

Complete text of Microsoft's 2004 MD&A

Art Durnev and Claudine Mangen

Below, we identify common and firm-specific MD&A sentences in the 2004 Microsoft MD&A (Microsoft Corporation, 2004). Sentences referring to *common* [**firm-specific**] information are in *italics* [**bold**].

For fiscal 2005, we believe industry-wide factors such as PC unit growth and the success of non-commercial software could significantly affect our results of operations and financial condition. PC unit growth was very strong in fiscal 2004, increasing approximately 13% from fiscal 2003. We do not expect similar growth to occur in fiscal 2005. We believe that PC unit shipments will grow 7% to 9%, resulting in a forecasted fiscal 2005 Client revenue growth rate that we believe will be between 5% and 7%. We continue to watch the evolution of open source software development and distribution, and continue to differentiate our products from competitive products including those based on open source software. **We believe that Microsoft's share of server units grew modestly in fiscal 2004, while Linux distributions rose slightly faster on an absolute basis.** *The increase in Linux distributions reflects some significant public announcements of support and adoption of open source software in both the server and desktop markets in the last year. To the extent open source software products gain increasing market acceptance, sales of our products may decline, which could result in a reduction in our revenue and operating margins.* **Additionally, due primarily to our announced special dividend and quarterly dividend payments, if continued, we expect investment balances and resulting investment income to decrease significantly in fiscal 2005. We have approximately \$1.1 billion in original Upgrade Advantage contract value that will reach their expiration dates in the first quarter of fiscal 2005. This revenue was recognized over the last two years and in the first quarter of fiscal 2005 the contract period expires. Our revenue growth for fiscal 2004 was driven by licensing of Windows Client operating systems through OEMs; Windows Server operating systems, Office, and other server applications as a result of growth in PC and server hardware shipments; and the continuing impact from multi-year licensing that occurred prior to the transition to our Licensing 6.0 program in the first quarter of fiscal 2003.** *We estimate growth in PC shipments was 13% during fiscal 2004, reflecting global economic improvement, which led to strength in the consumer segment in the first half of fiscal 2004 and to replacement PC and notebook sales in the enterprise segment in the second half of fiscal 2004.* **We estimate that total server hardware shipments grew 16%, with Windows Server shipments growing faster than the overall sector at 18% in fiscal 2004.** *The net impact of foreign exchange rates on revenue was positive in fiscal 2004, primarily due to a relative strengthening of most foreign currencies versus the U.S. dollar. Had*

the rates from the prior year been in effect in fiscal 2004, translated international revenue earned in local currencies would have been approximately \$1.10 billion lower. We hedge a portion of our international currency exposures, thereby reducing our overall translation exposure. Prior to the July 31, 2002 Licensing 6.0 transition date, we experienced a significant increase in multi-year licensing arrangements as customers enrolled in our maintenance programs, primarily Upgrade Advantage. Revenue growth in fiscal 2003 was driven primarily by multi-year licensing that occurred before the Licensing 6.0 transition date in the first quarter of fiscal 2003. The revenue growth also reflected a \$933 million or 13% increase associated with OEM licensing of Microsoft Windows operating systems and a \$309 million or 23% increase in revenue from Microsoft Xbox video game consoles. Revenue growth in fiscal 2002 was led by the addition of \$1.35 billion of Xbox video game system revenue and \$1.20 billion of revenue growth from Microsoft Windows XP Professional and Home operating systems. For fiscal 2004, the operating income decline of \$511 million was primarily caused by the \$2.53 billion of charges related to the Sun Microsystems settlement and a fine imposed by the European Commission in the third quarter of fiscal 2004 and \$2.21 billion of stock-based compensation expense related to our employee stock option transfer program in the second quarter of fiscal 2004. Operating income was positively influenced by the revenue growth described above and operational improvements in our MSN business. In fiscal 2003, the growth in operating income reflected an increase of \$3.82 billion in revenue, partially offset by an increase of \$2.55 billion in operating expenses, primarily related to employee and related costs associated with additional headcount and increased legal settlement expenses, primarily the Time Warner settlement charge of \$750 million. In fiscal 2002, the growth in operating income reflected an increase of \$3.07 billion in revenue, substantially offset by an increase of \$3.14 billion in operating expenses, which included the onset of costs related to Xbox video game systems.

In fiscal 2005, we do not expect revenue to grow at similarly high rates as fiscal 2004, even if information technology spending continues to improve. While we expect general economic conditions to remain stable with the improvements seen in the second half of fiscal 2004, we expect PC and server unit shipment growth rates to decline in fiscal 2005 from the high growth rates in fiscal 2004. We estimate PC shipments will grow from 7% to 9% and Server unit shipments will grow from 13% to 15% in fiscal 2005 compared to fiscal 2004. These lower growth rates may cause slower revenue growth in fiscal 2005. We are anticipating little or no year-over-year foreign exchange rate benefit in fiscal 2005. We anticipate that we will renew between 10% and 30% of the expiring Upgrade Advantage program revenue through conversions to Software Assurance or migration to Enterprise Agreements. Total revenue ex-

pected to be recognized in our Information Worker, Server and Tools, and Client businesses from previously deferred Upgrade Advantage revenue is \$56 million. MSN had a strong year in fiscal 2004 with revenue growth of 13% driven by over 40% growth in advertising revenue. In fiscal 2005, we expect MSN to see growth in advertising revenue and subscription and transaction revenue from premium Web services, partially offset by a reduction in access revenue as narrowband subscribers continue to decline. Accordingly, we do not expect the same level of revenue growth for MSN in fiscal 2005. Home and Entertainment revenue grew moderately in fiscal 2004. We do not expect significant growth in Home and Entertainment in fiscal 2005 as price reductions in the second half of fiscal 2004 related to the late stage of the Xbox lifecycle are expected to lead to lower revenue for the Xbox business. We expect our operating income growth in fiscal 2005 to exceed our revenue growth. Operating income is expected to reflect lower operating expenses due to the absence of certain legal settlements which occurred in fiscal 2004, lower stock-based compensation costs, and benefits achieved through continued progress in our previously announced cost efficacy initiative. We expect that our segments in fiscal 2004 that reported a segment operating loss —Mobile and Embedded Devices, Microsoft Business Solutions, and Home and Entertainment —will make significant progress toward segment profitability in fiscal 2005 with improved operations. Our seven segments are: Client; Server and Tools; Information Worker; Microsoft Business Solutions; MSN; Mobile and Embedded Devices; and Home and Entertainment. The revenue and operating income/(loss) amounts MD&A are presented on a basis consistent with U.S. GAAP applied at the segment level. Certain corporate level expenses have been excluded. Those expenses primarily include corporate operations related to sales and marketing, product support services, human resources, legal, finance, IT, corporate development and procurement activities, research and development and other costs, and accrued legal contingencies. Corporate expenses were \$3.08 billion, \$3.74 billion and \$4.66 billion in fiscal 2002, 2003 and 2004 respectively. Client includes revenue from Windows XP Professional and Home, Windows 2000 Professional, and other standard Windows operating systems. The growth of the Client segment's revenue is largely correlated with the growth of purchases of PCs from OEMs that pre-install versions of Windows operating systems. Client revenue increase was driven by a 14% growth in OEM licenses and 16% growth in OEM revenue on increased consumer PC unit shipments in the first half of the fiscal year and growth in business PC unit shipments in the second half of fiscal 2004. Revenue from commercial and retail licensing declined 4% due to lower revenue earned from Upgrade Advantage licensing agreements and lower packaged product sales. In fiscal 2003, Client revenue

growth was driven by OEM licensing revenue growth of \$933 million and a 9 percentage point increase in the mix of the higher priced Windows Professional operating systems, the majority of which was in the OEM channel. Windows Professional revenue growth for fiscal 2003 was \$1.59 billion, or 31%, compared to fiscal 2002. The Windows Professional growth in fiscal 2003 was partially offset by a \$573 million decline in revenue from earlier versions of Windows operating systems. Client operating income was flat for fiscal 2004 compared to fiscal 2003 due to increased operating expenses primarily related to the charge for the Sun Microsystems settlement of \$700 million in the third quarter of fiscal 2004 and \$307 million of stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004, offset by growth in revenue. Operating income for fiscal 2003 increased primarily as a result of the 11% growth in revenue, partially offset by an increase in operating expenses, largely attributed to headcount additions and related costs. *We estimate that PC market growth will be from 7% to 9% in fiscal 2005. We expect emerging markets to continue to outpace mature market growth rates and we expect to hold our share in these respective markets. The differential market growth rate is expected to result in lower unit license growth in the OEM business and lower revenue growth, as piracy continues to be problematic in emerging markets, and significant price changes are not anticipated. We plan to continue our efforts to increase premium product mix but expect to see only modest improvements in fiscal 2005. Growth in the overall market for information technology, both hardware and software, is the principal driver for Server and Tools revenue growth. The segment concentrates on licensing products, applications, tools, content, and services that make information technology professionals and developers more productive and efficient. Products are sold through OEMs, distributors, direct to customers, and through one-time licenses or multi-year volume license agreements.*

We estimate that overall server hardware shipments grew 16% in fiscal 2004 compared to the prior year. *Server and Server applications revenue, including CAL revenue, grew \$1.28 billion or 25% driven primarily by an estimated 18% increase in Windows-based server shipments resulting in 15% growth in new Windows Server licenses, and by favorable conversion of revenue billed in foreign currencies to U.S. dollars. Consulting and Premier product support services revenue increased \$189 million or 19% compared to fiscal 2003 due to increased customer penetration from new product offerings. Revenue from developer tools, training, certification, and Microsoft Press and other services declined \$128 million or 14% compared to fiscal 2003 due to recognition of revenue deferred in prior years. Foreign exchange rates contributed approximately \$350 million or 5% of Server and Tools revenue growth. Total Server and Tools revenue grew \$983 million or 16% in fiscal*

2003, driven by an increase in Windows-based server shipments and growth in SQL Server and Exchange revenue. Windows Server and CALs revenue grew \$787 million or 18% from fiscal 2002 as a result of increased new and anniversary multi-year licensing agreements. Consulting and Premier product support services increased \$91 million or 10% compared to fiscal 2002. Revenue from developer tools, training, certification, Microsoft Press, and other services increased \$105 million or 13% from fiscal 2002. Server and Tools operating income for fiscal 2004 declined primarily due to the charge for the Sun Microsystems settlement of \$1.22 billion in the third quarter of fiscal 2004 and \$651 million of stock-based compensation costs from the employee stock option transfer program in the second quarter of fiscal 2004. Server and Tools operating income for fiscal 2003 grew 50%, primarily as a result of the 16% increase in revenue. We anticipate that overall server hardware shipments will grow from 13% to 15% in fiscal 2005 and new licenses of Windows Server operating system will grow slightly faster than the overall market. We believe that Windows Server 2003 shipments will create opportunities for sales of Windows Server System products. *However, we face strong competition from the Linux-based, Unix, and other server operating systems. In addition, Server and Tools net revenue for fiscal 2005 will be unfavorably affected by the absence of revenue earned from our Upgrade Advantage program and no anticipated foreign exchange benefit. Information Worker consists of the Microsoft Office System of programs, servers, services, and solutions designed to increase personal, team, and organization productivity. Information Worker includes Microsoft Office, Microsoft Project, Microsoft Visio, SharePoint Portal Server CALs, other information worker products including Microsoft LiveMeeting and OneNote, and professional product support services. Most revenue from this segment comes from licensing our Office System products. Revenue growth depends on the ability to add value to the core Office product set and expand our product offerings in other Information Worker areas such as document lifecycle and collaboration. Revenue growth for fiscal 2004 from volume licensing, retail packaged product and pre-installed versions of Office in Japan was 15% in aggregate. This increase was driven by recognition of unearned revenue primarily from a large increase in multi-year licenses signed prior to the transition to our Licensing 6.0 programs and approximately \$110 million related to the launch of Office 2003. OEM licensing revenue grew 29% or \$325 million. Foreign exchange rates provided approximately \$485 million or 5% of total Information Worker revenue growth. The \$1.02 billion or 12% increase in revenue in fiscal 2003 compared to fiscal 2002 was primarily due to growth in Office suites revenue associated with new and anniversary multi-year licensing agreements and a \$264 million or 28% increase in revenue from the combined total of Microsoft Project, Microsoft Visio, and other stand-alone applications. Information Worker operating income in fiscal 2004 increased from the prior year primarily due to growth in revenue, partially offset by an increase in operating expenses,*

primarily related to \$351 million of stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004 and higher sales and marketing expenses. Information Worker operating profit for fiscal 2003 grew 9% compared to fiscal 2002, led by the 12% increase in revenue and partially offset by a 20% growth in operating expenses related to headcount additions and marketing expenses. *Fiscal 2005 Information Worker revenue is expected to be similar to fiscal 2004. We are expecting a reduction in revenue earned from our Upgrade Advantage licensing agreements and no anticipated foreign exchange rate benefit.* **The significant reduction in Upgrade Advantage earned revenue is expected to be offset by sustained momentum in our OEM and multi-year licensing offerings and increased purchasing of Office System 2003 as enterprises complete their product evaluations.**

Microsoft Business Solutions includes Microsoft Great Plains, Microsoft Navision, Microsoft Axapta, Microsoft Solomon, Microsoft CRM, MBN/Retail Manager and other business applications and services. *Our revenue is generally derived from developing and marketing integrated, end-to-end business applications and services designed to help small and mid-market businesses. The small and mid-market business applications market is highly fragmented and is intensely competitive in all sectors. Microsoft Business Solutions revenues are affected by the general economic environment and enterprise information technology spending in particular.* **The revenue increase in fiscal 2004 was primarily attributable to continued growth in licensing of Navision and Axapta ERP products, and new sales of Microsoft CRM. Microsoft Business Solutions revenue for fiscal 2003 grew \$259 million from fiscal 2002, of which \$246 million was attributable to the acquisition of Navision at the beginning of the fiscal year. The operating loss for fiscal 2004 declined from fiscal 2003 due to the increase in revenue and lower operating expenses including \$42 million of lower amortization costs, partially offset by \$27 million in stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004. Microsoft Business Solutions operating loss for fiscal 2003 increased from fiscal 2002 primarily due to operating losses associated with Navision, increases in sales and marketing expenses, research and development expenses, and acquisition-related costs.** *We announced in the fourth quarter of fiscal 2004 a plan to align and include the Small and Mid-Market Solutions & Partners (SMS&P) organization in the Microsoft Business Solutions segment. This change is designed to optimize our focus on delivering business applications to small and mid-market segment businesses. The SMS&P organization is currently part of the Information Worker segment. This reorganization will result in a corresponding change to the Microsoft Business Solutions and Information Worker reported results, primarily from the reorganization of approximately \$100 million in revenue and*

costs associated with our Partner program offerings, which will move from Information Worker segment to Microsoft Business Solutions. In fiscal 2005, we expect continued growth for Microsoft Business Solutions through CRM, Axapta, Navision, and Great Plains product lines with increased sales and marketing focus from the SMS&P organization, and new product launches for Great Plains and Navision. The MSN segment includes personal communications services, such as e-mail and instant messaging, and information services, such as MSN Search and the MSN portals and channels around the World. MSN also provides a variety of paid services resulting in revenue for the segment including MSN Internet Access, and MSN Premium Web Services. Revenue is principally generated from advertisers on MSN, from consumers through subscriptions and transactions generated from MSN Premium Web Services and from subscribers to MSN Narrowband Internet Access. In fiscal 2004, MSN advertising revenue increased \$360 million or 43% as a result of growth in paid search and growth in the overall Internet advertising market. This increase was partially offset by a decline of \$168 million or 15% in Internet access revenue, primarily from the migration of internet access subscribers to broadband or other competitively priced Internet service providers. Revenue from subscription and transaction services other than Internet access increased \$71 million in fiscal 2004 to \$95 million. At the end of the current fiscal year, MSN had 4.3 million internet access subscribers compared to 6.5 million at the end of the prior fiscal year and 8.8 million total subscribers compared to 8.6 million at the end of the prior year. In addition, MSN has over 350 million unique users monthly, 187 million active Hotmail accounts, and 135 million active Messenger accounts. Compared to fiscal 2002, MSN advertising revenue grew \$270 million or 48% in fiscal 2003 as a result of growth in paid search and strong online advertising sales across all geographic regions. MSN subscription revenue grew \$112 million or 11% in fiscal 2003 reflecting an increase in the number of paying non-promotion subscribers. MSN reached segment profitability in the first quarter of fiscal 2004 and was profitable for the full fiscal year. The improvement in profitability was primarily driven by an increase in revenue from advertising in both display and paid search, a decline in customer acquisition costs and other expenses related to the Internet access business, efficiency gains in the operations of the advertising and subscription businesses, and a \$48 million refund of prior year taxes, partially offset by \$144 million of stock-based compensation expense related to the employee stock option transfer program in the second quarter of fiscal 2004. MSN operating loss for fiscal 2003 decreased from fiscal 2002, primarily as a result of the growth in revenue and lower relative subscription acquisition and support costs. MSN expects advertising revenue and revenue from subscriptions and transactions for premium Web services to increase in fiscal 2005. Advertising revenue should benefit from expected increases in Internet spending and additions to the advertising platform including music download service, communication innovations, and an improved search engine. We expect revenue from narrowband Internet access to decline in fiscal 2005 as narrowband subscribers continue to migrate to broadband Internet access. We announced in the fourth quarter of fis-

cal 2004 an increase to the amount of storage we will provide for select MSN and Hotmail email accounts which will increase operating costs and may impact the revenues from our extra storage customers. However, we expect the segment to increase its profitability in fiscal 2005, led by continued operational efficiencies and lower unit margin costs in both the subscriber and advertising businesses. **Mobile and Embedded Devices** includes Windows Mobile software, Windows Embedded device operating systems, MapPoint, and Windows Automotive. The segment's products extend the advantages of the Windows platform to mobile phones and Pocket PCs. The segment is also responsible for managing sales and customer relations with device manufacturers and with network service providers, including telecommunications, cable and wireless companies, and host and network equipment providers. The embedded operating system market is highly fragmented with many competitive offerings and relatively short product life cycles that affect our continuing revenue streams. Unit volume increases drove revenue growth for fiscal 2004 over fiscal 2003 in all product lines. The growth was primarily due to the increase in the number of OEMs and mobile operators shipping Windows Mobile software for SmartPhones, increases in market share for our Pocket PC and embedded products and increased usage by existing customers of our MapPoint Web Service. Revenue for fiscal 2003 grew \$44 million driven by increased Pocket PC shipments and MapPoint licensing. **Mobile and Embedded Devices' operating loss for fiscal 2004 decreased compared to fiscal 2003 primarily due to growth in revenue and lower marketing expenses, partially offset by \$58 million of stock-based compensation expense from the employee stock option transfer program in the second quarter of fiscal 2004. Operating loss for fiscal 2003 grew 1% from the prior year as higher marketing expenses and headcount-related costs associated with product development offset the growth in revenue.** We expect demand for mobile and embedded devices based on Windows Mobile software to be driven by an overall increase in customer demand for connectivity as well as by an increase in the number of OEMs and mobile operators offering Windows-based devices. Home and Entertainment includes the Microsoft Xbox video game console system, PC games, the Home Products Division (HPD), and TV platform products for the interactive television industry. The relative success of competing video game consoles is determined by console functionality, the portfolio of video game content for the console, and the relative market share of the console. We are a relatively new entrant in the video game console businesses with our first release in fiscal 2002, and have established ourselves as one of the leaders. Revenue and unit volumes have grown quickly since 2002, but revenue growth moderated in fiscal 2004 due to price reductions typical at this stage in the console lifecycle. We believe our competitive position and revenue is bolstered by our increasing software game attach rates, providing higher margins to offset the decreasing price trend on consoles sold. In fiscal 2004, Xbox revenue increased \$144 million or 9% with \$269 million related to higher Xbox software volumes and \$117 million due to higher Xbox console

volumes, partially offset by a \$242 million decline related to price reductions of Xbox consoles and software. Overall, Xbox console volumes increased 11% in fiscal 2004 compared to fiscal 2003. The Xbox life-to-date U.S. games attach rate increased to 6.9 games per console according to industry analyst NPD as of June 30, 2004. Revenue from consumer hardware and software, PC games and TV platforms declined \$16 million or 1% compared to fiscal 2003 due to lower PC games software and PC gaming devices sales, partially offset by the new release of Mac Office. The increase in Home and Entertainment revenue in fiscal 2003 from fiscal 2002 was the result of sales of Xbox video game systems and related games which were available for all of fiscal 2003. Xbox revenue grew \$309 million or 23% in fiscal 2003 reflecting a \$779 million increase from higher volumes for Xbox consoles, games, and peripherals partially offset by a \$470 million decrease due to price changes. Revenue from consumer hardware and software and PC games declined \$14 million or 1% in fiscal 2003, driving the decrease in Home. In fiscal 2005, we expect Xbox console unit volumes and revenue to decrease from fiscal 2004 consistent with this stage of the Xbox console lifecycle, partially offset by increased unit volumes driven by the launch of software titles such as Halo2. In fiscal 2005 we expect PC games revenue to decrease from fiscal 2004 driven by fewer new game titles. **Other HPD revenue are expected to increase moderately as a result of the launch of the latest version of Mac Office late in the fourth quarter of fiscal 2004. In fiscal 2005, we expect operating margins to improve from fiscal 2004 driven by lower unit volumes of negative margin consoles and increased sales of high margin software. We expect development spending to be higher in fiscal 2005 driven by investment in the next generation Xbox platform design. Cost of revenue includes manufacturing and distribution costs for products and programs sold, operating costs related to product support service centers and product distribution centers, costs incurred to support and maintain Internet-based products and services, and costs associated with the delivery of consulting services. The increase in fiscal 2004 was primarily due to increased product support and consulting services costs of \$508 million, \$214 million of stock-based compensation expense from the employee stock option transfer program, and a lower of cost or market adjustment in the fourth quarter of fiscal 2004 by approximately \$90 million, reflecting the current stage of the life cycle of the Xbox console, partially offset by \$365 million decrease in MSN services costs. In fiscal 2003, the primary driver of the increase was a 4.4 percentage point increase from Home and Entertainment products and a 1.6 percentage point decrease from MSN product and service costs in fiscal 2003 compared to fiscal 2002. Our effective tax rate for fiscal 2004 was 33%. A benefit of \$208 million was recorded during the fourth quarter from the reversal of previously accrued taxes from resolving the remaining open issue remanded by the 9th Circuit Court of Appeals ruling in December 2002. The effective tax rate for the fourth quarter of**

fiscal 2004 was approximately 27%. During the third quarter the tax rate increased due to the European Commission fine, which is not tax deductible. The effective tax rate for fiscal 2003 and fiscal 2002 was 32% each year. The fiscal 2003 rate reflected a benefit in the second quarter of \$126 million from the reversal of previously accrued taxes related to the initial items from the 9th Circuit Court of Appeals ruling referred to above, that reversed, in part, a previous Tax Court ruling that had denied tax benefits on certain revenue earned from the distribution of software to foreign customers. Excluding this reversal, the effective tax rate would have been 33%. Unearned revenue from volume licensing programs represents customer billings, paid either upfront or annually at the beginning of each billing coverage period, that are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. For certain other licensing arrangements revenue attributable to undelivered elements, including free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis, is based on the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the related product's life cycle. The percentage of revenue recorded as unearned due to undelivered elements ranges from approximately 15% to 25% of the sales price for Windows XP Home, approximately 5% to 15% of the sales price for Windows XP Professional, and approximately 1% to 15% of the sales price for desktop applications, depending on the terms and conditions of the license and prices of the elements. Product life cycles are currently estimated at three-and-one-half years for Windows operating systems and two years for desktop applications. Unearned revenue also includes payments for online advertising for which the advertisement has yet to be displayed and payments for post-delivery support services to be performed in the future. Unearned revenue as of June 30, 2004 decreased \$838 million from June 30, 2003, reflecting recognition of unearned revenue from multi-year licensing that has outpaced additions by \$397 million, primarily due to recognition from Upgrade Advantage licensing agreements and a \$489 million decline in revenue deferred for undelivered elements. Starting April 1, 2003 revenue deferred for undelivered elements reflected lower deferral rates, partially offset by lengthened product life cycles for the underlying products licensed, resulting in a higher proportion of revenue earned. We earned approximately \$1.8 billion and \$1.1 billion from the Upgrade Advantage programs for fiscal 2003 and 2004, respectively and expect to earn approximately \$56 million in fiscal 2005 from those programs. Cash flow from operations for fiscal 2004 decreased \$1.17 billion to \$14.63 billion. The decrease primarily reflects the combined cash outflows of \$2.56 billion related to the Sun Microsystems settlement and the European Commission fine

mentioned above partially offset by increased cash receipts from customers driven by the rise in revenue billings. Cash used for financing was \$2.36 billion in fiscal 2004, a decrease of \$2.86 billion from the prior year. The decrease reflects that we did not repurchase any common stock in the fourth quarter of fiscal 2004 combined with a \$628 million increase primarily from stock issuances related to employee stock options exercises, partially offset by an \$872 million increase in cash dividends paid. We repurchased 123.7 million shares of common stock under our share repurchase program in fiscal 2004. Cash used for investing was \$2.75 billion in fiscal 2004, a decrease of \$4.47 billion from fiscal 2003, due to a \$3.63 billion decrease in net investment purchases and a \$1.06 billion decrease in acquisition spending. Cash flow from operations was \$15.80 billion for fiscal 2003, an increase of \$1.29 billion from fiscal 2002. The increase primarily reflects the rise in cash receipts from customers driven by the increase in revenue billings and maintenance of relatively stable accounts receivable levels. Cash used for financing was \$5.22 billion in fiscal 2003, an increase of \$651 million from the prior year. The increase reflects a cash dividend payment of \$857 million in 2003 and an increase of \$417 million in common stock repurchase, offsetting \$623 million received for common stock issued. We repurchased 238.2 million shares of common stock under our share repurchase program in fiscal 2003. Cash used for investing was \$7.21 billion in fiscal 2003, a decrease of \$3.63 billion from fiscal 2002, due to stronger portfolio performance on sold and matured investments. Cash flow from operations was \$14.51 billion for fiscal 2002, an increase of \$1.09 billion from fiscal 2001. The increase reflected strong growth in unearned revenue as a result of the significant number of customers that purchased Upgrade Advantage during the Licensing 6.0 transition period. This resulted in an increase in billings and a corresponding increase in the unearned revenue amount. Cash used for financing was \$4.57 billion in fiscal 2002, a decrease of \$1.01 billion from the prior year. The decrease reflected the repurchase of put warrants in the prior year. We repurchased 245.6 million shares of common stock under our share repurchase program in fiscal 2002. In addition, 10.2 million shares of common stock were acquired in fiscal 2002 under a structured stock repurchase transaction. We entered into the structured stock repurchase transaction in fiscal 2001, which gave us the right to acquire 10.2 million of our shares in exchange for an up-front net payment of \$264 million. Cash used for investing was \$10.85 billion in fiscal 2002, an increase of \$2.11 billion from fiscal 2001. *We have unconditionally guaranteed the repayment of certain Japanese yen denominated bank loans and related interest and fees of Jupiter Telecommunication, Ltd., a Japanese cable company (Jupiter). These guarantees arose on February 1, 2003 in conjunction with the expiration of prior financing arrangements, including previous guarantees by*

us. The financing arrangements were entered into by Jupiter as part of financing its operations. As part of Jupiter's new financing agreement, we agreed to guarantee repayment by Jupiter of the loans of approximately \$51 million. The estimated fair value and the carrying value of the guarantees was \$11 million and did not result in a charge to operations. The guarantees are in effect until the earlier of either repayment of the loans, including accrued interest and fees, or February 1, 2009. The maximum amount of the guarantees is limited to the sum of the total due and unpaid principal amounts, accrued and unpaid interest, and any other related expenses. Additionally, the maximum amount of the guarantees, denominated in Japanese yen, will vary based on fluctuations in foreign exchange rates. If we were required to make payments under the guarantees, we might recover all or a portion of those payments upon liquidation of Jupiter's assets. The proceeds from an asset liquidation cannot be accurately estimated due to the many factors that would affect the valuation and realization of the proceeds. Since our inception, our business model has been based upon customers agreeing to pay a fee to license software developed and distributed by us. Under this commercial software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. We believe the commercial software model has had substantial benefits for users of software, allowing them to rely on our expertise and the expertise of other software developers that have powerful incentives to develop innovative software that is useful, reliable, and compatible with other software and hardware. In recent years, there has been a growing challenge to the commercial software model. Under the non-commercial software model, open source software produced by loosely associated groups of unpaid programmers and made available for license to end users without charge is distributed by firms at nominal cost that earn revenue on complementary services and products, without having to bear the full costs of research and development for the open source software. The most notable example of open source software is the Linux operating system. While we believe our products provide customers with significant advantages in security and productivity, and generally have a lower total cost of ownership than open source software, the popularization of the non-commercial software model continues to pose a significant challenge to our business model, including recent efforts by proponents of open source software to convince governments worldwide to mandate the use of open source software in their purchase and deployment of software products. To the extent open source software gains increasing market acceptance, sales of our products may decline, we may have to reduce the prices we charge for our products, and revenue and operating margins may consequently decline. We defend our intellectual property rights, but unlicensed copying and use of software and intellectual property rights represents a loss of revenue to us. While this adversely affects U.S. revenue, the impact on revenue from outside the United States is more significant, particularly in countries where laws are less protective of intellectual property rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and ed-

ucate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may not affect revenue positively, and revenue could be adversely affected by further deterioration in compliance with existing legal protections or reductions in the legal protection for intellectual property rights of software developers. **From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. Responding to these claims may require us to enter into royalty and licensing agreements on unfavorable terms, require us to stop selling or to redesign affected products, or to pay damages or to satisfy indemnification commitments with our customers. If we are required to enter into such agreements or take such actions, our operating margins may decline as a result. We have made significant investments in research, development and marketing for new products, services, and technologies, including Longhorn, Microsoft .NET, Xbox, business applications, MSN, and mobile and wireless technologies. Significant revenue from new product and service investments may not be achieved for a number of years, if at all. Moreover, these products and services may not be profitable, and even if they are profitable, operating margins for these businesses may not be as high as the margins we have experienced historically.** *Maintaining the security of computers and computer networks is an issue of critical importance for us and our customers. There are malicious hackers who develop and deploy viruses, worms, and other malicious software programs that attack our products. While this is an industry-wide phenomenon that affects computers across all platforms, our customers in particular have been victims of such attacks and will likely continue to be so. We are devoting significant resources to addressing these critical issues. We are focusing our efforts on engineering more secure products, optimizing security and reliability options and settings when we deliver products, and providing guidance to help our customers make the best use of our products and services to protect against computer viruses and other attacks on their computing environment. In addition, we are working to improve the deployment of software updates to address security vulnerabilities discovered after our products are released. We are also investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed. We are also advising customers on how to help protect themselves from security threats through the use of our online automated security tools, our published security guidance, and the deployment of security software such as firewalls, antivirus, and other security software. These steps could adversely affect our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to purchase competitive products. Customers may also increase their expenditures on protecting their computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. If overall market demand for PCs, servers, and*

other computing devices declines significantly, or consumer or corporate spending for such products declines, our revenue will be adversely affected. Additionally, our revenue would be unfavorably impacted if customers reduce their purchases of new software products or upgrades to existing products because new product offerings are not perceived as adding significant new functionality or other value to prospective purchasers. A significant number of customers purchased license agreements providing upgrade rights to specific licensed products prior to the transition to Licensing 6.0 in July 2002. These agreements generally expired throughout fiscal 2004 and will largely be expired by the end of the first fiscal quarter in 2005. The rate at which such customers renew these contracts could adversely affect future revenue. We are making significant investments in the next release of the Windows operating system, code-named Longhorn. If this system is not perceived as offering significant new functionality or value to prospective purchasers, our revenue and operating margins could be adversely affected. **The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products, particularly any delays in the Longhorn operating system, could adversely affect our revenue.**

Softness in corporate information technology spending or other changes in general economic conditions that affect demand for computer hardware or software could adversely affect our revenue. Terrorist activity and armed conflict pose the additional risk of general economic disruption and could require changes in our operations and security arrangements, thus increasing our operating costs. These conditions lend additional uncertainty to the timing and budget for technology investment decisions by our customers. We continue to experience intensive competition across all markets for our products and services. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins, and operating income. In August 2001, a World Trade Organization (“WTO”) dispute panel determined that the tax provisions of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (“ETI”) constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures. The U.S. government appealed the panel’s decision and lost its appeal. On March 1, 2004, the European Union began imposing retaliatory tariffs on a specified list of U.S.-source goods. In May, the U.S. Senate passed the Jumpstart our Business Strength (JOBS) Act that would repeal ETI, provide a three-year phase-out of current ETI benefits, and would replace ETI with a phased-in 9% domestic production activity deduction that would not be fully effective until 2012. The U.S. House of Representatives passed similar legislation in June that would repeal ETI effective December 31, 2004, provide a two-year phase-out of ETI benefits, and replace ETI with a 3% tax rate reduction

for income from domestic production activities that would be full phased in by 2006. Neither bill will fully replace our current ETI tax benefits. Both bills must still be reconciled in conference, and significant changes could be made to the final legislation, so we remain unable to assess the ultimate form and financial impact of this legislation, if enacted. If the ETI provisions are repealed and financially comparable replacement tax legislation is not enacted, the loss of the ETI tax benefit to us could be significant. We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different than that which is reflected in historical income tax provisions and accruals. Should additional taxes be assessed as a result of an audit or litigation, a material effect on our income tax provision and net income in the period or periods for which that determination is made could result. In addition to conventional third-party insurance arrangements, we have entered into captive insurance arrangements for the purpose of protecting against possible catastrophic and other risks not covered by traditional insurance markets. As of June 30, 2004, the face value of captive insurance arrangements was \$2.0 billion. Actual value at any particular time will vary due to deductibles, exclusions, other restrictions, and claims. While we believe these arrangements are an effective way to insure against such risks, the potential liabilities associated with certain of the issues and uncertainties discussed in this document or other events could exceed the coverage provided by such arrangements. We are a highly automated business and a disruption or failure of our systems in the event of a major earthquake, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales and providing services. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our future operating results could be adversely affected.

References

Microsoft Corporation, 2004. 2004 Annual Report. Available at: <https://www.microsoft.com/en-us/Investor/annual-reports.aspx>.