

# Expecting an in-line June qtr; Vista an FY08 growth driver

## Vista results likely to be in-line; little chance of upside

We don't expect much 4Q07 (June) upside for Vista given the OEM inventory build-up in 3Q07 and a lack of catalysts such as holiday or back-to-school buying. Inventory may slip to four weeks, which could impact 4Q07 Client revenues by about \$100-200mn vs our estimate of \$3.9bn, potentially trimming our Client growth estimate of 15% y/y to 9-12%. However, processor shipments (a leading indicator of PC demand) look positive for H2. This will coincide with the release of Microsoft's SP1 later this year, which should address ongoing compatibility issues with peripherals and device drivers, a positive for the enterprise market. The Dec quarter could be boosted by holiday buying. Our thesis on Vista is that a clearer feature differentiation between Professional and Home versions should lead to a higher ASP, and that better anti-piracy protection will reduce revenue leakage.

## Catalysts for 2H07: Longhorn release & deal for aQuantive

Winders Server, code-named Longhorn, will likely be released later this year. It could be a positive catalyst for the Server business given that the last major refresh was in 2003. The Online business should see a boost from the pending \$6bn acquisition of AQNT, a leader in branded advertising. This is already a promising growth engine for MSFT (vs search advertising), and puts to rest, at least for now, any speculation of MSFT buying Yahoo. We'll be looking for details on MSFT's online advertising strategy on the earnings call and at FAM.

## Vista thesis intact: Reiterate Buy and \$33 price objective

We think there is potential upside to our current FY08 EPS estimate of \$1.70 to \$1.80-1.85. Vista upside in FY08 could be: 1) \$0.02 to \$0.06 from higher ASP's due to premium SKU's; and 2) \$0.04 to \$0.07 from lower piracy rates. Improving Xbox 360 profitability and share buybacks are added catalysts. Our \$33 PO is based on a DCF (9.7% WACC, 10-yr CF estimates, 3% terminal growth).

## Estimates (Jun)

(US\$)	2005A	2006A	2007E	2008E	2009E
EPS	1.15	1.29	1.42	1.70	1.87
GAAP EPS	1.12	1.20	1.42	1.70	1.87
EPS Change (YoY)	35.3%	12.2%	10.1%	19.7%	10.0%
Consensus EPS (First Call: 10-Jul-2007)			1.49	1.71	1.92
Dividend Rate	3.31	0.34	0.39	0.40	0.40

## Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	26.8x	23.9x	21.7x	18.1x	16.5x
GAAP P/E	27.4x	25.7x	21.7x	18.1x	16.4x
Dividend Yield	10.8%	1.1%	1.3%	1.3%	1.3%
EV / EBITDA*	17.8x	16.8x	15.5x	13.2x	12.5x
Free Cash Flow Yield*	5.2%	4.2%	5.4%	5.3%	5.8%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 13.



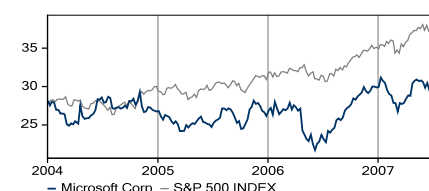
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## Stock Data

Price	US\$30.78
Price Objective	US\$33.00
Date Established	16-Oct-2006
Investment Opinion	B-1-7
Volatility Risk	MEDIUM
52-Week Range	US\$22.26-31.48
Mrkt Val / Shares Out (mn)	US\$303,552 / 9,862.0
ML Symbol / Exchange	MSFT / NAS
Bloomberg / Reuters	MSFT US / MSFT.O
ROE (2007E)	36.5%
Total Dbt to Cap (Mar-2007A)	0%
Est. 5-Yr EPS / DPS Growth	12.0% / 15.0%



## Quarterly Earnings Estimates

	2006	2007
Q1	0.31A	0.35A
Q2	0.34A	0.26A
Q3	0.32A	0.50A
Q4	0.31A	0.31E

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# iQprofile<sup>SM</sup> Microsoft Corp

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2005A	2006A	2007E	2008E	2009E
Return on Capital Employed	22.2%	27.7%	33.5%	38.3%	32.7%
Return on Equity	20.4%	29.8%	36.5%	42.0%	35.5%
Operating Margin	41.8%	39.7%	36.6%	39.1%	38.2%
Free Cash Flow	15,793	12,826	16,272	15,997	17,741

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2005A	2006A	2007E	2008E	2009E
Cash Realization Ratio	1.3x	1.1x	1.3x	1.1x	1.1x
Asset Replacement Ratio	0.9x	1.7x	1.5x	1.6x	1.8x
Tax Rate	26.4%	31.0%	30.5%	30.5%	30.5%
Net Debt-to-Equity Ratio	-10.1%	-15.5%	-2.1%	-19.3%	-26.6%
Interest Cover	NA	NA	NA	NA	NA

## Income Statement Data (Jun)

(US\$ Millions)	2005A	2006A	2007E	2008E	2009E
Sales	39,788	44,282	50,939	56,699	61,787
% Change	8.0%	11.3%	15.0%	11.3%	9.0%
Gross Profit	33,843	36,632	40,141	46,394	50,704
% Change	11.1%	8.2%	9.6%	15.6%	9.3%
EBITDA	17,497	18,484	20,023	23,524	24,789
% Change	48.9%	5.6%	8.3%	17.5%	5.4%
Net Interest & Other Income	2,067	1,790	1,564	1,236	1,601
Net Income (Adjusted)	12,535	13,596	14,038	16,272	17,528
% Change	36.2%	8.5%	3.3%	15.9%	7.7%

## Free Cash Flow Data (Jun)

(US\$ Millions)	2005A	2006A	2007E	2008E	2009E
Net Income from Cont Operations (GAAP)	12,254	12,599	14,038	16,272	17,528
Depreciation & Amortization	855	903	1,379	1,347	1,169
Change in Working Capital	174	(2,397)	(538)	(1,596)	(1,275)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	3,322	3,299	3,404	2,091	2,437
Capital Expenditure	(812)	(1,578)	(2,012)	(2,118)	(2,119)
Free Cash Flow	15,793	12,826	16,272	15,997	17,741
% Change	16.8%	-18.8%	26.9%	-1.7%	10.9%

## Balance Sheet Data (Jun)

(US\$ Millions)	2005A	2006A	2007E	2008E	2009E
Cash & Equivalents	4,851	6,714	701	8,446	14,613
Trade Receivables	7,180	9,316	9,525	10,859	11,340
Other Current Assets	36,706	32,980	33,151	34,715	39,978
Property, Plant & Equipment	2,346	3,044	4,218	5,191	6,316
Other Non-Current Assets	19,732	17,543	17,517	17,162	16,982
<b>Total Assets</b>	<b>70,815</b>	<b>69,597</b>	<b>65,113</b>	<b>76,373</b>	<b>89,229</b>
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	16,877	19,325	23,576	24,774	26,066
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	5,823	7,051	7,737	7,831	8,145
<b>Total Liabilities</b>	<b>22,700</b>	<b>26,376</b>	<b>31,313</b>	<b>32,605</b>	<b>34,211</b>
<b>Total Equity</b>	<b>48,115</b>	<b>43,221</b>	<b>33,799</b>	<b>43,768</b>	<b>55,018</b>
<b>Total Equity &amp; Liabilities</b>	<b>70,815</b>	<b>69,597</b>	<b>65,113</b>	<b>76,373</b>	<b>89,229</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 13.

## Company Description

Microsoft was founded in 1975 by Bill Gates and Paul Allen, and went public on 13 March 1986. In September 2005, the company was re-organized into three business units (down from seven): 1) Platform Products and Services (combining Windows Client, Server & Tools, MSN) 2) Business (combining Information Worker & MBS), & 3) Entertainment & Devices (combining Mobile & Embedded Devices, & Home & Entertainment).

## Stock Data

Average Daily Volume	54,212,548
Brokers Covered (FirstCall)	19

## Expect in-line Q4

### The numbers...

We are expecting total revenues of \$13,188 billion, up 11.7% y/y. This is slightly below the mid-point of guidance of \$13.1-13.4 billion, and consensus of \$13,270.

Our EPS estimate is \$0.31, impacted by \$0.08 after Microsoft's announcement last week that it would be taking a charge related to its Xbox warranty. This is in-line with consensus, and at the high end of guidance of \$0.37-0.39 (before the warranty charge).

Chart 1: Our estimates for 4Q07 (June) are slightly below the mid-point of guidance

\$ Millions	ML estimate	MSFT guidance
Client	\$3,870	\$3,866
Server and Tools	3,139	3,134
Microsoft Business Division	4,458	4,434
Online Services Group (MSN)	670	653
Entertainment and Devices	1,052	1,170
<b>Total Revenue</b>	<b>\$13,188</b>	<b>\$13,256</b>

Source: Merrill Lynch; Microsoft

Guidance reflects the mid-point provided by Microsoft

Table 1: We are forecasting strong Q4 growth in cash flow and unearned revenue

\$ Millions	Mar. 3Q07A	June 4Q07E
Cash & Equivalents	\$7,611	\$701
Short-term Investments	20,625	26,672
<b>Total cash and short-term investments</b>	<b>\$28,236</b>	<b>\$27,374</b>
<b>Cash flow from operations</b>	<b>\$7,291</b>	<b>\$4,890</b>
Y/Y Growth	60%	49%
<b>Free cash flow</b>	<b>\$6,830</b>	<b>\$4,323</b>
Y/Y Growth	60%	70%
<b>Short-term Unearned Revenue</b>	<b>8,551</b>	<b>9,979</b>
Y/Y Growth	18.5%	9.2%
Q/Q Growth	-14.7%	16.7%
<b>Long-term Unearned Revenue</b>	<b>1,732</b>	<b>2,169</b>
Y/Y Growth	2.7%	23.0%
Q/Q Growth	-5.8%	25.2%
<b>Total Unearned Revenue</b>	<b>10,283</b>	<b>12,148</b>
Y/Y Growth	15.5%	11.4%
Q/Q Growth	-13.3%	18.1%

Source: Merrill Lynch

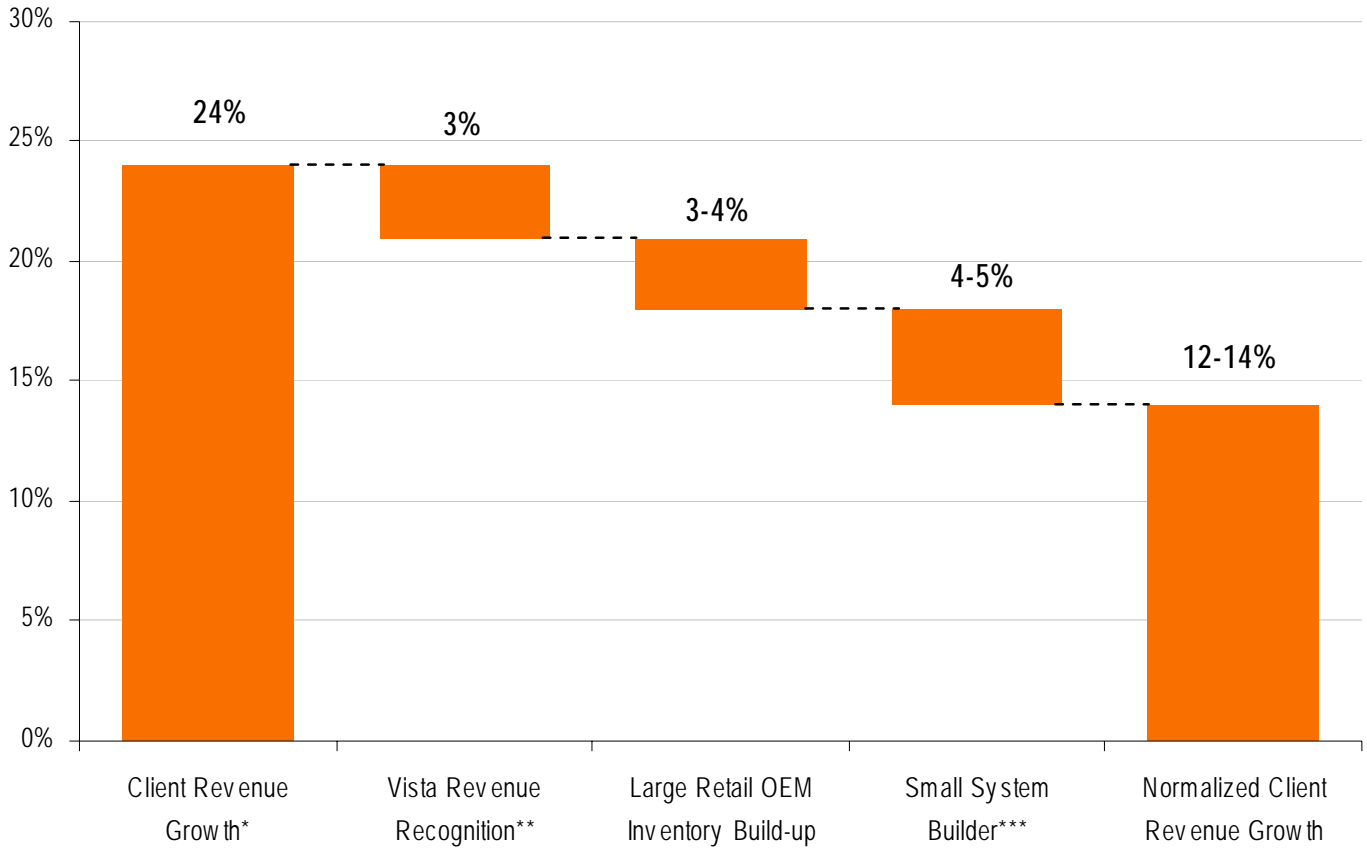
### Similar Vista build-up less likely to repeat in 4Q07 (June)

Our view is OEM's will not increase inventory in 4Q07, especially with a lack of catalysts such as holiday or back-to-school buying. Device and driver issues may also gate near-term Vista adoption. Inventory may slip to four weeks, which could impact 4Q07 Client revenues by about \$100-200mn vs. our estimate of \$3.9bn, potentially trimming our Client growth estimate of 15% y/y to 9-12% worst case.

### OEM and system builder inventory build benefited Vista in 3Q07 (March)

Microsoft's 3Q07 OEM revenue, which accounts for about 80% of Vista revenues, grew 24% y/y (excluding the Tech Guarantee deferral). This spike in revenue, after the Vista launch, benefited by 3-4% (about \$95-125 million) from large retail OEM's as they built inventory and 4-5% from system builders as they built inventory (about \$70 million) and pirated less. We estimate total OEM inventory build therefore accounted for about \$165-195 million. Growth was 12-14% y/y, normalizing for this build and Vista revenue recognition benefits. Large retail OEM's built Vista inventories from two weeks at the beginning of Q3 to five weeks at the end of Q3, slightly above the normal four weeks.

Chart 2: Microsoft's 3Q07 Client revenue growth benefited 3-4% due to inventory build-up at large retail OEM's, and about another 2% from small system builders



Source: Merrill Lynch, Microsoft

\* Excluding recognition of Tech Guaranty deferrals for 2Q07

\*\* Faster revenue recognition for Vista because Microsoft previously deferred XP revenues due to undeliverable elements

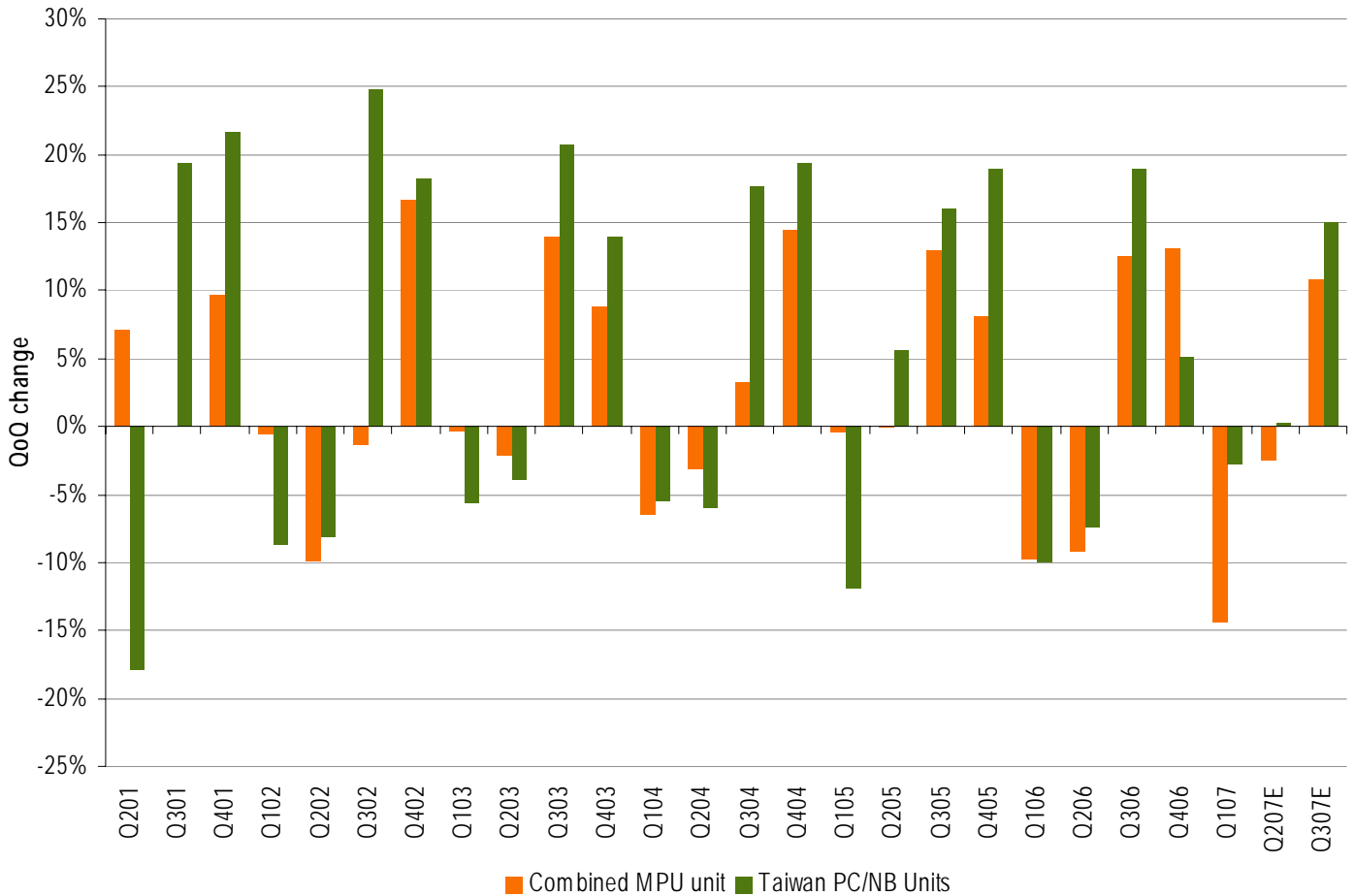
\*\*\* Split roughly 50/50 between inventory build-up and reduced piracy

**Vista should be a positive 2H07 driver**

We remain positive on Vista. Microsoft's release of SP1 later this year and updates for device and software drivers should be material drivers in 2H07 especially as we head in to the back-to-school and holiday season. As such, Vista should benefit the first half of FY08 (June) more than 4Q07 (June). We reiterate potential EPS upside of \$0.06-0.13 in FY08 on top of our estimate of \$1.70 from Vista: 1) \$0.02 to \$0.06 from higher ASP's due to premium SKU's; and 2) \$0.04 to \$0.07 from lower piracy rates.

Microprocessor shipments – a leading indicator of PC demand – look to be on the upswing for H2. This should be a positive for Microsoft and Vista heading into the latter part of this calendar year.

Chart 3: After a weak H1, microprocessor shipments should see improvement in H2



Source: Merrill Lynch

### Vista Levers

#### Higher ASP as premium SKU's garner a higher percentage of mix

The premium mix assumption for Vista could increase as we work through the cycle. Microsoft increased its Client forecast for FY07 by \$350 million even before the retail launch of Vista on January 30<sup>th</sup>. More increases could come through if the premium mix assumptions embedded in the forecast are revised upwards.

Higher mix of Premium SKU's especially weighted towards the Professional version could add \$0.02 to \$0.06 to EPS in FY08 depending on the mix between Home Premium and Pro Business, because the latter SKU is priced at \$100 vs \$60 for Home Premium.

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**Chart 4: A higher premium SKU mix could add \$0.02-\$0.06 to EPS in FY08**

	Base Case: Current ASP of \$73.5			Scenario 1: Target ASP of \$77			Scenario 2: Target ASP of \$77			Scenario 3: Target ASP of \$79		
	Assumed Mix	Price	Weighted Ave ASP	Assumed Mix	Price	Weighted Ave ASP	Assumed Mix	Price	Weighted Ave ASP	Assumed Mix	Price	Weighted Ave ASP
Home Premium	15%	\$60	\$9	25%	\$60	\$15	20%	\$60	\$12	15%	\$60	\$9
Pro (Business)	44%	\$100	\$44	45%	\$100	\$45	50%	\$100	\$50	55%	\$100	\$55
	59%			70%			70%			70%		
Home Basic, Starter, etc.	41%	\$50	\$21	30%	\$50	\$15	30%	\$50	\$15	30%	\$50	\$15
	100%		\$73.50	100%		\$75.00	100%		\$77.00	100%		\$79.00
<b>Incremental ASP</b>						<b>\$1.50</b>			<b>\$3.50</b>			<b>\$5.50</b>

Worldwide PC Shipments - FY08 (mn)	269	269	269
Microsoft's (Vista) share of worldwide PC shipments	70%	70%	70%
PC Shipments with Vista	188	188	188
<b>Incremental Revenue (\$mn)</b>	<b>\$282</b>	<b>\$658</b>	<b>\$1,034</b>
Client Operating Margin	75%	75%	75%
Operating income	\$212	\$494	\$776
Tax rate	31%	31%	31%
<b>Incremental Net income</b>	<b>\$146</b>	<b>\$341</b>	<b>\$535</b>
<b>Potential incremental EPS in FY08</b>	<b>\$0.02</b>	<b>\$0.04</b>	<b>\$0.06</b>

Source: Merrill Lynch

In addition, there is now a Home Ultimate edition, which is a new SKU. This is a higher-priced SKU, and could also benefit Microsoft's ASP.

#### Lower piracy rates would benefit revenues and EPS

Piracy and competition together account for 30% of worldwide PC market. Microsoft has the remaining 70% share. Blocking of internet usage and the inability to use the full 3D GUI effect could potentially reduce the piracy rate longer term. We don't want to get too aggressive with our assumptions. Even reducing it by 5% could add \$0.04 to FY08 EPS. Reducing it by 10% could add \$0.07 to FY08 EPS.

**Chart 5: Lowering piracy could add \$0.04-\$0.07 to FY08 EPS**

Worldwide PC Shipments - FY08 (mn)	269
Windows Share	70%
Windows based PCs (mn)	188
Loss to Piracy and Competition	30%
Pirated Windows plus Competition (mn)	56

Scenario 1: 5% Piracy reduction from Vista		Scenario 2: 10% Piracy reduction from Vista	
Loss from Piracy and Competition	25%	Loss from Piracy and Competition	20%
Net gain in Windows Copies (mn)	9.4	Net gain in Windows Copies (mn)	18.8
Vista Average Selling Price (ASP)	\$73.5	Vista Average Selling Price (ASP)	\$73.5
Incremental revenue opportunity (mn)	\$691	Incremental revenue opportunity (mn)	\$1,382
Client operating margin	75%	Client operating margin	75%
Incremental operating income	\$518	Incremental operating income	\$1,037
Tax rate	31%	Tax rate	31%
Incremental Net income	\$358	Incremental Net income	\$715
<b>Potential incremental EPS</b>	<b>\$0.04</b>	<b>Potential incremental EPS</b>	<b>\$0.07</b>

Source: Merrill Lynch

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**Chart 6: At 17.5x CY08 P/E, Microsoft is currently fairly valued relative to Oracle at 15.4x**

Steady Growers	Ticker	7/17/2007	Rating	EPS 5yr CAGR	Proforma P/E		PEG		EV/FCF		EV/Revenue	
					CY07E	CY08E	CY07E	CY08E	CY07E	CY08E	CY07E	CY08E
Blackbaud	BLKB	\$22.64	C-2-7	10%	27.3x	20.8x	2.7x	2.1x	15.7x	13.8x	4.2x	3.7x
Microsoft	MSFT	\$30.78	B-1-7	12%	18.2x	17.5x	1.5x	1.5x	17.5x	16.5x	4.8x	4.6x
Oracle	ORCL	\$20.38	B-1-9	10%	18.7x	15.4x	1.9x	1.5x	15.6x	15.4x	5.4x	4.9x
SAP	SAP	\$52.79	B-1-7	18%	24.4x	20.1x	1.4x	1.1x	27.1x	21.5x	4.3x	3.8x
<b>Average</b>				<b>13%</b>	<b>22.2x</b>	<b>18.5x</b>	<b>1.9x</b>	<b>1.5x</b>	<b>19.0x</b>	<b>16.8x</b>	<b>4.7x</b>	<b>4.2x</b>
<b>Companies in Transition</b>												
BEA	BEAS	\$13.85	C-2-9	10%	23.9x	22.3x	2.4x	2.2x	15.5x	14.3x	3.2x	2.9x
JDA Software	JDAS	\$20.00	C-2-9	14%	18.2x	15.7x	1.3x	1.1x	19.6x	18.4x	2.1x	2.0x
Lawson	LWSN	\$9.95	C-1-9	12%	38.3x	23.7x	3.2x	2.0x	17.4x	15.2x	2.1x	1.9x
Sybase	SY	\$24.77	B-1-9	15%	16.1x	14.2x	1.1x	0.9x	11.9x	11.0x	2.0x	1.9x
TIBCO	TIBX	\$9.23	C-1-9	15%	24.6x	19.0x	1.6x	1.3x	16.1x	13.5x	3.0x	2.5x
<b>Average</b>				<b>13%</b>	<b>24.2x</b>	<b>19.0x</b>	<b>1.9x</b>	<b>1.5x</b>	<b>16.1x</b>	<b>14.5x</b>	<b>2.5x</b>	<b>2.2x</b>
<b>Growth Companies</b>												
Blackboard	BBBB	\$45.36	C-1-9	20%	41.2x	35.7x	2.1x	1.8x	33.4x	26.9x	5.7x	5.0x
Concur	CNQR	\$23.50	C-2-9	20%	73.4x	57.3x	3.7x	2.9x	48.6x	49.1x	7.3x	5.6x
Opware	OPSW	\$10.10	C-2-9	25%	95.2x	36.9x	3.8x	1.5x	142.5x	32.8x	6.6x	5.0x
Red Hat	RHT	\$21.84	C-1-9	25%	32.6x	27.6x	1.3x	1.1x	17.7x	14.9x	8.6x	6.6x
RightNow	RNOW	\$16.27	C-2-9	36%	NM	69.4x	NM	1.9x	43.8x	15.4x	3.8x	2.9x
Salesforce	CRM	\$44.02	C-1-9	50%	95.7x	71.0x	1.9x	1.4x	31.1x	26.1x	6.7x	5.2x
Taleo	TLEO	\$21.43	C-2-9	27%	67.0x	45.6x	2.5x	1.7x	41.2x	31.4x	4.0x	3.4x
<b>Average</b>				<b>29%</b>	<b>67.5x</b>	<b>49.1x</b>	<b>2.5x</b>	<b>1.8x</b>	<b>51.2x</b>	<b>28.1x</b>	<b>6.1x</b>	<b>4.8x</b>
<b>Group Average</b>				<b>20%</b>	<b>41.0x</b>	<b>32.0x</b>	<b>2.2x</b>	<b>1.6x</b>	<b>32.2x</b>	<b>21.0x</b>	<b>4.6x</b>	<b>3.9x</b>
<b>Group Average excluding Outliers</b>				<b>14%</b>	<b>25.1x</b>	<b>20.5x</b>	<b>1.9x</b>	<b>1.6x</b>	<b>19.0x</b>	<b>16.7x</b>	<b>3.7x</b>	<b>3.3x</b>

Source: Merrill Lynch estimates

\* Outliers include Concur, Opware, Red Hat, RightNow, Salesforce, &amp; Taleo

\*\* MSFT GAAP EPS

**Chart 7: Our DCF suggests a theoretical fair value of \$33 per share**

Years Out	FY05A	FY06A	FY07E	FY08E	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E	FY15E	FY16E
FCF	\$15,793	\$12,826	\$16,272	\$15,997	\$17,741	\$19,603	\$21,368	\$23,077	\$24,692	\$26,174	\$27,483	\$28,582
FCF - Growth		(18.8%)	26.9%	(1.7%)	10.9%	11%	9%	8%	7%	6%	5%	4%
DCF			14,831	13,289	13,433	13,529	13,441	13,231	12,903	12,466	11,931	11,309

**Key assumptions:**

Risk free rate	4.68%
Equity risk premium	5.30%
Beta (adjusted)	0.95
Cost of equity	9.7%
Cost of debt	0.0%
Debt/Total Capital	0.0%
<b>WACC</b>	<b>9.7%</b>
Current cash (M)	\$28,873
Current debt (M)	\$0

Terminal Growth Assumptions	0%	1%	2%	3%	4%
Terminal Multiple	10x	11x	13x	15x	17x
WACC	9.7%	9.7%	9.7%	9.7%	9.7%
Terminal FCF (\$000)	\$28,582				
Terminal Value (\$000)	\$294,204	\$327,963	\$370,473	\$425,643	\$500,122
Present Value of Terminal Value (\$000)	\$116,410	\$129,767	\$146,587	\$168,417	\$197,886
Present Value of Cash Flows (\$000)	\$130,364				
Enterprise Value (\$000)	\$246,773	\$260,131	\$276,951	\$298,781	\$328,250
Plus Cash minus Debt (\$000)	\$275,646	\$289,004	\$305,824	\$327,654	\$357,123
Shares Outstanding (000)	9,942				
<b>Fair Value per share</b>	<b>\$27.73</b>	<b>\$29.07</b>	<b>\$30.76</b>	<b>\$32.96</b>	<b>\$35.92</b>

Source: Company data; Merrill Lynch estimates

Chart 8: Microsoft Income Statement

\$ Millions (except per share data)	YEAR FY05A	Sep. 1Q06A	Dec. 2Q06A	Mar. 3Q06A	June 4Q06A	YEAR FY06A	Sep. 1Q07A	Dec. 2Q07A	Mar. 3Q07A	June 4Q07E	YEAR FY07E	Sep. 1Q08E	Dec. 2Q08E	Mar. 3Q08E	June 4Q08E	YEAR FY08E	YEAR FY09E
<b>Revenues</b>																	
Client Pro-forma												3,788	3,853	4,007	4,123	\$15,771	
Revenues from Vista Rev-Rec												158	172	158	172	\$660	
<b>Client</b>	<b>\$12,151</b>	\$3,187	\$3,459	\$3,187	\$3,376	<b>\$13,209</b>	\$3,303	\$2,589	\$5,272	\$3,870	<b>\$15,034</b>	3,947	4,024	4,165	4,295	<b>\$16,431</b>	<b>\$17,226</b>
Server and Tools	<b>8,370</b>	2,127	2,438	2,398	2,690	<b>9,653</b>	2,499	2,845	2,749	3,139	<b>11,232</b>	2,979	3,179	3,026	3,405	<b>12,589</b>	<b>13,646</b>
Information Worker	<b>11,169</b>	2,675	2,979	2,946	3,133	<b>11,733</b>	2,745	2,730	4,031	3,620	<b>13,126</b>	3,544	3,445	3,496	3,881	<b>14,366</b>	<b>15,598</b>
MBS	<b>2,352</b>	608	710	663	774	<b>2,755</b>	680	782	798	838	<b>3,098</b>	796	814	805	966	<b>3,381</b>	<b>3,949</b>
Microsoft Business Division	<b>13,521</b>	3,283	3,689	3,609	3,907	<b>14,488</b>	3,425	3,512	4,829	4,458	<b>16,224</b>	4,340	4,258	4,302	4,847	<b>17,747</b>	<b>19,548</b>
Online Services Group (MSN)	<b>2,344</b>	564	594	561	580	<b>2,299</b>	539	624	623	670	<b>2,456</b>	621	715	722	758	<b>2,816</b>	<b>3,243</b>
MED	<b>262</b>	74	101	89	113	<b>377</b>	110	201	116	191	<b>618</b>	186	269	296	326	<b>1,077</b>	<b>1,287</b>
Home & Entertainment	<b>3,140</b>	506	1,556	1,056	1,138	<b>4,256</b>	920	2,763	813	860	<b>5,356</b>	1,071	2,894	1,119	956	<b>6,039</b>	<b>6,837</b>
Entertainment and Devices	<b>3,402</b>	580	1,657	1,145	1,251	<b>4,633</b>	1,030	2,964	929	1,052	<b>5,974</b>	1,256	3,163	1,415	1,282	<b>7,115</b>	<b>8,124</b>
Unallocated and Other							15	8	(4)		<b>19</b>					<b>0</b>	<b>0</b>
<b>Total Revenue</b>	<b>39,788</b>	<b>9,741</b>	<b>11,837</b>	<b>10,900</b>	<b>11,804</b>	<b>44,282</b>	<b>10,811</b>	<b>12,542</b>	<b>14,398</b>	<b>13,188</b>	<b>50,939</b>	<b>13,143</b>	<b>15,339</b>	<b>13,630</b>	<b>14,586</b>	<b>56,699</b>	<b>61,787</b>
Cost of Revenue	<b>5,945</b>	1,253	2,239	2,028	2,130	<b>7,650</b>	1,696	3,620	2,140	3,342	<b>10,798</b>	2,234	2,991	2,453	2,626	<b>10,304</b>	<b>11,083</b>
<b>Gross Profit (before stock comp)</b>	<b>33,843</b>	<b>8,488</b>	<b>9,598</b>	<b>8,872</b>	<b>9,674</b>	<b>36,632</b>	<b>9,115</b>	<b>8,922</b>	<b>12,258</b>	<b>9,846</b>	<b>40,141</b>	<b>10,909</b>	<b>12,348</b>	<b>11,177</b>	<b>11,961</b>	<b>46,394</b>	<b>50,704</b>
<b>Operating Expenses*</b>																	
Research & Development*	<b>4,953</b>	1,515	1,591	1,617	1,861	<b>6,584</b>	1,786	1,637	1,750	1,912	<b>7,085</b>	1,971	1,994	1,840	2,086	<b>7,891</b>	<b>9,179</b>
Sales & Marketing*	<b>8,025</b>	1,945	2,689	2,362	2,822	<b>9,818</b>	2,191	2,999	2,936	3,007	<b>11,133</b>	3,062	3,398	2,999	3,209	<b>12,668</b>	<b>13,926</b>
General & Administration*	<b>1,776</b>	621	661	608	759	<b>2,649</b>	664	814	983	818	<b>3,279</b>	881	951	886	941	<b>3,658</b>	<b>3,980</b>
<b>Operating Expenses*</b>	<b>14,753</b>	<b>4,081</b>	<b>4,941</b>	<b>4,587</b>	<b>5,442</b>	<b>19,051</b>	<b>4,641</b>	<b>5,450</b>	<b>5,669</b>	<b>5,737</b>	<b>21,497</b>	<b>5,914</b>	<b>6,343</b>	<b>5,725</b>	<b>6,236</b>	<b>24,218</b>	<b>27,085</b>
<b>Operating Income*</b>	<b>19,090</b>	<b>4,407</b>	<b>4,657</b>	<b>4,285</b>	<b>4,232</b>	<b>17,581</b>	<b>4,474</b>	<b>3,472</b>	<b>6,589</b>	<b>4,109</b>	<b>18,644</b>	<b>4,994</b>	<b>6,005</b>	<b>5,452</b>	<b>5,725</b>	<b>22,177</b>	<b>23,620</b>
<i>* Excludes stock comp expense through end of FY05</i>																	
Losses on Equity Investments	<b>0</b>																
Investment Income	<b>2,067</b>																
Pretax Income (before stock comp)	<b>21,157</b>																
Taxes (Pro forma)	<b>6,982</b>																
<b>Net Income (Pro forma, before stock comp)</b>	<b>14,175</b>																
<b>EPS (Pro forma, before stock comp)</b>	<b>\$1.30</b>																
Stock-based Compensation	<b>2,448</b>																
<b>Operating Income (after stock comp)</b>	<b>16,642</b>	4,407	4,657	4,285	4,232	<b>17,581</b>	4,474	3,472	6,589	4,109	<b>18,644</b>	4,994	6,005	5,452	5,725	<b>22,177</b>	<b>23,620</b>
Investment Income		506	480	427	377	<b>1,790</b>	567	333	\$382	\$282	<b>1,564</b>	274	\$298	\$308	\$356	<b>1,236</b>	<b>1,601</b>
Pretax Income (after stock comp)	<b>18,709</b>	4,913	5,137	4,712	4,609	<b>19,371</b>	5,041	3,805	6,971	4,392	<b>20,208</b>	5,268	6,303	5,760	6,081	<b>23,413</b>	<b>25,221</b>
Taxes (Pro forma)	<b>6,174</b>	1,523	1,484	1,338	1,430	<b>5,775</b>	1,563	1,179	2,045	1,383	<b>6,170</b>	1,607	1,923	1,757	1,855	<b>7,141</b>	<b>7,692</b>
<b>Net Income (Pro forma, after stock comp)</b>	<b>12,535</b>	<b>3,390</b>	<b>3,653</b>	<b>3,374</b>	<b>3,179</b>	<b>13,596</b>	<b>3,478</b>	<b>2,626</b>	<b>4,926</b>	<b>3,008</b>	<b>14,038</b>	<b>3,661</b>	<b>4,381</b>	<b>4,004</b>	<b>4,226</b>	<b>16,272</b>	<b>17,528</b>
<b>EPS (Pro forma, after stock comp)</b>	<b>\$1.15</b>	<b>\$0.31</b>	<b>\$0.34</b>	<b>\$0.32</b>	<b>\$0.31</b>	<b>\$1.29</b>	<b>\$0.35</b>	<b>\$0.26</b>	<b>\$0.50</b>	<b>\$0.31</b>	<b>\$1.42</b>	<b>\$0.38</b>	<b>\$0.46</b>	<b>\$0.42</b>	<b>\$0.45</b>	<b>\$1.70</b>	<b>\$1.87</b>
Extraordinary Charges	<b>2,060</b>	361		397	351	<b>1,109</b>					<b>0</b>					<b>0</b>	<b>0</b>
Impairments	<b>0</b>	0				<b>0</b>					<b>0</b>					<b>0</b>	<b>0</b>
Pretax Income (GAAP)	<b>16,649</b>	4,552	5,137	4,315	4,258	<b>18,262</b>	5,041	3,805	6,971	4,392	<b>20,208</b>	5,268	6,303	5,760	6,081	<b>23,413</b>	<b>25,221</b>
Taxes (GAAP)	<b>4,395</b>	1,411	1,484	1,338	1,430	<b>5,663</b>	1,563	1,179	2,045	1,383	<b>6,170</b>	1,607	1,923	1,757	1,855	<b>7,141</b>	<b>7,692</b>
<b>Net Income (GAAP)</b>	<b>12,254</b>	<b>3,141</b>	<b>3,653</b>	<b>2,977</b>	<b>2,828</b>	<b>12,599</b>	<b>3,478</b>	<b>2,626</b>	<b>4,926</b>	<b>3,008</b>	<b>14,038</b>	<b>3,661</b>	<b>4,381</b>	<b>4,004</b>	<b>4,226</b>	<b>16,272</b>	<b>17,528</b>
<b>EPS (GAAP)</b>	<b>\$1.12</b>	<b>\$0.29</b>	<b>\$0.34</b>	<b>\$0.29</b>	<b>\$0.28</b>	<b>\$1.20</b>	<b>\$0.35</b>	<b>\$0.26</b>	<b>\$0.50</b>	<b>\$0.31</b>	<b>\$1.42</b>	<b>\$0.38</b>	<b>\$0.46</b>	<b>\$0.42</b>	<b>\$0.45</b>	<b>\$1.70</b>	<b>\$1.87</b>
Shares (fully diluted)	<b>10,906</b>	10,772	10,638	10,415	10,255	<b>10,520</b>	10,010	9,942	9,862	9,690	<b>9,876</b>	9,639	9,587	9,536	9,484	<b>9,561</b>	<b>9,355</b>

Source: Merrill Lynch estimates; Company data



Chart 9: Microsoft Income Statement Analysis

Margin & Growth Analysis	YEAR FY05A	Sep. 1Q06A	Dec. 2Q06A	Mar. 3Q06A	June 4Q06A	YEAR FY06A	Sep. 1Q07A	Dec. 2Q07A	Mar. 3Q07A	June 4Q07E	YEAR FY07E	Sep. 1Q08E	Dec. 2Q08E	Mar. 3Q08E	June 4Q08E	YEAR FY08E	YEAR FY09E
<b>Gross Margin</b>	<b>85.1%</b>	87.1%	81.1%	81.4%	82.0%	<b>82.7%</b>	84.3%	71.1%	85.1%	74.7%	<b>78.8%</b>	83.0%	80.5%	82.0%	82.0%	<b>81.8%</b>	<b>82.1%</b>
Research & Development*	<b>12.4%</b>	15.6%	13.4%	14.8%	15.8%	<b>14.9%</b>	16.5%	13.1%	12.2%	14.5%	<b>13.9%</b>	15.0%	13.0%	13.5%	14.3%	<b>13.9%</b>	<b>14.9%</b>
Sales & Marketing*	<b>20.2%</b>	20.0%	22.7%	21.7%	23.9%	<b>22.2%</b>	20.3%	23.9%	20.4%	22.8%	<b>21.9%</b>	23.3%	22.2%	22.0%	22.0%	<b>22.3%</b>	<b>22.5%</b>
General & Administration*	<b>4.5%</b>	6.4%	5.6%	5.6%	6.4%	<b>6.0%</b>	6.1%	6.5%	6.8%	6.2%	<b>6.4%</b>	6.7%	6.2%	6.5%	6.5%	<b>6.5%</b>	<b>6.4%</b>
<b>Operating Margin (before stock comp)</b>	<b>48.0%</b>	<b>45.2%</b>	<b>39.3%</b>	<b>39.3%</b>	<b>35.9%</b>	<b>39.7%</b>	<b>41.4%</b>	<b>27.7%</b>	<b>45.8%</b>	<b>31.2%</b>	<b>36.6%</b>	<b>38.0%</b>	<b>39.2%</b>	<b>40.0%</b>	<b>39.3%</b>	<b>39.1%</b>	<b>38.2%</b>
<b>Operating Margin (after stock comp)</b>	<b>41.8%</b>	<b>45.2%</b>	<b>39.3%</b>	<b>39.3%</b>	<b>35.9%</b>	<b>39.7%</b>	<b>41.4%</b>	<b>27.7%</b>	<b>45.8%</b>	<b>31.2%</b>	<b>36.6%</b>	<b>38.0%</b>	<b>39.2%</b>	<b>40.0%</b>	<b>39.3%</b>	<b>39.1%</b>	<b>38.2%</b>
Tax Rate (Pro forma)	<b>33.0%</b>	31.0%	28.9%	28.4%	31.0%	<b>29.8%</b>	31.0%	31.0%	29.3%	31.5%	<b>30.5%</b>	30.5%	30.5%	30.5%	30.5%	<b>30.5%</b>	<b>30.5%</b>
Tax Rate (GAAP)	<b>26.4%</b>	31.0%	28.9%	31.0%	33.6%	<b>31.0%</b>	31.0%	31.0%	29.3%	31.5%	<b>30.5%</b>	30.5%	30.5%	30.5%	30.5%	<b>30.5%</b>	<b>30.5%</b>
Net Margin (Pro forma, before stock comp)	<b>35.6%</b>	0.0%	0.0%	0.0%	0.0%	<b>0.0%</b>	0.0%	0.0%	0.0%	0.0%	<b>0.0%</b>	0.0%	0.0%	0.0%	0.0%	<b>0.0%</b>	<b>0.0%</b>
<b>Net Margin (Pro forma, after stock comp)</b>	<b>31.5%</b>	<b>34.8%</b>	<b>30.9%</b>	<b>31.0%</b>	<b>26.9%</b>	<b>30.7%</b>	<b>32.2%</b>	<b>20.9%</b>	<b>34.2%</b>	<b>22.8%</b>	<b>27.6%</b>	<b>27.9%</b>	<b>28.6%</b>	<b>29.4%</b>	<b>29.0%</b>	<b>28.7%</b>	<b>28.4%</b>
<b>Net Margin (GAAP)</b>	<b>30.8%</b>	<b>32.2%</b>	<b>30.9%</b>	<b>27.3%</b>	<b>24.0%</b>	<b>28.5%</b>	<b>32.2%</b>	<b>20.9%</b>	<b>34.2%</b>	<b>22.8%</b>	<b>27.6%</b>	<b>27.9%</b>	<b>28.6%</b>	<b>29.4%</b>	<b>29.0%</b>	<b>28.7%</b>	<b>28.4%</b>
<b>Growth Rates</b>																	
<b>Quarter-over-Quarter</b>																	
Client		5.7%	8.5%	-7.9%	5.9%		-2.2%	-21.6%	103.6%	-26.6%		-2.1%	1.7%	4.0%	2.9%		
Server and Tools		-5.3%	14.6%	-1.6%	12.2%		-7.1%	13.8%	-3.4%	14.2%		-5.1%	6.7%	-4.8%	12.5%		
Information Worker		-9.1%	11.4%	-1.1%	6.3%		-12.4%	-0.5%	47.7%	-10.2%		-2.1%	-2.8%	1.5%	11.0%		
MBS		-12.3%	16.8%	-6.6%	16.7%		-12.1%	15.0%	2.0%	5.0%		-5.0%	2.2%	-1.0%	20.0%		
Microsoft Business Division		-9.7%	12.4%	-2.2%	8.3%		-12.3%	2.5%	37.5%	-7.7%		-2.6%	-1.9%	1.0%	12.7%		
Online Services Group (MSN)		-5.7%	5.3%	-5.6%	3.4%		-7.1%	15.8%	-0.2%	5.8%		4.0%	1.0%	1.0%	5.0%		
MED		-7.5%	36.5%	-11.9%	27.0%		-2.7%	82.7%	-42.3%	65.0%		-3.0%	45.0%	10.0%	10.0%		
Home & Entertainment		-13.8%	207.5%	-32.1%	7.8%		-19.2%	200.5%	-70.6%	5.8%		24.4%	170.3%	-61.3%	-14.5%		
Entertainment and Devices		-13.0%	185.7%	-30.9%	9.3%		-17.7%	187.9%	-68.7%	13.2%		19.5%	151.8%	-55.3%	-9.4%		
<b>Total Revenue</b>		<b>-4.1%</b>	<b>21.5%</b>	<b>-7.9%</b>	<b>8.3%</b>		<b>-8.4%</b>	<b>16.0%</b>	<b>14.8%</b>	<b>-8.4%</b>		<b>-0.3%</b>	<b>16.7%</b>	<b>-11.1%</b>	<b>7.0%</b>		
<b>Year-over-Year</b>																	
Client	<b>5.2%</b>	6.9%	8.3%	7.5%	12.0%	<b>8.7%</b>	3.6%	-25.2%	65.4%	14.6%	<b>13.8%</b>	19.5%	55.4%	-21.0%	11.0%	<b>9.3%</b>	<b>4.8%</b>
Server and Tools	<b>-1.3%</b>	11.6%	12.8%	16.5%	19.8%	<b>15.3%</b>	17.5%	16.7%	14.6%	16.7%	<b>16.4%</b>	19.2%	11.7%	10.1%	8.4%	<b>12.1%</b>	<b>8.4%</b>
Information Worker	<b>3.4%</b>	3.1%	5.5%	5.0%	6.4%	<b>5.0%</b>	2.6%	-8.4%	36.8%	15.5%	<b>11.9%</b>	29.1%	26.2%	-13.3%	7.2%	<b>9.4%</b>	<b>8.6%</b>
MBS	<b>252.6%</b>	23.8%	20.7%	14.3%	11.7%	<b>17.1%</b>	11.8%	10.1%	20.4%	8.3%	<b>12.4%</b>	17.1%	4.0%	0.9%	15.3%	<b>9.2%</b>	<b>16.8%</b>
Microsoft Business Division	<b>17.9%</b>	6.4%	8.1%	6.6%	7.4%	<b>7.2%</b>	4.3%	-4.8%	33.8%	14.1%	<b>12.0%</b>	26.7%	21.2%	-10.9%	8.7%	<b>9.4%</b>	<b>10.1%</b>
Online Services Group (MSN)	<b>5.8%</b>	0.9%	-2.0%	-3.4%	-3.0%	<b>-1.9%</b>	-4.4%	5.1%	11.1%	15.5%	<b>6.8%</b>	15.2%	14.6%	15.9%	13.1%	<b>14.7%</b>	<b>15.1%</b>
MED	<b>6.1%</b>	51.0%	40.3%	45.9%	41.3%	<b>43.9%</b>	48.6%	99.0%	30.3%	69.4%	<b>64.0%</b>	68.8%	33.9%	155.3%	70.2%	<b>74.1%</b>	<b>19.5%</b>
Home & Entertainment	<b>9.2%</b>	-16.9%	13.3%	84.9%	93.9%	<b>35.5%</b>	81.7%	77.6%	-23.0%	-24.4%	<b>25.8%</b>	16.4%	4.7%	37.6%	11.1%	<b>12.8%</b>	<b>13.2%</b>
Entertainment and Devices	<b>8.9%</b>	-11.9%	14.7%	81.2%	87.6%	<b>36.2%</b>	77.5%	78.9%	-18.9%	-15.9%	<b>29.0%</b>	22.0%	6.7%	52.3%	21.9%	<b>19.1%</b>	<b>14.2%</b>
<b>Total Revenue</b>	<b>8.0%</b>	<b>6.0%</b>	<b>9.4%</b>	<b>13.3%</b>	<b>16.2%</b>	<b>11.3%</b>	<b>11.0%</b>	<b>6.0%</b>	<b>32.1%</b>	<b>11.7%</b>	<b>15.0%</b>	<b>21.6%</b>	<b>22.3%</b>	<b>-5.3%</b>	<b>10.6%</b>	<b>11.3%</b>	<b>9.0%</b>
Operating Income*	<b>17.2%</b>																
Net Income (Pro forma, before stock comp)	<b>8.6%</b>																
<b>EPS (Pro forma, before stock comp)</b>	<b>8.2%</b>																
Operating Income (after stock comp)	<b>57.6%</b>	8.8%	-1.9%	4.6%	13.0%	<b>5.6%</b>	1.5%	-25.4%	53.8%	-2.9%	<b>6.0%</b>	11.6%	73.0%	-17.3%	39.3%	<b>18.9%</b>	<b>6.5%</b>
Net Income (Pro forma, after stock comp)	<b>36.2%</b>	16.9%	5.5%	9.6%	2.8%	<b>8.5%</b>	2.6%	-28.1%	46.0%	-5.4%	<b>3.3%</b>	5.3%	66.8%	-18.7%	40.5%	<b>15.9%</b>	<b>7.7%</b>
<b>EPS (Pro forma, after stock comp)</b>	<b>35.6%</b>	<b>18.5%</b>	<b>8.6%</b>	<b>15.1%</b>	<b>8.4%</b>	<b>12.4%</b>	<b>10.4%</b>	<b>-23.1%</b>	<b>54.2%</b>	<b>0.1%</b>	<b>10.0%</b>	<b>9.3%</b>	<b>73.0%</b>	<b>-15.9%</b>	<b>43.5%</b>	<b>19.8%</b>	<b>10.1%</b>
Net Income (GAAP)	<b>50.0%</b>	24.2%	5.5%	16.2%	-23.6%	<b>2.8%</b>	10.7%	-28.1%	65.5%	6.4%	<b>11.4%</b>	5.3%	66.8%	-18.7%	40.5%	<b>15.9%</b>	<b>7.7%</b>
<b>EPS (GAAP)</b>	<b>49.5%</b>	<b>26.0%</b>	<b>8.6%</b>	<b>21.9%</b>	<b>-19.4%</b>	<b>6.5%</b>	<b>19.1%</b>	<b>-23.1%</b>	<b>74.7%</b>	<b>12.6%</b>	<b>18.8%</b>	<b>9.3%</b>	<b>73.0%</b>	<b>-15.9%</b>	<b>43.5%</b>	<b>19.8%</b>	<b>10.1%</b>

Source: Merrill Lynch estimates; Company data

Chart 10: Microsoft Operating Data by Segment

Margin & Growth Analysis	YEAR FY05A	Sep. 1Q06A	Dec. 2Q06A	Mar. 3Q06A	June 4Q06A	YEAR FY06A	Sep. 1Q07A	Dec. 2Q07A	Mar. 3Q07A	June 4Q07E	YEAR FY07E	Sep. 1Q08E	Dec. 2Q08E	Mar. 3Q08E	June 4Q08E	YEAR FY08E	YEAR FY09E
<b>Operating Revenue (% of total)</b>																	
<b>Segment Revenue</b>																	
Client	31%	33%	29%	29%	29%	30%	31%	21%	37%	29%	30%	30%	26%	31%	29%	29%	28%
Server and Tools	21%	22%	21%	22%	23%	22%	23%	23%	19%	24%	22%	23%	21%	22%	23%	22%	22%
Information Worker	28%	27%	25%	27%	27%	26%	25%	22%	28%	27%	26%	27%	22%	26%	27%	25%	25%
MBS	6%	6%	6%	6%	7%	6%	6%	6%	6%	6%	6%	6%	5%	6%	7%	6%	6%
Microsoft Business Division	34%	34%	31%	33%	33%	33%	32%	28%	34%	34%	32%	33%	28%	32%	33%	31%	32%
Online Services Group (MSN)	6%	6%	5%	5%	5%	5%	5%	5%	4%	5%	5%	5%	5%	5%	5%	5%	5%
MED	1%	1%	1%	1%	1%	1%	1%	2%	1%	1%	1%	1%	2%	2%	2%	2%	2%
Home & Entertainment	8%	5%	13%	10%	10%	10%	9%	22%	6%	7%	11%	8%	19%	8%	7%	11%	11%
Entertainment and Devices	9%	6%	14%	11%	11%	10%	10%	24%	6%	8%	12%	10%	21%	10%	9%	13%	13%
<b>Total Operating Income</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Operating Income by Segment</b>																	
<b>Segment Operating Income</b>																	
Client	9,403	2,569	2,638	2,471	2,504	10,182	2,637	1,880	4,244	2,786	11,547	3,157	3,139	3,249	3,178	12,723	13,387
Server and Tools	2,109	606	762	746	903	3,017	827	1,032	979	1,256	4,094	953	1,081	1,089	1,362	4,485	5,005
Information Worker	8,044	1,944	2,113	2,098	2,150	8,305	1,935	1,801	3,046	2,642	9,425	2,516	2,480	2,535	2,814	10,345	11,313
MBS	1,072	307	353	316	384	1,360	318	368	375	394	1,454	374	382	379	454	1,589	1,856
Microsoft Business Division	9,116	2,251	2,466	2,414	2,534	9,665	2,253	2,169	3,421	3,036	10,879	2,890	2,862	2,913	3,268	11,934	13,169
Online Services Group (MSN)	411	81	58	(26)	(190)	(77)	(136)	(155)	(200)	(134)	(625)	(124)	(129)	(130)	(136)	(519)	(162)
MED	(65)	(2)	20	(14)	(2)	2	(6)	(19)	(12)	(10)	(47)	(9)	(11)	(12)	(7)	(38)	(19)
Home & Entertainment	(532)	(180)	(316)	(408)	(435)	(1,339)	(90)	(270)	(303)	(1,186)	(1,849)	(64)	(29)	(11)	48	(57)	90
Entertainment and Devices	(607)	(182)	(296)	(422)	(437)	(1,337)	(96)	(289)	(315)	(1,196)	(1,896)	(74)	(40)	(23)	41	(95)	71
Reconciling amount	(5,871)	(1,279)	(971)	(1,295)	(1,433)	(4,978)	(1,011)	(1,165)	(1,540)	(1,639)	(5,355)	(1,809)	(909)	(1,647)	(1,987)	(6,352)	(7,850)
<b>Total Operating Income</b>	<b>14,561</b>	<b>4,046</b>	<b>4,657</b>	<b>3,888</b>	<b>3,881</b>	<b>16,472</b>	<b>4,474</b>	<b>3,472</b>	<b>6,589</b>	<b>4,109</b>	<b>18,644</b>	<b>4,994</b>	<b>6,005</b>	<b>5,452</b>	<b>5,725</b>	<b>22,177</b>	<b>23,620</b>
<b>Operating Income by Segment (% of total)</b>																	
<b>Segment Operating Income</b>																	
Client	65%	63%	57%	64%	65%	62%	59%	54%	64%	68%	62%	63%	52%	60%	56%	57%	57%
Server and Tools	14%	15%	16%	19%	23%	18%	18%	30%	15%	31%	22%	19%	18%	20%	24%	20%	21%
Information Worker	55%	48%	45%	54%	55%	50%	43%	52%	46%	64%	51%	50%	41%	46%	49%	47%	48%
MBS	7%	8%	8%	8%	10%	8%	7%	11%	6%	10%	8%	7%	6%	7%	8%	7%	8%
Microsoft Business Division	63%	56%	53%	62%	65%	59%	50%	62%	52%	74%	58%	58%	48%	53%	57%	54%	56%
Online Services Group (MSN)	3%	2%	1%	-1%	-5%	0%	-3%	-4%	-3%	-3%	-3%	-2%	-2%	-2%	-2%	-2%	-1%
MED	0%	0%	0%	0%	0%	0%	0%	-1%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Home & Entertainment	-4%	-4%	-7%	-10%	-11%	-8%	-2%	-8%	-5%	-29%	-10%	-1%	0%	0%	1%	0%	0%
Entertainment and Devices	-4%	-4%	-6%	-11%	-11%	-8%	-2%	-8%	-5%	-29%	-10%	-1%	-1%	0%	1%	0%	0%
Reconciling amount	-40%	-32%	-21%	-33%	-37%	-30%	-23%	-34%	-23%	-40%	-29%	-36%	-15%	-30%	-35%	-29%	-33%
<b>Total Operating Income</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Operating Expense by Segment</b>																	
<b>Segment Operating Expense</b>																	
Client	\$2,748	\$618	\$821	\$716	\$872	\$3,027	\$666	\$709	\$1,028	\$1,084	\$3,487	\$789	\$885	\$916	\$1,117	\$3,708	\$3,839
Server and Tools	\$6,261	\$1,521	\$1,676	\$1,652	\$1,787	\$6,636	\$1,672	\$1,813	\$1,770	\$1,884	\$7,139	\$2,026	\$2,098	\$1,937	\$2,043	\$8,103	\$8,642
Information Worker	\$3,125	\$731	\$866	\$848	\$983	\$3,428	\$810	\$929	\$985	\$977	\$3,701	\$1,028	\$964	\$961	\$1,067	\$4,021	\$4,286
MBS	\$1,280	\$301	\$357	\$347	\$390	\$1,395	\$362	\$414	\$423	\$444	\$1,644	\$422	\$431	\$427	\$512	\$1,792	\$2,093
Microsoft Business Division	\$4,405	\$1,032	\$1,223	\$1,195	\$1,373	\$4,823	\$1,172	\$1,343	\$1,408	\$1,421	\$5,344	\$1,450	\$1,396	\$1,388	\$1,579	\$5,813	\$6,379
Online Services Group (MSN)	\$1,933	\$483	\$536	\$587	\$770	\$2,376	\$675	\$779	\$823	\$804	\$3,081	\$745	\$844	\$852	\$894	\$3,336	\$3,405
MED	\$327	\$76	\$81	\$103	\$115	\$375	\$116	\$220	\$128	\$201	\$665	\$195	\$280	\$308	\$332	\$1,115	\$1,306
Home & Entertainment	\$3,672	\$686	\$1,872	\$1,464	\$1,573	\$5,595	\$1,010	\$3,033	\$1,116	\$2,046	\$7,205	\$1,135	\$2,923	\$1,130	\$908	\$6,095	\$6,747
Entertainment and Devices	\$4,009	\$762	\$1,953	\$1,567	\$1,688	\$5,970	\$1,126	\$3,253	\$1,244	\$2,247	\$7,870	\$1,330	\$3,203	\$1,438	\$1,240	\$7,210	\$8,053
Reconciling amount	1,476	247	(252)	100	60	155	(146)	(170)	128	218	30	359	(487)	258	408	539	1,471
<b>Total Operating Expenses</b>	<b>25,227</b>	<b>5,695</b>	<b>7,180</b>	<b>7,012</b>	<b>7,923</b>	<b>27,810</b>	<b>6,337</b>	<b>9,070</b>	<b>7,809</b>	<b>9,079</b>	<b>32,295</b>	<b>8,149</b>	<b>9,334</b>	<b>8,178</b>	<b>8,861</b>	<b>34,522</b>	<b>38,167</b>
<b>Segment Operating Margin</b>																	
Client	77.4%	80.6%	76.3%	77.5%	74.2%	77.1%	79.8%	72.6%	80.5%	72.0%	76.8%	80.0%	78.0%	78.0%	74.0%	77.4%	77.7%
Server and Tools	25.2%	28.5%	31.3%	31.1%	33.6%	31.3%	33.1%	36.3%	35.6%	40.0%	36.4%	32.0%	34.0%	36.0%	40.0%	35.6%	36.7%
Information Worker	72.0%	72.7%	70.9%	71.2%	68.6%	70.8%	70.5%	66.0%	75.6%	73.0%	71.8%	71.0%	72.0%	72.5%	72.5%	72.0%	72.5%
MBS	45.6%	50.5%	49.7%	47.7%	49.6%	49.4%	46.8%	47.0%	47.0%	47.0%	46.9%	47.0%	47.0%	47.0%	47.0%	47.0%	47.0%
Microsoft Business Division	67.4%	68.6%	66.8%	66.9%	64.9%	66.7%	65.8%	61.8%	70.8%	68.1%	67.1%	66.6%	67.2%	67.7%	67.4%	67.2%	67.4%
Online Services Group (MSN)	17.5%	14.4%	9.8%	-4.6%	-32.8%	-3.3%	-25.2%	-24.8%	-32.1%	-20.0%	-25.4%	-20.0%	-18.0%	-18.0%	-18.0%	-18.4%	-5.0%
MED	-24.8%	-2.7%	19.8%	-15.7%	-1.8%	0.5%	-5.5%	-9.6%	-10.3%	-5.0%	-7.6%	-5.0%	-4.0%	-4.0%	-2.0%	-3.6%	-1.5%
Home & Entertainment	-16.9%	-35.6%	-20.3%	-38.6%	-38.2%	-31.5%	-9.8%	-9.8%	-37.3%	-137.9%	-34.5%	-6.0%	-1.0%	-1.0%	5.0%	-0.9%	1.3%
Entertainment and Devices	-17.8%	-31.4%	-17.9%	-36.9%	-34.9%	-28.9%	-9.3%	-9.8%	-33.9%	-113.7%	-31.7%	-5.9%	-1.3%	-1.6%	2.0%	-1.3%	0.9%

Source: Merrill Lynch estimates; Company data

Chart 11: Microsoft Balance Sheet

\$ Millions	YEAR FY05A	Sep. 1Q06A	Dec. 2Q06A	Mar. 3Q06A	June 4Q06A	YEAR FY06A	Sep. 1Q07A	Dec. 2Q07A	Mar. 3Q07A	June 4Q07E	YEAR FY07E	Sep. 1Q08E	Dec. 2Q08E	Mar. 3Q08E	June 4Q08E	YEAR FY08E	YEAR FY09E
<b>Current Assets</b>																	
Cash & Equivalents	\$4,851	\$2,974	\$4,083	\$4,351	\$6,714	\$6,714	\$9,076	\$6,859	\$7,611	\$701	\$701	\$5,471	\$5,379	\$7,664	\$8,446	\$8,446	\$14,613
Short-term Investments	32,900	37,082	30,618	30,465	27,447	27,447	22,756	22,014	20,625	26,672	26,672	24,337	25,457	27,889	27,500	27,500	31,732
Total Accounts Receivable	7,180	5,799	7,758	6,818	9,316	9,316	6,879	9,895	8,454	9,525	9,525	7,824	10,053	8,178	10,859	10,859	11,340
Deferred Taxes	1,701	1,480	1,487	2,036	1,940	1,940	2,068	2,407	1,969	2,231	2,231	2,332	2,117	2,246	2,246	2,246	2,206
Other Current Assets	2,105	2,496	2,748	2,958	3,593	3,593	4,579	3,805	4,124	4,248	4,248	4,418	4,594	4,778	4,969	4,969	6,040
<b>Total Current Assets</b>	<b>\$48,737</b>	<b>\$49,831</b>	<b>\$46,694</b>	<b>\$46,628</b>	<b>\$49,010</b>	<b>\$49,010</b>	<b>\$45,358</b>	<b>\$45,180</b>	<b>\$42,783</b>	<b>\$43,378</b>	<b>\$43,378</b>	<b>\$44,381</b>	<b>\$47,601</b>	<b>\$50,755</b>	<b>\$54,020</b>	<b>\$54,020</b>	<b>\$65,931</b>
Net PP&E	2,346	2,351	2,452	2,543	3,044	3,044	3,193	3,686	3,923	4,218	4,218	4,451	4,655	4,936	5,191	5,191	6,316
Equity Investments	11,004	10,062	9,095	8,888	9,232	9,232	8,762	9,631	9,624	9,634	9,634	9,643	9,653	9,663	9,672	9,672	9,711
Goodwill	3,808	4,006	3,553	3,609	3,866	3,866	4,153	4,189	4,217	4,154	4,154	4,095	4,041	3,980	3,923	3,923	3,692
Other	4,920	5,212	5,463	5,186	4,445	4,445	3,888	3,685	3,344	3,730	3,730	3,579	3,512	3,643	3,567	3,567	3,579
<b>Total Assets</b>	<b>\$70,815</b>	<b>\$71,462</b>	<b>\$67,257</b>	<b>\$66,854</b>	<b>\$69,597</b>	<b>\$69,597</b>	<b>\$65,354</b>	<b>\$66,371</b>	<b>\$63,891</b>	<b>\$65,113</b>	<b>\$65,113</b>	<b>\$66,150</b>	<b>\$69,461</b>	<b>\$72,977</b>	<b>\$76,373</b>	<b>\$76,373</b>	<b>\$89,229</b>
<b>Current Liabilities</b>																	
Short-term Unearned Revenue	7,502	7,148	7,118	7,215	9,138	9,138	8,310	10,023	8,551	9,979	9,979	8,998	9,201	9,857	10,456	10,456	11,067
Payables	2,086	1,852	2,477	2,354	2,909	2,909	2,406	2,944	2,843	3,049	3,049	2,842	3,476	3,484	3,515	3,515	3,844
Accrued Compensation	1,662	1,196	1,249	1,516	1,938	1,938	1,401	1,559	1,878	1,928	1,928	1,953	2,003	2,053	2,103	2,103	2,278
Income taxes	2,020	3,123	2,787	2,805	1,557	1,557	1,994	1,337	1,930	1,980	1,980	2,005	2,055	2,105	2,155	2,155	2,330
Other	3,607	3,703	3,116	4,477	3,783	3,783	7,861	6,352	6,425	6,640	6,640	6,520	6,544	6,552	6,544	6,544	6,547
<b>Total Current Liabilities</b>	<b>\$16,877</b>	<b>\$17,022</b>	<b>\$16,747</b>	<b>\$18,367</b>	<b>\$19,325</b>	<b>\$19,325</b>	<b>\$21,972</b>	<b>\$22,215</b>	<b>\$21,627</b>	<b>\$23,576</b>	<b>\$23,576</b>	<b>\$22,319</b>	<b>\$23,279</b>	<b>\$24,051</b>	<b>\$24,774</b>	<b>\$24,774</b>	<b>\$26,066</b>
LT Unearned revenue	1,665	1,658	1,720	1,686	1,764	1,764	1,787	1,838	1,732	2,169	2,169	2,107	2,244	2,155	2,231	2,231	2,558
Deferred Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
LT Other	4,158	4,455	4,582	4,763	5,287	5,287	5,494	5,684	5,559	5,568	5,568	5,623	5,573	5,587	5,600	5,600	5,587
<b>Total Liabilities</b>	<b>\$22,700</b>	<b>\$23,135</b>	<b>\$23,049</b>	<b>\$24,816</b>	<b>\$26,376</b>	<b>\$26,376</b>	<b>\$29,253</b>	<b>\$29,737</b>	<b>\$28,918</b>	<b>\$31,313</b>	<b>\$31,313</b>	<b>\$30,049</b>	<b>\$31,096</b>	<b>\$31,793</b>	<b>\$32,605</b>	<b>\$32,605</b>	<b>\$34,211</b>
<b>Total Stockholders' Equity</b>	<b>48,115</b>	<b>48,327</b>	<b>44,208</b>	<b>42,038</b>	<b>43,221</b>	<b>43,221</b>	<b>36,101</b>	<b>36,634</b>	<b>34,973</b>	<b>33,799</b>	<b>33,799</b>	<b>36,101</b>	<b>38,365</b>	<b>41,184</b>	<b>43,768</b>	<b>43,768</b>	<b>55,018</b>
<b>Total Liabilities &amp; Equity</b>	<b>\$70,815</b>	<b>\$71,462</b>	<b>\$67,257</b>	<b>\$66,854</b>	<b>\$69,597</b>	<b>\$69,597</b>	<b>\$65,354</b>	<b>\$66,371</b>	<b>\$63,891</b>	<b>\$65,113</b>	<b>\$65,113</b>	<b>\$66,150</b>	<b>\$69,461</b>	<b>\$72,977</b>	<b>\$76,373</b>	<b>\$76,373</b>	<b>\$89,229</b>
<b>ST Unearned Revenue</b>	<b>7,502</b>	<b>7,148</b>	<b>7,118</b>	<b>7,215</b>	<b>9,138</b>	<b>9,138</b>	<b>8,310</b>	<b>10,023</b>	<b>8,551</b>	<b>9,979</b>	<b>9,979</b>	<b>8,998</b>	<b>9,201</b>	<b>9,857</b>	<b>10,456</b>	<b>10,456</b>	<b>11,067</b>
ST Y/Y Growth		16.2%	13.6%	15.0%	21.8%	21.8%	16.3%	40.8%	18.5%	9.2%	9.2%	8.3%	-8.2%	15.3%	4.8%	4.8%	5.8%
ST Q/Q Growth		-4.7%	-0.4%	1.4%	26.7%	26.7%	-9.1%	20.6%	-14.7%	16.7%	16.7%	-9.8%	2.3%	7.1%	6.1%	6.1%	6.1%
<b>LT Unearned Revenue</b>	<b>1,665</b>	<b>1,658</b>	<b>1,720</b>	<b>1,686</b>	<b>1,764</b>	<b>1,764</b>	<b>1,787</b>	<b>1,838</b>	<b>1,732</b>	<b>2,169</b>	<b>2,169</b>	<b>2,107</b>	<b>2,244</b>	<b>2,155</b>	<b>2,231</b>	<b>2,231</b>	<b>2,558</b>
LT Y/Y Growth		1.5%	1.2%	1.2%	5.9%	5.9%	7.8%	6.9%	2.7%	23.0%	23.0%	17.9%	22.1%	24.4%	2.8%	2.8%	14.7%
LT Q/Q Growth		-0.4%	3.7%	-2.0%	4.6%	4.6%	1.3%	2.9%	-5.8%	25.2%	25.2%	-2.9%	6.5%	-4.0%	3.5%	3.5%	3.5%
<b>Total Unearned Revenue</b>	<b>9,167</b>	<b>8,806</b>	<b>8,838</b>	<b>8,901</b>	<b>10,902</b>	<b>10,902</b>	<b>10,097</b>	<b>11,861</b>	<b>10,283</b>	<b>12,148</b>	<b>12,148</b>	<b>11,105</b>	<b>11,445</b>	<b>12,011</b>	<b>12,687</b>	<b>12,687</b>	<b>13,625</b>
Y/Y Growth		13%	10.9%	12.1%	18.9%	18.9%	15%	34.2%	15.5%	11.4%	11.4%	10%	-3.5%	16.8%	4.4%	4.4%	7.4%
Q/Q Growth		-3.9%	0.4%	0.7%	22.5%	22.5%	-7.4%	17.5%	-13.3%	18.1%	18.1%	-8.6%	3.1%	5.0%	5.6%	5.6%	5.6%
LTM Revenues		40,340	41,359	42,639	44,282	44,282	45,352	46,057	49,555	50,939	50,939	53,272	56,069	55,301	56,699	56,699	56,699
ST Unearned revenue to LTM revs		17.7%	17.2%	16.9%	20.6%	20.6%	18.3%	21.8%	10.3%	19.3%	19.3%	17.5%	14.5%	17.9%	17.5%	17.5%	17.5%
Payables to LTM revs		4.6%	6.0%	5.5%	6.6%	6.6%	5.3%	6.4%	3.4%	6.0%	6.0%	5.3%	6.2%	6.3%	6.2%	6.2%	6.2%
LT Unearned rev to LTM revs		4.1%	4.2%	4.0%	4.0%	4.0%	3.9%	4.0%	2.1%	3.7%	3.7%	3.3%	2.8%	3.4%	3.3%	3.3%	3.3%
<b>Balance Sheet Analysis</b>																	
Cash & ST Investments	\$37,751	\$40,056	\$34,701	\$34,816	\$34,161	\$34,161	\$31,832	\$28,873	\$28,236	\$27,374	\$27,374	\$29,808	\$30,836	\$35,553	\$35,946	\$35,946	\$46,345
Cash & ST Investments per Share	\$3.46	\$3.72	\$3.26	\$3.34	\$3.33	\$3.25	\$3.18	\$2.90	\$2.86	\$2.82	\$2.77	\$3.09	\$3.22	\$3.73	\$3.79	\$3.76	\$4.95
Days Receivable	65	54	59	56	71	76	57	71	53	65	67	54	59	54	67	69	66
Current Ratio	2.89	2.93	2.79	2.54	2.54	2.54	2.06	2.03	1.98	1.84	1.84	1.99	2.04	2.11	2.18	2.18	2.53
Quick Ratio	2.66	2.69	2.54	2.27	2.25	2.25	1.76	1.75	1.70	1.57	1.57	1.69	1.76	1.82	1.89	1.89	2.21
Cap SW/Share	\$1.01	\$0.93	\$0.85	\$0.85	\$0.90	\$0.88	\$0.88	\$0.97	\$0.98	\$0.99	\$0.98	\$1.00	\$1.01	\$1.01	\$1.02	\$1.01	\$1.04
Goodwill/Share	\$0.35	\$0.37	\$0.33	\$0.35	\$0.38	\$0.37	\$0.41	\$0.42	\$0.43	\$0.43	\$0.42	\$0.42	\$0.42	\$0.42	\$0.41	\$0.41	\$0.39

Source: Merrill Lynch estimates; Company data

Chart 12: Microsoft Cash Flow Statement

\$ Millions	YEAR FY05A	Sep. 1Q06A	Dec. 2Q06A	Mar. 3Q06A	June 4Q06A	YEAR FY06A	Sep. 1Q07A	Dec. 2Q07A	Mar. 3Q07A	June 4Q07E	YEAR FY07E	Sep. 1Q08E	Dec. 2Q08E	Mar. 3Q08E	June 4Q08E	YEAR FY08E	YEAR FY09E
<b>Net Income</b>	<b>\$12,254</b>	<b>\$3,141</b>	<b>\$3,653</b>	<b>\$2,977</b>	<b>\$2,828</b>	<b>\$12,599</b>	<b>\$3,478</b>	<b>\$2,626</b>	<b>\$4,926</b>	<b>\$3,008</b>	<b>\$14,038</b>	<b>\$3,661</b>	<b>\$4,381</b>	<b>\$4,004</b>	<b>\$4,226</b>	<b>\$16,272</b>	<b>\$17,528</b>
Depreciation & Amortization	855	234	231	177	261	903	249	365	445	320	1,379	355	359	312	322	1,347	1,169
Stock option compensation, tax benefit	3,116	433	514	374	341	1,662	456	429	314	423	1,622	390	363	402	383	1,538	1,539
Net Investment Gains	(527)	(130)	(75)	(59)	(6)	(270)	(206)	(29)	(61)		(296)					0	0
Deferred Income Taxes	(179)	(128)	157	(294)	448	183	166	(517)	981	262	892	101	(215)	129	0	15	(40)
Unearned Revenue *	13,831	3,032	3,670	3,670	6,081	16,453	3,217	6,029	4,551	1,865	15,662	(1,043)	340	567	675	539	938
Recognition of Unearned Revenue	(12,919)	(3,419)	(3,622)	(3,615)	(4,073)	(14,729)	(4,050)	(4,265)	(6,121)		(14,436)					0	0
Other						0	(40)				(40)					0	0
<b>Change in Working Capital</b>	<b>174</b>	<b>1,166</b>	<b>(2,297)</b>	<b>1,333</b>	<b>(2,599)</b>	<b>(2,397)</b>	<b>791</b>	<b>(2,596)</b>	<b>2,256</b>	<b>(989)</b>	<b>(539)</b>	<b>1,369</b>	<b>(1,832)</b>	<b>1,704</b>	<b>(2,837)</b>	<b>(1,596)</b>	<b>(1,275)</b>
Changes in AR	(1,243)	1,408	(2,012)	972	(2,439)	(2,071)	2,501	(2,945)	1,455	(1,071)	(60)	1,701	(2,229)	1,875	(2,681)	(1,334)	(481)
Other current assets	(245)	(340)	(354)	(134)	(577)	(1,405)	(1,080)	723	7	(124)	(474)	(170)	(177)	(184)	(191)	(722)	(1,071)
Other long term assets	21	2	(10)	(4)	(37)	(49)	(135)	(264)	(32)	(10)	(441)	(10)	(10)	(10)	(10)	(39)	(39)
Other current liabilities	(396)	(209)	(89)	229	(76)	(145)	(842)	(354)	772	206	(218)	(207)	634	8	31	466	329
Other long term liabilities	1,245	305	168	270	530	1,273	347	244	54	9	654	55	(50)	14	13	32	(14)
<b>Cash Flow from Operations</b>	<b>\$16,605</b>	<b>\$4,329</b>	<b>\$2,231</b>	<b>\$4,563</b>	<b>\$3,281</b>	<b>\$14,404</b>	<b>\$4,061</b>	<b>\$2,042</b>	<b>\$7,291</b>	<b>\$4,890</b>	<b>\$18,284</b>	<b>\$4,832</b>	<b>\$3,396</b>	<b>\$7,117</b>	<b>\$2,769</b>	<b>\$18,114</b>	<b>\$19,859</b>
Common Stock Issued	3,109	1,001	466	442	192	2,101	385	4,449	784	784	6,402	600	600	600	600	2,400	2,400
Common Stock Repurchased	(8,057)	(3,116)	(7,435)	(4,675)	(3,981)	(19,207)	(7,683)	(5,797)	(6,878)	(5,000)	(25,358)	(1,500)	(1,500)	(1,500)	(1,500)	(6,000)	(6,000)
Common Stock Dividends	(36,112)	(857)	(846)	(925)	(917)	(3,545)	(897)	(980)	(976)	(969)	(3,822)	(964)	(959)	(954)	(948)	(3,825)	(3,742)
Other	(18)	31	13	23	22	89	20	5	7		32					0	0
<b>Cash Flow from Financing</b>	<b>(\$41,078)</b>	<b>(\$2,941)</b>	<b>(\$7,802)</b>	<b>(\$5,135)</b>	<b>(\$4,684)</b>	<b>(\$20,651)</b>	<b>(\$8,175)</b>	<b>(\$2,323)</b>	<b>(\$7,063)</b>	<b>(\$5,185)</b>	<b>(\$22,778)</b>	<b>(\$1,864)</b>	<b>(\$1,859)</b>	<b>(\$1,854)</b>	<b>(\$1,848)</b>	<b>(\$7,425)</b>	<b>(\$7,342)</b>
Capital Expenditures	(812)	(213)	(318)	(302)	(745)	(1,578)	(411)	(572)	(461)	(568)	(2,012)	(534)	(509)	(547)	(528)	(2,118)	(2,119)
Acquisitions	(207)	(187)	(63)	(83)	(316)	(649)	(336)	(125)	(41)	0	0	0	0	0	0	0	0
Purchases of Investments	(68,045)	(19,410)	(16,151)	(10,082)	(5,474)	(51,117)	(12,855)	(9,102)	(7,257)	(20,071)	(49,285)	(11,331)	(12,207)	(15,847)	(12,376)	(51,761)	(54,454)
Maturities of Investments	29,153	949	743	1,208	977	3,877	834	1,325	1,688	1,140	4,987	1,415	1,460	1,285	1,408	5,568	5,506
Sales of Investments	54,938	15,600	22,481	10,092	9,297	57,470	19,229	6,516	6,582	12,884	45,211	12,251	9,627	12,130	11,356	45,365	44,716
<b>Cash Flow from Investing</b>	<b>\$15,027</b>	<b>(\$3,261)</b>	<b>\$6,692</b>	<b>\$833</b>	<b>\$3,739</b>	<b>\$8,003</b>	<b>\$6,461</b>	<b>(\$1,958)</b>	<b>\$511</b>	<b>(\$6,615)</b>	<b>(\$1,601)</b>	<b>\$1,801</b>	<b>(\$1,629)</b>	<b>(\$2,979)</b>	<b>(\$139)</b>	<b>(\$2,945)</b>	<b>(\$6,351)</b>
<b>Net Change in Cash</b>	<b>(\$9,446)</b>	<b>(\$1,873)</b>	<b>\$1,121</b>	<b>\$261</b>	<b>\$2,336</b>	<b>\$1,845</b>	<b>\$2,347</b>	<b>(\$2,239)</b>	<b>\$739</b>	<b>(\$6,910)</b>	<b>(\$6,063)</b>	<b>\$4,769</b>	<b>(\$92)</b>	<b>\$2,285</b>	<b>\$782</b>	<b>\$7,745</b>	<b>\$6,167</b>
Effect of Exchange Rates	(7)	(4)	(12)	7	27	18	15	22	13		0					0	0
Cash at Beginning of Period	14,304	4,851	2,974	4,083	4,351	4,851	6,714	9,076	6,859	7,611	6,714	651	5,420	5,329	7,613	651	8,396
<b>Cash at End of Period</b>	<b>\$4,851</b>	<b>\$2,974</b>	<b>\$4,083</b>	<b>\$4,351</b>	<b>\$6,714</b>	<b>\$6,714</b>	<b>\$9,076</b>	<b>\$6,859</b>	<b>\$7,611</b>	<b>\$701</b>	<b>\$651</b>	<b>\$5,420</b>	<b>\$5,329</b>	<b>\$7,613</b>	<b>\$8,396</b>	<b>\$8,396</b>	<b>\$14,562</b>
<b>FCF</b>	<b>\$15,793</b>	<b>\$4,116</b>	<b>\$1,913</b>	<b>\$4,261</b>	<b>\$2,536</b>	<b>\$12,826</b>	<b>\$3,650</b>	<b>\$1,470</b>	<b>\$6,830</b>	<b>\$4,323</b>	<b>\$16,272</b>	<b>\$4,298</b>	<b>\$2,887</b>	<b>\$6,570</b>	<b>\$2,242</b>	<b>\$15,997</b>	<b>\$17,741</b>
Y/Y growth in FCF	16.8%	7.4%	-44.4%	-11.2%	-31.8%	-18.8%	-11.3%	-23.2%	60.3%	70.5%	26.9%	17.8%	96.4%	-3.8%	-48.1%	-1.7%	10.9%
FCF per share	\$1.45	\$0.38	\$0.18	\$0.41	\$0.25	\$1.22	\$0.36	\$0.15	\$0.69	\$0.45	\$1.65	\$0.45	\$0.30	\$0.69	\$0.24	\$1.67	\$1.90

Source: Merrill Lynch estimates; Company data

## Price objective basis & risk

### Microsoft Corp (MSFT)

Our 12-month PO is \$33.00 and is based on DCF analysis. Our DCF analysis assumes a WACC of 9.7%, cash flow forecasts going out 10 years, and a terminal growth rate of 3%.

Risks to achieving our price objective are: 1) continued or expanded operating losses in the Entertainment and Devices division, 2) competition from open source providers, including Linux; 3) software piracy, which could limit growth; 4) potential failure to meet major product release dates, especially Vista and Office 2007; 5) retention of skilled developers in the midst of a competitive hiring market; 6) possible loss of key senior executives, notably Steve Ballmer (CEO), Chris Liddell (CFO), as well as the leaders of Microsoft's various business units; and 7) litigation and regulatory actions.

## Analyst Certification

I, Kash Rangan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### *iQmethod*<sup>SM</sup> Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

*iQmethod*<sup>SM</sup> is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

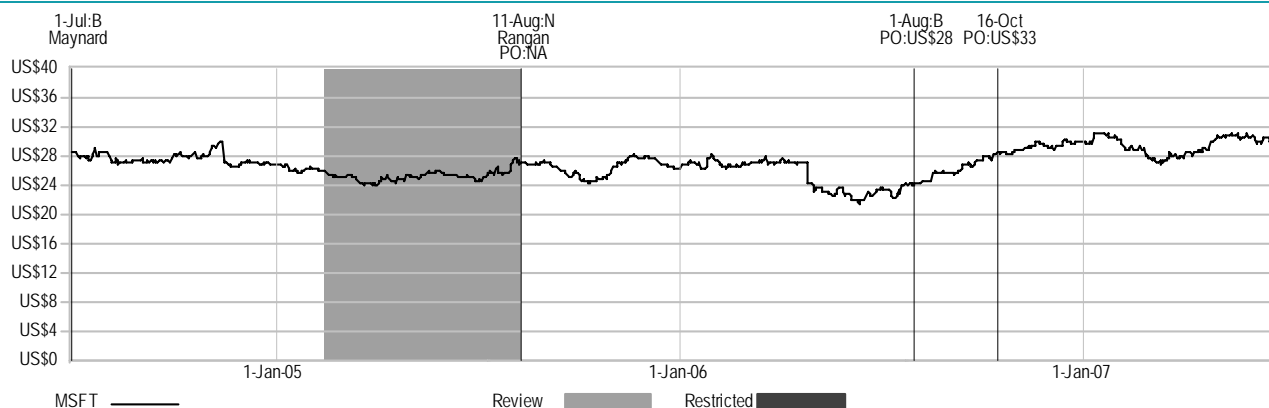
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18 July 2007

## Important Disclosures

### MSFT Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of June 30, 2007 or such later date as indicated.

### Investment Rating Distribution: Technology Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	121	42.61%	Buy	25	23.15%
Neutral	148	52.11%	Neutral	32	23.02%
Sell	15	5.28%	Sell	1	7.14%

### Investment Rating Distribution: Global Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1675	47.16%	Buy	435	29.21%
Neutral	1633	45.97%	Neutral	438	29.67%
Sell	244	6.87%	Sell	47	21.66%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

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