	99	52	108	18
Market value	\$3,778	\$7,471	\$2,360	\$6,993	\$44
Price/revenue ratio	4.2x	4.4x	4.7x	11.1x	0.6x
Price/earnings ratio - trailing twelve	18.0x	n/m	n/m	51.5x	n/m
Price/earnings ratio - future 4 qtrs.	21.3x	84.8x	23.6x	28.3x	34.8x
Headcount (most recent disclosure)	2,266	6,000	2,044	1,813	646
Revenue/employee (in thousands)	\$394	\$282	\$247	\$348	\$113
Book value per share	\$11.63	\$1.13	\$5.56	\$5.31	\$0.11
Price/book value ratio	4.3x	66.7x	8.2x	12.2x	21.9x
Growth statistics (over comparable quarter):					
Revenue	27%	42%	20%	29%	(33%)
Research and development	19%	20%	33%	17%	(34%)
Sales and marketing	29%	45%	16%	31%	(42%)
General and administrative	27%	57%	13%	14%	(41%)
Net income	79% (c)	(174%) (d)	68% (e)	28%	198%

- a) Adobe's current quarter included \$26 million gain on an investment.
b) Adobe's trailing 12 months included \$126 million for purchased R&D write-offs and a \$59 million gain on the sale of venture investments, including Netscape.
c) AOL's current quarter included goodwill amortization of \$2 million and a contract termination charge of \$25 million.
d) AOL's trailing 12 months included charges of \$385 million to write-off capitalized marketing expenses, \$74 million for restructuring, and \$24 million for estimated credits and refunds to customers as agreed to with various State Attorneys General.
e) Autodesk's trailing 12 months included a \$55 million charge for acquired R&D relating to its acquisition of Softdesk.
f) BMC's trailing 12 months included \$60 million of acquired R&D development costs.
g) Banyan recorded a pre-tax charge of \$10 million for severance costs and facility and product line consolidations.
h) Banyan's trailing 12 months included charges of \$0.32 per share for workforce reductions and \$0.47 per share for the write-off of deferred tax assets.

SOFTWARE COMPANIES - CONTINUED

(in millions)	Computer					
	Borland	Broderbund	CompuServe	Assoc	Corel	Electronic Arts
	9/30/97	8/31/97	7/31/97	9/30/97	8/31/97	9/30/97
Income statement						
Most recent quarter						
Revenue	\$43	\$46	\$206	\$1,122	\$56	\$190
Net income (loss)	2	(19) (c)	(4)	272	(31)	0 (h)
EPS	0.03	(0.91)	(0.04)	0.72	(0.47)	0.00
Trailing twelve months						
Revenue	\$158	\$191	\$839	\$4,271	\$375	\$722
Net income (loss)	(70) (a)	(13) (d)	(94) (e)	451 (f)	(130) (g)	49
EPS	(1.88)	(0.65)	(1.02)	1.21	(1.84)	0.86
Net income (loss) as a % of net revenue	(44%)	(7%)	(11%)	11%	(35%)	7%
Balance sheet						
Cash	\$83	\$94	\$168	\$189	\$22	\$250
Other current assets	30	41	221	1,374	124	196
Other assets	110	52	398	4,316	102	159
	<u>\$223</u>	<u>\$187</u>	<u>\$787</u>	<u>\$5,879</u>	<u>\$248</u>	<u>\$605</u>
Liabilities	\$98	\$39	\$141	\$4,231	\$88	\$149
Equity	125 (b)	148	646	1,648	159	456
	<u>\$223</u>	<u>\$187</u>	<u>\$787</u>	<u>\$5,879</u>	<u>\$248</u>	<u>\$605</u>
Other data						
Closing stock price (September 30, 1997)	\$10.13	\$34.00	\$13.75	\$71.81	\$3.88	\$8.31
Common shares outstanding	39	21	93	379	67	61
Market value	\$395	\$714	\$1,279	\$27,217	\$260	\$507
Price/revenue ratio	2.5x	3.7x	1.5x	6.4x	0.7x	0.7x
Price/earnings ratio - trailing twelve	n/m	n/m	n/m	59.5x	n/m	9.7x
Price/earnings ratio - future 4 qtrs.	n/m	39.5x	n/m	21.8x	n/m	n/m
Headcount (most recent disclosure)	700	638	3,650	10,000	1,218	1,700
Revenue/employee (in thousands)	\$226	\$299	\$230	\$427	\$308	\$425
Book value per share	\$3.21	\$7.05	\$6.95	\$4.35	\$2.38	\$7.48
Price/book value ratio	3.2x	4.8x	2.0x	16.5x	1.6x	1.1x
Growth statistics (over comparable quarter):						
Revenue	17%	42%	(1%)	13%	(34%)	47%
Research and development	(25%)	112%	(17%)	(100%)	14%	26%
Sales and marketing	(11%)	156%	45%	(100%)	2%	50%
General and administrative	n/a	52%	57%	n/a	35%	14%
Net income	115%	(353%) (c)	86%	22%	(881%)	(99%) (h)

- a) Borland's trailing 12 months included \$35 million in restructuring charges and acquisition costs related to Open Environment.
- b) Borland obtained \$25 million in a privately placed financing of mandatorily redeemable convertible preferred stock.
- c) Broderbund's current quarter included \$24 million of charges for in-process technology and restructuring.
- d) Broderbund's trailing 12 months included \$27 million of charges associated with acquisitions of purchased technology and restructuring and a \$37 million write-off for in-process technology related to its T/Maker and Living Books acquisitions.
- e) CompuServe's trailing 12 months included a \$0.06 per share charge for the consolidation of facilities and the sale or write-down of certain equity investments, a \$45 million charge for a change in its deferred subscriber acquisition costs amortization period, an \$8 million charge for the termination of its WOW! online service, an \$18 million charge for the disposition of Spry, and \$9 million in restructuring charges.
- f) Computer Associates trailing 12 months included a \$598 million, or \$1.61 per share, acquired R&D charge relating to Cheyenne Software.
- g) Corel's trailing 12 months included a \$114 million write-down, or \$1.55 per share, of previously capitalized technologies, primarily WordPerfect.
- h) Electronic Arts' current quarter included \$11 million of merger costs and restructuring expenses associated with the acquisition of Maxis, Inc.

SOFTWARE COMPANIES - CONTINUED

<i>(in millions)</i>	The Learning Company				
	Intuit 7/31/97	Company 9/30/97	Microsoft 9/30/97	Netscape 9/30/97	Novell 7/31/97
Income statement					
Most recent quarter					
Revenue	\$94	\$96	\$3,130	\$100	\$90
Net income (loss)	(20)	(98)	663 (e)	8	(122) (g)
EPS	(0.42) (a)	(1.98) (c)	0.50	0.09	(0.35)
Trailing twelve months					
Revenue	\$599	\$363	\$12,193	\$471	\$1,122
Net income (loss)	68 (b)	(399)	3,503	(19) (f)	(26)
EPS	1.46	(8.53) (d)	2.65	(0.22)	(0.08)
Net income (loss) as a % of net revenue	11%	(110%)	29%	(4%)	(2%)
Balance sheet					
Cash	\$431	\$97	\$9,634	\$201	\$1,056
Other current assets	59	129	1,204	147	397
Other assets	174	215	4,528	189	435
	<u>\$664</u>	<u>\$441</u>	<u>\$15,366</u>	<u>\$537</u>	<u>\$1,888</u>
Liabilities	\$249	\$643	\$3,901	\$146	\$334
Equity	<u>415</u>	<u>(202)</u>	<u>11,465</u>	<u>391</u>	<u>1,554</u>
	<u>\$664</u>	<u>\$441</u>	<u>\$15,366</u>	<u>\$537</u>	<u>\$1,888</u>
Other data					
Closing stock price (September 30, 1997)	\$32.00	\$14.97	\$132.31	\$36.00	\$8.97
Common shares outstanding	47	49	1,333	88	349
Market value	\$1,504	\$733	\$176,373	\$3,168	\$3,130
Price/revenue ratio	2.5x	2.0x	14.5x	6.7x	2.8x
Price/earnings ratio - trailing twelve	22.0x	n/m	49.9x	n/m	n/m
Price/earnings ratio - future 4 qtrs.	36.8x	10.5x	39.0x	52.9x	49.8x
Headcount (most recent disclosure)	3,000	990	23,811	1,811	4,800
Revenue/employee (in thousands)	\$200	\$367	\$512	\$260	\$234
Book value per share	\$8.83	\$(4.12)	\$8.60	\$4.44	\$4.45
Price/book value ratio	3.6x	(3.6)x	15.4x	8.1x	2.0x
Growth statistics (over comparable quarter):					
Revenue	3%	7%	36%	0%	(75%)
Research and development	(10%)	(5%)	31%	0%	15%
Sales and marketing	0%	14%	26%	0%	(22%)
General and administrative	9%	(2%)	10%	0%	(2%)
Net income	10% (a)	(5%) (c)	8% (e)	0% (g,h)	(307%) (g)

a) Intuit's current quarter included \$16 million of acquisition and restructuring charges.

b) Intuit's trailing 12 months included a \$0.15 per share acquired R&D charge in the Nihon Micom acquisition.

c) The Learning Company's (formerly SoftKey) current quarter included a \$127 million charge relating to the acquisitions of The Learning Company, Minnesota Educational Computing Corporation (MECC), and Compton's New Media.

d) The Learning Company's trailing 12 months included charges of \$502 million related to above-mentioned acquisitions.

e) Microsoft's current quarter included a \$296 million charge for acquired in-process technology from WebTV.

f) Netscape's trailing 12 months included \$53 million, or \$0.59 per share, in charges for in-process R&D for the acquisitions of DigitalStyle and Portola Communications.

g) Novell's current quarter included \$55 million of restructuring charges.

SOFTWARE COMPANIES - CONTINUED

(in millions)	Software Companies					
	Oracle	Quarterdeck	SouthCom	Sterling	Subsys	Sybase
	8/31/97	6/30/97	9/30/97	6/30/97	9/30/97	9/30/97
Income statement						
Most recent quarter						
Revenue	\$1,369	\$21	\$52	\$114	\$244	\$139
Net income (loss)	40 (a)	1	5	(185) (g)	5	21
EPS	0.04	0.02	0.12 (e)	(4.81)	0.07	0.35
Trailing twelve months						
Revenue	\$6,001	\$88	\$194	\$444	\$992	\$528
Net income (loss)	749	(55) (d)	(15) (f)	(122) (b)	18 (g)	61 (h)
EPS	0.74 (b)	(1.37)	(0.41)	(3.19)	0.23	1.07
Net income (loss) as a % of net revenue	12%	(62%)	(8%)	(28%)	2%	12%
Balance sheet						
Cash	\$1,488	\$11	\$52	\$617	\$199	\$36
Other current assets	1,647	16	50	177	248	0
Other assets	1,462	29	45	245	304	0
	<u>\$4,597</u>	<u>\$56</u>	<u>\$147</u>	<u>\$1,039</u>	<u>\$751</u>	<u>\$36</u>
Liabilities	\$2,120	\$51	\$66	\$317	\$327	\$36
Equity	2,477	5	81	722	424	0
	<u>\$4,597</u>	<u>\$56</u>	<u>\$147</u>	<u>\$1,039</u>	<u>\$751</u>	<u>\$36</u>
Other data						
Closing stock price (September 30, 1997)	\$36.44	\$3.03	\$5.56	\$35.88	\$18.00	\$22.75
Common shares outstanding	1,006 (c)	47	37	39	80	59
Market value	\$36,656	\$142	\$206	\$1,399	\$1,440	\$1,342
Price ratios						
Price/revenue ratio	6.1x	1.6x	1.1x	3.1x	1.5x	2.5x
Price/earnings ratio - trailing twelve	49.0x	n/m	n/m	n/m	77.9x	21.3x
Price/earnings ratio - future 4 qtrs.	34.8x	18.9x	10.7x	17.7x	43.9x	15.6x
Headcount and Revenue/employee						
Headcount (most recent disclosure)	25,000	600	1,188	3,300	5,484	2,000
Revenue/employee (in thousands)	\$240	\$147	\$163	\$135	\$181	\$264
Book value and Price/book value ratio						
Book value per share	\$2.46	\$0.11	\$2.19	\$18.51	\$5.30	\$0.00
Price/book value ratio	14.8x	28.5x	2.5x	1.9x	3.4x	n/m
Growth statistics (over comparable quarter):						
Revenue	30%	31% (e)	(6%)	(34%)	(2%)	27%
Research and development	36%	(30%)	(2%)	(49%)	(14%)	13%
Sales and marketing	25%	(58%)	(12%)	(38%)	(4%)	16%
General and administrative	7%	(60%)	(19%)	n/a	(10%)	15%
Net income	(64%) (a)	105%	11%	(731%) (g)	110%	2233%

- a) Oracle's current quarter included a write-off for in-process technology for the Treasury Services Corp (\$92 million) and Navio (\$76 million) and \$26 million of minority interest due to the merger.
- b) Oracle's trailing 12 months included \$37 million, or \$0.04 per share, in acquisition charges related to Datalogix.
- c) Oracle stock split 3-for-2 stock on August 1st.
- d) Quarterdeck's trailing 12 months included non-recurring charges of \$29 million for acquisitions and restructuring charges.
- e) Quarterdeck's revenue growth from the prior year was due to the absence of high returns reserves a year ago.
- f) SCO's trailing 12 months suffered from \$23 million of channel inventory reductions and a restructuring charge of \$8 million.
- g) Sterling's current quarter included a \$244 million charge for the purchased R&D and restructuring charges associated with the acquisition of Texas Instruments software division.
- h) Sterling's trailing 12 months included a \$12 million gain, net of tax, from discontinued operations.

HARDWARE COMPANIES

(in millions)	Apple	Cisco	Compaq	Dell	Digital
Income statement	9/26/97	10/25/97	9/30/97	8/3/97	9/30/97
Most recent quarter					
Revenue	\$1,614	\$1,869	\$6,474	\$2,814	\$2,960
Net income (loss)	(161) (a)	337 (c)	517	214	16
EPS	(1.26)	0.48	0.66 (e)	0.59	0.11
Trailing twelve months					
Revenue	\$7,081	\$6,874	\$21,713	\$9,833	\$13,096
Net income (loss)	(1,045) (b)	1,437 (d)	1,580 (f)	745	196
EPS	(8.29)	2.07	3.85	2.01	1.28
Net income (loss) as a % of net revenue	(15%)	21%	7%	8%	1%
Balance sheet					
Cash	\$1,459	\$1,827	\$5,958	\$1,515	\$2,353
Other current assets	1,965	1,776	5,948	1,737	4,505
Other assets	809	2,572	2,437	300	2,372
	<u>\$4,233</u>	<u>\$6,175</u>	<u>\$14,343</u>	<u>\$3,552</u>	<u>\$9,230</u>
Liabilities	\$3,033	\$1,372	\$5,775	\$2,340	\$5,815
Put Warrants	0	0	0	85	0
Equity	1,200	4,803	8,568 (g)	1,127	3,415
	<u>\$4,233</u>	<u>\$6,175</u>	<u>\$14,343</u>	<u>\$3,552</u>	<u>\$9,230</u>
Other data					
Closing stock price (September 30, 1997)	\$21.69	\$73.06	\$74.75	\$96.88	\$43.31
Common shares outstanding	128	704	789	364	151
Market value	\$2,776	\$51,436	\$58,978	\$35,263	\$6,540
Price/revenue ratio	0.4x	7.5x	2.7x	3.6x	0.5x
Price/earnings ratio - trailing twelve	n/m	35.3x	19.4x	48.3x	33.9x
Price/earnings ratio - future 4 qtrs.	n/m	28.0x	23.4x	33.4x	15.5x
Headcount (most recent disclosure)	10,896	8,782	18,900	13,300	55,100
Revenue/employee (in thousands)	\$650	\$783	\$1,149	\$739	\$238
Book value per share	\$9.38	\$6.82	\$10.86	\$3.10	\$22.62
Price/book value ratio	2.3x	10.7x	6.9x	n/m	1.9x
Growth statistics (over comparable quarter):					
Revenue	(30%)	30%	44%	67%	2%
Research and development	(36%)	55%	103%	71%	3%
Sales and marketing	(28%)	29%	68%	44%	(3%)
General and administrative	n/a	35%	n/a	n/a	n/a
Net income	(744%) (a)	86% (c)	48% (e)	108%	122%

a) Apple's current quarter included \$137 million charge for termination of license agreement and restructuring.

b) Apple's trailing 12 months included a \$375 million in-process R&D charge relating to its NeXT acquisition and restructuring charges of \$127 million.

c) Cisco's current quarter included a \$127 million acquired in-process R&D charge from the acquisition of DAGAZ Technologies.

d) Cisco's trailing 12 months included a \$0.03 gain on the sale of minority stock investment, a \$217 million in charges for acquired in-process R&D relating to NETSYS and Telebit, and \$135 million from the sales of minority stock investments.

e) Compaq current quarter includes \$44 million of merger related costs.

f) Compaq's trailing 12 months included a \$208 million, or \$0.73 per share, charge for acquired in-process technology in connection with the Microcom acquisition.

g) Compaq acquired Tandem Computers in a stock transaction.

HARDWARE COMPANIES - CONTINUED

(in millions)	Hewlett Packard		IBM	Intel	Silicon Graphics	
	Gateway	Pk Card			Sun	
	9/30/97	7/31/97	9/30/97	9/27/97	9/30/97	9/30/97
Income statement						
Most recent quarter						
Revenue	\$1,505	\$10,471	\$18,605	\$6,155	\$768	\$2,099
Net income (loss)	(107) (a)	617	1,354	1,574	(56) (b)	108 (d)
EPS	(0.68)	0.58	1.38	0.88	(0.30)	0.27
Trailing twelve months						
Revenue	\$5,870	\$41,253	\$77,928	\$25,003	\$3,665	\$8,838
Net income (loss)	105	2,961	6,003	7,112	44 (c)	747
EPS	0.67	2.82	6.01	3.96	0.25	7.11 (e)
Net income (loss) as a % of net revenue	2%	7%	8%	28%	1%	8%
Balance sheet						
Cash	\$295	\$2,795	\$6,486	\$8,960	\$600	\$987
Other current assets	1,035	15,063	31,704	6,180	1,584	2,489
Other assets	503	10,624	40,103	12,061	1,072	1,072
	<u>\$1,833</u>	<u>\$28,482</u>	<u>\$78,293</u>	<u>\$27,201</u>	<u>\$3,256</u>	<u>\$4,548</u>
Liabilities	\$992	\$13,255	\$58,537	\$6,673	\$1,390	\$1,698
Put warrants	0	0	0	582	0	0
Equity	841	15,227	19,756	19,946	1,866	2,850
	<u>\$1,833</u>	<u>\$28,482</u>	<u>\$78,293</u>	<u>\$27,201</u>	<u>\$3,256</u>	<u>\$4,548</u>
Other data						
Closing stock price (September 30, 1997)	\$0.00	\$69.56	\$106.00	\$92.31	\$26.25	\$46.81
Common shares outstanding	157	1,060	978	1,797	182	395
Market value	\$0	\$73,736	\$103,668	\$165,886	\$4,778	\$18,491
Price/revenue ratio	0.0x	1.8x	1.3x	6.6x	1.3x	2.1x
Price/earnings ratio - trailing twelve	0.0x	24.7x	17.6x	23.3x	107.0x	6.6x
Price/earnings ratio - future 4 qtrs.	17.4x	21.2x	15.7x	23.3x	21.5x	19.8x
Headcount (most recent disclosure)	9,700	120,500	268,648	48,500	10,358	22,867
Revenue/employee (in thousands)	\$605	\$342	\$290	\$516	\$354	\$386
Book value per share	\$5.36	\$14.37	\$20.20	\$11.10	\$10.25	\$7.22
Price/book value ratio	0.0x	4.8x	5.2x	8.3x	2.6x	6.5x
Growth statistics (over comparable quarter):						
Revenue	25%	15%	3%	20%	0%	13%
Research and development	n/a	10%	4%	31%	7%	20%
Sales and marketing	53%	14%	(6%)	20%	13%	17%
General and administrative	n/a	n/a	n/a	n/a	n/a	n/a
Net income	(276%) (a)	45%	6%	20%	(156%) (b)	(12%) (d)

a) Gateway's current quarter included a write-off of R&D from an acquisition of \$114 million.

b) Silicon's current quarter included \$19 million of acquired technology and merger costs.

c) Silicon's trailing 12 months included several charges totaling \$27 million for in-process R&D relating to the Cray Research acquisition.

d) Sun's current quarter included \$52 million of one-time acquired in-process technology and R&D charges.

e) Sun's trailing 12 months included a \$0.04 per share acquisition charge related to LongView Technologies and an \$0.11 per share gain on the sale of an equity investment.

THE MICROSOFT FAMILY OF FUNDS

During Q95-4, MS's cash investment portfolio was migrated into five distinct sub-portfolios - four fixed-income portfolios and one opportunity portfolio. Each portfolio is a separate mutual fund or risk bucket, with unique guidelines and risk/return expectations. Collectively, the portfolios are the MS "Family of Funds". In Q97-4, the original Family of Funds performance benchmarks were replaced with benchmarks exhibiting higher return expectations and moderate increases in risk.

With this strategy, MS is increasing the sophistication of our portfolio management efforts, focusing on Total Rate-of-Return portfolio management (as opposed to yield-to-maturity) and using duration as a risk management tool (instead of term-to-maturity).

The goals of this strategy are to:

- Segregate the cash portfolio into individual funds of a more manageable size.
- Enhance the total return on Microsoft's Cash assets.
- Establish risk and return expectations for each Fund.
- Provide pro-active risk management of financial assets.
- Benchmark performance relative to market indices.
- Allow allocation of cash among the various risk segments of the short-term fixed-income market.

Following is a high level summary of the general guidelines of each Fund:

- **Level 1: Money Market Fund**—Designed to meet the operating cash requirements of MS Corporation, and other legal entities, MS MBV, MS IBV, and MS Puerto Rico, this fund has a targeted duration of 20-45 days and a maximum maturity of 91 days. Little principal value fluctuation is expected. Benchmark: 30-Day US Commercial Paper.

GENERAL & ADMINISTRATIVE DEFINITIONS

- For financial reporting, distributions of General & Administrative expenses are made to all domestic groups and are included in people and infrastructure expenses.
- For internal management reports, the net corporate G&A costs are allocated to the channels and product groups as part of corporate allocations.
- ITG costs include application development, regional support, and distributed infrastructure costs. These
- Employee services group provides administrative support including building services, library services, mail, food and beverage, administrative procurement, travel services, and copy centers. These costs are

- **Level 2: Enhanced Money Market Fund**—Designed as a secondary source of liquidity supporting the Money Market Fund, this fund has a maximum maturity of 13 months. The longer targeted duration of 2 to 6 months, will provide opportunity for increased return with a modest increase in risk. A small amount of principal value fluctuation is expected. Benchmark: 90-Day US LIBOR.

- **Level 3: Short-term Fixed Income Fund**—This fund will carry an increased focus on interest rate changes, security sectors and temporary market anomalies to provide the opportunity for returns above money market rates. Duration is further extended to a target of 1.25 to 2.25 years. Some principal value fluctuation is expected, and negative monthly total returns may occur occasionally. Benchmark: 50%/50% Lehman Brothers Corporate/Government 1-3 Yr Index.

- **Level 4: Intermediate Fixed Income Fund**—An actively managed portfolio with a targeted duration of 2.5 to 4.0 years. This "short bond fund" will focus on the optimal security type, sector, and credit risk to achieve superior returns. Principal value fluctuation is expected. Months with negative returns will occur and an occasional negative quarter is possible. Benchmark: 50%/50% Lehman Brothers Corporate/Government 3-5 Yr. Index.

- **Level 5: Opportunity Fund**—This fund will seek investment opportunities that provide yield enhancement, meet tax-planning objectives, and mirror MS's strategic investments and business relationships. This fund requires senior management approval of each transaction, and does not carry specific maturity constraint. Benchmark: Lehman Brothers Government/Corporate.

costs are driven primarily by demand from supported organizations for new technology and tools, support of existing systems, and sales increased demands on the corporate WAN and telecommunications network.

- Human resources costs are driven primarily by employee headcount. Allocated expenses include employee development, payroll, and stock administration. Distributed HR costs include recruiting and domestic employee benefits such as health insurance, 401(k) match, and health club dues. driven by user demand and are indirectly correlated to headcount growth.
- Real estate and facilities costs include allocated functional costs related to facilities planning and development that are driven primarily by growth in

domestic headcount and distributed infra-structure costs such as depreciation, rent, utilities, and maintenance which are driven by the number of employees and contingent staff using MS facilities.

- Finance, legal, and executive costs are corporate functional groups supporting MS on a worldwide basis.

COST OF REVENUE - DEFINITIONS

- Cost of revenue includes product costs, royalties, pipe and channel costs, and the cost of obsolete and scrapped inventory as described below. The cost of product engineering, configuration and testing prior to release are included as well as the activities of purchasing, manufacturing, and assembling finished

goods. In addition, the activities of supply chain management, customer operations, licensing/contract administration, program management, and all the associated costs of IT systems and support are part of cost of revenue.

PRODUCT COSTS

- Standard product costs represent both the standard material cost for media, manuals, packaging, hardware and collateral per a bill of materials (BOM) for each product as well as labor and overhead expenses incurred in the procurement and assembly of physical product.
- Other costs include expenses for hardware tooling, prep charges incurred to establish the manufacturing process for a product, cancellation fees, blueline scrap, and recost impacts.
- Purchasing variances include material purchase price variances (PPV), turnkey PPV, purchase discounts, expediting or change order charges with turnkey vendors, and freight-in and duty/customs expenses incurred to ship raw materials to the location of final assembly or packaging.

- Manufacturing variances represent manufacturing costs incurred in the internal or external assembly of product which are not included in the standard product cost. This includes operating expenses to manage turnkey vendors, manufacturing absorption variances, material usage variances, BOM variances and variances related to outsourcing packaged product.
- Program costs and variances represent the material costs of Select Welcome and Upgrade kits as well as any product costs incurred for programs such as MSDN, TechNet or Courseware not included in Standard Product Cost. Cost recovery programs such as MSP (Solution Provider) are charged to marketing operations.

ROYALTIES

- Royalties include payments to third parties for the right to use intellectual property in MS products.

- The Royalty P&L line item includes both third party royalty payments and the payment or amortization of license fees.

PIPE COSTS

- Pipe operations represent all of the operating expenses incurred by an individual pipe or by a worldwide organization in direct support of the various revenue-generating business streams of MS. These operations include primarily customer operations (order processing, billing, and collection), supply chain management, program management, worldwide licensing, and project management.
- Distribution represents internal and external costs of picking and packing MS products, including operating expenses of the distribution department, storage costs of finished goods and shipping supplies.
- Central services represent all of the operating expenses incurred by centralized organizations that provide supporting functions across all pipes and business streams. These include OBS expenses, hardware operating expenses, operations management

and planning, supply base management, and product information and release services.

- Online telecom consists of network costs for internet connectivity and network access for MSN Subscribers as well as internal expenses for the MSN Network and online operations groups.
- Online data center captures all facilities, maintenance, operational support and staffing of the online data center including MS internal data center operations people and infrastructure costs, and external contracts for facilities and maintenance costs.
- Online processing is comprised of credit card processing fees, internet advertising tracking and reporting costs, and financial operations people and infrastructure expenses for the MSN and online operations groups.

OBSOLETE & SCRAPPED INVENTORY

- Damaged and obsolete inventory includes charges for in-house scrap, provision for inventory obsolescence, and cycle count adjustments. Costs included in damaged and obsolete inventory are primarily results of actions by the regional operation service centers (ROSCs).

- Returns scrap and rework includes the material, labor, and overhead of product scrapped and/or reworked and the operating expenses of the returns department and outsourced labor.

CHANNEL COSTS

- Local customer operations primarily includes all costs related to fulfillment including programs at both the MS international sales locations and ROSCs. Additionally, this line item includes all customer operations activities (order processing, billing and collection activities) incurred by MS international sales locations.

- Freight includes freight out on finished goods product shipped to customers or subsidiary locations and any related duty and customs charges on importing/exporting of finished product into international subsidiary locations. Freight is net of any reimbursements from customers or distributors.

BUSINESS STREAM DEFINITIONS

- Channel full packaged product (FPP) includes Software FPP, MLPs and hardware sales. Hardware sales include both OEM and retail activity.
- Licensing includes OEM and retail channel revenue and costs. Retail channel includes Select, Open billings and costs include associated disks and documents.

- Programs include subscriptions such as MSDN, solution provider and TechNet and fulfillment revenue from products such as supplemental parts and courseware.

Q98-1 GROSS REVENUE SUMMARY

(in thousands, except licenses, variance to plan)	Revenue				Licenses				
	Actual	Plan	Variance	Var %	Actual	Plan	Variance	Var %	CALs
Office - Standard (FPP)	\$ 52,568	\$ 44,828	\$ 7,739	17%	132,026	116,374	15,652	13%	-
Office - Standard (MLP/Open)	85,648	53,372	32,276	60%	268,207	182,754	85,453	47%	-
Office - Standard (Select/OEM/Other)	103,788	88,498	15,290	17%	435,502	388,447	47,055	12%	2,160
Office - Standard (Academic-FPP)	10,154	9,028	1,126	12%	81,690	76,076	5,614	7%	-
Office - Standard (Academic-MLP/Open/Select/Other)	9,704	6,393	3,310	52%	182,781	118,504	64,277	54%	-
Small Business Edition - Standard	39,802	46,569	(6,767)	(15%)	563,024	522,820	40,204	8%	-
Small Business Edition (DSP) - Standard	3,721	7,809	(4,088)	(52%)	18,768	40,570	(21,802)	(54%)	-
Office - Standard Product	305,383	256,497	48,886	19%	1,681,998	1,445,545	236,453	16%	2,160
Office Professional - Standard (FPP)	95,126	69,492	25,633	37%	209,782	151,347	58,435	39%	-
Office Professional - Standard (MLP/Open)	79,389	60,755	18,634	31%	217,187	171,780	45,407	26%	-
Office Professional - Standard (Select/OEM/Other)	148,270	73,512	74,759	102%	662,901	272,344	390,557	143%	-
Office Professional - Standard (Acad-MLP/Open/Select/Other)	31,167	37,763	(6,596)	(17%)	220,241	283,782	(63,541)	(22%)	6,380
Office Professional - Standard (Acad-MLP/Open/Select/Other)	27,887	15,886	12,001	76%	471,176	266,927	204,249	77%	-
Office Professional - Standard Product	381,839	247,408	134,431	48%	1,781,287	1,146,180	635,107	55%	6,380
Office - Upgrade (FPP)	46,522	39,701	6,821	17%	229,799	188,739	41,060	22%	-
Office - Upgrade (MLP/Open)	47,912	33,234	14,678	44%	280,311	189,258	91,053	48%	-
Office - Upgrade (Select/Other)	55,008	40,183	14,825	37%	407,247	285,788	121,459	42%	-
Small Business Edition - Upgrade	13,847	22,893	(9,046)	(40%)	70,786	115,766	(44,980)	(39%)	-
Office - Upgrade	163,289	136,011	27,278	20%	988,143	779,551	208,592	27%	-
Office Professional - Upgrade (FPP)	67,598	76,526	(8,928)	(12%)	260,389	274,656	(14,267)	(5%)	-
Office Professional - Upgrade (MLP/Open)	41,318	34,623	6,695	19%	176,147	154,106	22,041	14%	-
Office Professional - Upgrade (Select/Other)	59,969	36,439	23,530	65%	527,750	230,580	297,170	129%	-
Office Professional - Upgrade	168,885	147,588	21,297	14%	964,286	659,342	304,944	36%	-
Office and Office Professional - Upgrades	332,175	283,599	48,576	17%	1,952,420	1,438,893	513,526	36%	-
All Office Standard and Upgrade - Total	1,019,397	797,404	221,993	28%	5,415,714	4,030,618	1,385,096	34%	8,540
Word/Excel Bundle - Standard	\$ 44,995	\$ 35,973	\$ 9,022	25%	425,566	389,201	36,365	9%	-
Standalone Office Apps - Standard	66,473	54,767	11,706	21%	777,142	936,703	(159,561)	(17%)	220
Standalone Office Apps - Upgrade	16,814	16,807	7	0%	213,012	217,163	(4,151)	(2%)	-
Project/Team Manager	51,023	48,801	2,222	5%	207,020	212,929	(5,909)	(3%)	-
Home Essentials	5,888	11,745	(5,856)	(50%)	79,561	233,349	(153,788)	(66%)	-
Publisher	14,307	9,622	4,686	49%	824,424	248,603	575,821	232%	-
Works	24,615	14,344	10,271	72%	2,510,662	2,115,674	394,988	19%	-
FrontPage	9,211	16,979	(7,768)	(46%)	103,916	165,254	(61,338)	(37%)	-
Outlook	535	1,109	(574)	(52%)	10,230	13,975	(3,745)	(27%)	-
Crags WS, PictureIt, Other DAD	14,956	6,844	8,112	119%	657,025	412,619	244,406	59%	-
Desktop Applications (Non-Office) - Total	248,818	216,992	31,826	15%	4,808,458	4,945,470	(83,012)	(1%)	220
Office Custom Agreements	15,458	36,521	(21,063)	(58%)	97,801	371,346	(273,545)	(74%)	-
Office Pro Custom Agreements	9,328	50,610	(41,282)	(82%)	123,334	433,416	(310,082)	(72%)	-
DAD Recognized Maintenance	124,478	104,502	19,976	19%	1,056,818	684,775	372,043	54%	-
Desktop Applications Division - Total	1,417,479	1,206,129	211,349	18%	12,502,325	10,465,625	2,036,699	19%	8,760
Visual Basic - Pro	17,682	22,448	(4,766)	(21%)	113,798	102,775	11,023	11%	-
Visual Basic - Enterprise	13,747	16,680	(2,933)	(18%)	22,972	32,367	(9,395)	(29%)	-
Visual Basic - Standard	3,922	4,008	(86)	(2%)	43,070	55,098	(12,028)	(22%)	-
C++	20,999	25,996	(4,996)	(19%)	118,592	110,914	7,678	7%	-
Visual J++	968	3,590	(2,622)	(73%)	33,427	51,403	(17,976)	(35%)	-
Visual InterDev	168	5,262	(5,094)	(97%)	642	22,202	(21,560)	(97%)	-
Visual Studio - Pro	11,737	11,409	328	3%	29,279	24,293	4,986	21%	-
Visual Studio - Enterprise	23,149	11,276	11,873	105%	30,725	13,744	16,981	124%	-
MSDN	29,266	27,055	2,211	8%	28,173	40,170	(11,997)	(30%)	-
Other Developer Tools	21,823	21,553	270	1%	151,679	105,206	46,473	44%	-
Tools Division - Total	143,462	149,277	(5,815)	(4%)	572,357	558,172	14,185	3%	-
IE Starter Kit/Other	2,692	6,319	(3,627)	(57%)	248,635	222,272	26,363	12%	-
Internet Client and Collaboration Division - Total	2,692	6,319	(3,627)	(57%)	248,635	222,272	26,363	12%	-
Applications and Internet Client Group - Total	1,563,633	1,361,726	201,907	15%	13,323,217	11,246,069	2,077,148	18%	8,760
MS-DOS	27,318	23,286	4,032	17%	1,438,931	1,139,998	298,933	26%	-
Windows, WinT	28,816	28,951	(135)	(0%)	924,816	882,293	42,523	5%	-
Windows 95 - Standard	682,397	623,812	58,585	9%	13,018,988	12,274,649	744,339	6%	-
Windows 95 - Upgrade	113,903	69,078	44,825	65%	1,475,480	940,076	535,404	57%	-
Memphis	-	94	(94)	(100%)	-	1,858	-	(100%)	-
Windows NT Workstation - Standard	174,212	161,602	12,610	8%	1,498,816	1,363,202	135,614	10%	-
Windows NT Workstation - Upgrade	67,418	27,979	39,439	141%	590,520	232,750	357,770	154%	-
MS Plus!	8,570	5,108	3,462	68%	775,363	754,339	21,024	3%	-
Other Personal Systems	2,743	2,666	76	3%	907,353	55,522	851,831	1000%	-
Personal Systems Custom Agreements	9,796	14,880	(5,084)	(34%)	187,785	200,862	(13,077)	(7%)	-
Personal Systems Recognized Maintenance	67,409	48,930	18,479	38%	850,859	1,000,442	(149,583)	(15%)	-
Personal Systems Division - Total	\$ 1,182,582	\$ 1,006,386	\$ 176,196	18%	21,668,911	18,845,991	2,822,920	15%	-

* Bundled CALs indicate client licenses bundled with server products.