2,795,000 Shares

MICROSOFT®

Microsoft Corporation

Common Stock

Of the 2,795,000 shares of Common Stock offered hereby, 2,000,000 shares are being sold by the Company and 795,000 shares are being sold by the Selling Stockholders. See "Principal and Selling Stockholders." The Company will not receive any of the proceeds from the sale of shares by the Selling Stockholders.

Prior to this offering, there has been no public market for the Common Stock of the Company. For the factors which were considered in determining the initial public offering price, see "Underwriting."

See "Certain Factors" for a discussion of certain factors which should be considered by prospective purchasers of the Common Stock offered hereby.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Initial Public Offering Price	Underwriting Discount (1)	Proceeds to Company (2)	Proceeds to Selling Stockholders (2)
Per Share	$21.00	$1.31	$19.69	$19.69
Total (3)	$58,695,000	$3,661,450	$39,380,000	$15,653,550

(1) The Company and the Selling Stockholders have agreed to indemnify the Underwriters against certain liabilities, including liabilities under the Securities Act of 1933.

(2) Before deducting expenses of the offering estimated at $541,000, of which $452,000 will be paid by the Company and $89,000 by the Selling Stockholders.

(3) The Company has granted to the Underwriters an option to purchase up to an additional 300,000 shares at the initial public offering price, less the underwriting discount, solely to cover over-allotments. If such option is exercised in full, the total Initial Public Offering Price, Underwriting Discount and Proceeds to Company will be $64,995,000, $4,054,450 and $45,287,000, respectively.

The shares are offered severally by the Underwriters, as specified herein, subject to receipt and acceptance by them and subject to their right to reject any order in whole or in part. It is expected that the certificates for the shares will be ready for delivery at the offices of Goldman, Sachs & Co., New York, New York on or about March 20, 1986.

Goldman, Sachs & Co. **Alex. Brown & Sons Incorporated**

The date of this Prospectus is March 13, 1986.

Milestones in Microsoft History.

January 1975 Microsoft develops a BASIC Interpreter for the first commercially available personal computer, the MITS Altair. Over the next four years Microsoft licenses the BASIC Interpreter to Apple Computer, Commodore International, and Tandy Corporation; and introduces the Microsoft® FORTRAN and Microsoft® COBOL Compilers and the Microsoft® Macro Assembler.

October 1978 Microsoft retains ASCII Corporation as its sales representative in Japan for the Far Eastern Market.

February 1980 Microsoft introduces Microsoft® XENIX®, a UNIX®-based operating system for 16-bit multi-user computer systems.

August 1980 Microsoft begins development of systems and language software for the IBM® Personal Computer.

Microsoft releases the Microsoft® SoftCard® system, a software/hardware enhancement product that adds the CP/M® operating system to the Apple® II.

August 1981 IBM introduces the IBM Personal Computer, which offers the Microsoft® MS-DOS® operating system and the Microsoft BASIC Interpreter. At the same time, Microsoft introduces other language products for the IBM PC.

April 1982 Microsoft expands sales operations to the European market and offers localized products.

August 1982 Microsoft introduces its first application software program, the Microsoft® Multiplan® electronic worksheet.

March 1983 Microsoft forms Microsoft Press to publish and market computer-oriented books.

July 1983 Microsoft introduces the Microsoft® Mouse, a hand-held pointing and editing device.

October 1983 A graphics-based word processor, Microsoft® Word, is added to the applications product line. Three additional MS-DOS business applications are released over the next two years: Microsoft® Chart, Microsoft® Project and Microsoft® Access.

January 1984 Microsoft releases versions of the Microsoft BASIC Interpreter and Microsoft Multiplan simultaneously with Apple's introduction of the Apple® Macintosh™. Macintosh versions of Microsoft Word, Microsoft Chart, and Microsoft® File for the Apple Macintosh follow within a year.

August 1984 IBM introduces an advanced version of the Personal Computer called the IBM PC AT. Systems software offered on the PC AT includes MS-DOS, Microsoft® Networks, and Microsoft XENIX.

October 1985 Microsoft begins shipping Microsoft® Excel, a spreadsheet integrated with business graphics and database modules, for the Apple Macintosh.

November 1985 Microsoft begins shipping Microsoft® Windows, a graphical operating environment that runs on the Microsoft MS-DOS operating system.

The Company intends to furnish its stockholders with annual reports containing audited financial statements certified by an independent public accounting firm and quarterly reports for the first three quarters of each fiscal year containing unaudited interim financial information.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE COMMON STOCK OF THE COMPANY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

PROSPECTUS SUMMARY

The following summary is qualified in its entirety by the more detailed information and Consolidated Financial Statements appearing elsewhere in this Prospectus. All information relating to the Company's Common Stock contained in this Prospectus, except as presented in the Consolidated Financial Statements, reflects the conversion of all outstanding shares of Preferred Stock into Common Stock on the date of this Prospectus.

The Company

Microsoft designs, develops, markets, and supports a product line of systems and applications microcomputer software for business and professional use. The Microsoft Software Product Line chart inside the front cover of this Prospectus illustrates the evolution and diversity of the Company's product line. Microsoft's systems software products include Microsoft® MS-DOS®, a 16-bit microcomputer operating system used on the IBM PC and IBM compatible computers, and computer language products in six computer languages. The Company offers business applications software products in the following categories: word processing, spreadsheet, file management, graphics, communications, and project management. The Company's products are available for 8-bit, 16-bit, and 32-bit microcomputers, including IBM, Tandy, Apple, COMPAQ, Olivetti, AT&T, Zenith, Wang, Hewlett-Packard, DEC, Siemens, Philips, Mitsubishi, and NEC. Microsoft develops most of its software products internally using proprietary development tools and methodology. The Company markets and distributes its products domestically and internationally through the original equipment manufacturer ("OEM") channel and through the retail channel primarily by means of independent distributors and dealers and by direct marketing to corporate, governmental, and educational customers.

The Offering

Common Stock offered by the Company	2,000,000 shares (1)
Common Stock offered by the Selling Stockholders	795,000 shares
Common Stock to be outstanding after the offering	24,715,113 shares (1)
Proposed NASDAQ symbol.............................	MSFT
Use of Proceeds	For general corporate purposes, principally working capital, product development, and capital expenditures.

Selected Consolidated Financial Information

(In thousands, except per share data)

	Year Ended June 30,				Six Months Ended December 31,	
	1982	1983	1984	1985	1984	1985
					(Unaudited)	
Income Statement Data:						
Net revenues …………………………....	$ 24,486	$ 50,065	$ 97,479	$140,417	$ 62,837	$ 85,050
Income before income taxes…….…….....	5,595	11,064	28,030	42,843	18,219	29,048
Net income……………………………....	3,507	6,487	15,880	24,101	9,996	17,118
Net income per share……………………....	$ .17	$ .29	$ .69	$ 1.04	$ .43	$ .72
Shares used in computing net income per share…….……….....	21,240	22,681	22,947	23,260	23,253	23,936

	December 31, 1985	
	Actual	As Adjusted (1) (2)
	(Unaudited)	
Balance Sheet Data:		
Working capital……………….……………….………………..……..……	$57,574	$ 96,502
Total assets……………….……………….……………….…….………	94,438	133,366
Total long-term debt ………..……………….…………………………...	—	—
Stockholders' equity……………….……………….……….….…….	71,845	110,773

THE COMPANY

Microsoft designs, develops, markets, and supports a product line of systems and applications microcomputer software for business and professional use. The Microsoft Software Product Line chart inside the front cover of this Prospectus illustrates the evolution and diversity of the Company's product line. Microsoft markets over 40 software products, including three operating systems, computer language products in six computer languages, and business applications products in six categories: word processing, spreadsheet, file management, graphics, communications, and project management. The Company's products are available on 8-bit, 16-bit, and 32-bit microcomputers, including IBM, Tandy, Apple, COMPAQ, Olivetti, AT&T, Zenith, Wang, Hewlett-Packard, DEC, Siemens, Philips, Mitsubishi, and NEC. Microsoft develops most of its software products internally using proprietary development tools and methodology.

Microsoft® MS-DOS®, introduced in 1981 as a 16-bit operating system for Intel microprocessor architectures, is running on approximately four million IBM PC and IBM compatible microcomputers, according to industry publications. Microsoft® XENIX®, a UNIX®-based multi-user operating system for microcomputers, is designed to accommodate transaction oriented data processing tasks. The Company's most widely used language product, Microsoft® BASIC Interpreter, is running on an estimated eight million microcomputers, according to industry publications. The Company markets compiler products in the following computer languages: BASIC, "C", FORTRAN, COBOL, and Pascal, and machine language assembler products. Microsoft® Word, a word processing product, Microsoft® Multiplan®, an electronic spreadsheet, and Microsoft® Chart, a graphics program, are business applications products which run on Microsoft MS-DOS-based computers and on the Apple Macintosh™. Microsoft® Excel, an integrated spreadsheet, and Microsoft® File, a file management product, run on the Apple Macintosh. Microsoft® Access, a communications product, and Microsoft® Project, a project management tool, are MS-DOS applications.

Microsoft markets and distributes its software products domestically and internationally through both the OEM and retail channels. In the OEM channel, Microsoft generally provides an OEM with master copies of the software and documentation which the OEM duplicates, packages, and distributes, although there is increasing OEM marketing of Microsoft's packaged language and application products. Domestic retail marketing involves the distribution of Microsoft's packaged software products primarily through independent distributors, large volume dealers, corporate key dealers, and other dealers, and direct marketing to corporate customers, government agencies, and colleges and universities. International OEM and retail marketing and distribution of domestic and foreign language versions of Microsoft's systems and applications software products are conducted through seven foreign subsidiaries and several independent sales representatives.

The Company was founded as a partnership in 1975 and was incorporated in the state of Washington on June 25, 1981. The principal executive offices of Microsoft are located at 16011 NE 36th Street, Redmond, Washington 98073-9717, and its telephone number is (206) 882-8080. Unless the context otherwise requires, the terms "Microsoft" and the "Company" are used herein to refer to Microsoft Corporation and its subsidiaries.

CERTAIN FACTORS

The following factors should be carefully considered in evaluating the Company and its business before purchasing the shares offered hereby.

Market Acceptance of Microsoft MS-DOS Operating System. The Company believes Microsoft MS-DOS is the most widely used operating system for the IBM PC and IBM compatible microcomputers. If another developer were to produce and successfully market an operating system that competes against MS-DOS, the Company could lose substantial revenues. In addition, since IBM has been the leader in sales of microcomputers since its introduction of the IBM PC in 1981, a decision by IBM not to offer MS-DOS or to indicate a preference for another operating system on its current or future microcomputers would have an adverse impact on the Company's revenues. Finally, the Company's reputation in the microcomputer industry is partially based on its position as a major supplier of systems software to many microcomputer OEMs, and if MS-DOS were to lose its position as the most widely used operating system for the IBM PC and IBM compatibles it could adversely affect the Company's relationships with its customers.

Reliance on Key Officer. William H. Gates III, a founder of Microsoft and its chairman and chief executive officer, plays an important role in the technical development and management efforts of the Company. Mr. Gates participates actively in significant operating decisions, leads deliberations concerning strategic decisions, and meets with OEM customers. Mr. Gates also has overall supervisory responsibility for the Company's research and development work. The loss of his services could have a material adverse effect on the Company's position in the microcomputer software industry and on its new product development efforts. There is no employment agreement between Mr. Gates and the Company.

Price Competition. To date price competition has not been a major factor in the microcomputer software market. It seems likely to management, however, that price competition, with its attendant reduced profit margins, will emerge in the next few years as a significant consideration. The recent increase of "site licenses" (permitting copying of the program and documentation) and discount pricing for large volume retail customers is evidence of such competition.

Change in Marketing Structure in Japan. The Company's exclusive sales representative agreement with its Japanese agent terminates on or before March 17, 1986. A wholly-owned subsidiary, Microsoft K.K., was formed by the Company in Japan in February 1986 to handle OEM and retail business. The transition could adversely affect net revenues in Japan. In fiscal 1985, customers in Japan accounted for approximately 12% of the Company's net revenues. See "Business—Marketing and Distribution—International OEM Distribution."

Tax Considerations. In the course of a current examination of the years ended June 30, 1983 and 1984 by the Internal Revenue Service, a field agent has proposed that Microsoft is subject to the personal holding company ("PHC") tax. The PHC tax is 50% of after-tax income and through December 31, 1985 could be as much as approximately $30,000,000 plus interest. At its option, a corporation subject to the PHC tax may declare a "deficiency dividend" to its stockholders of record at the time such a dividend is declared in an amount equal to the corporation's undistributed PHC income. For Microsoft this could be as much as approximately $60,000,000 as of December 31, 1985. The payment of a deficiency dividend avoids a PHC tax to the corporation but is taxable to the stockholders. If a PHC tax were to be assessed and the Company elected to pay the tax, the payment of tax would be recorded as a charge to operations and would reduce net income accordingly. If a PHC tax were to be assessed and the Company elected to declare a deficiency dividend, retained earnings would be reduced by the amount of such a dividend. Although management and counsel presently believe there is a small risk that the Company might have to either pay a PHC tax or declare a deficiency dividend, they believe that it is more likely than not that neither a material payment of a PHC tax nor a material deficiency dividend will be required. Because the total amount of any PHC tax that might be assessed could vary significantly based upon the specific year for which such an assessment might occur and other facts and circumstances and because management and counsel presently believe that it is more likely than not that neither a material payment of a PHC tax nor a material deficiency dividend will be required, management has not formulated specific intentions as to how the Company will proceed in the event such a tax is assessed. For additional information see Note 4 of Notes to Consolidated Financial Statements.

A corporation not subject to the PHC tax may be subject to the accumulated earnings tax (“AET”), a penalty tax assessed against corporations that avoid income tax at the stockholder level by unnecessarily accumulating funds in the corporation rather than paying dividends. The tax, at approximately 38.5%, is assessed on excess income after adjustments for regular corporate taxes and the reservation of funds reasonably required for normal business operations. Although Microsoft has and expects to continue to have significant retained earnings, management believes the accumulated funds together with the proceeds of this offering are necessary for working capital, product development, capital expenditures and potential acquisitions, and that the AET will not be applicable. However, the AET involves subjective questions and there is some risk that the Company might be subject to the AET in the future.

Shares Eligible for Future Sale. Approximately 230,000 shares of Common Stock held by current stockholders are eligible for sale in the open market without restriction and approximately 21,766,000 additional shares will be eligible for sale under Rule 144 under the Securities Act of 1933 beginning 90 days after the date of this Prospectus. Of these 21,766,000 shares, approximately 21,070,000 shares are subject to an agreement with the Underwriters which restricts their sale without the prior written approval of the Underwriters for 120 days after the date of this Prospectus. Prior to the end of this 120 day period, the Company also intends to register approximately 2,900,000 shares of Common Stock issuable under its 1981 Stock Option Plan and 300,000 shares of Common Stock issuable under its 1986 Employee Stock Purchase Plan. Sales of substantial amounts of Common Stock in the public market could adversely affect the market price of Common Stock. See “Shares Eligible for Future Sale.”

Absence of Previous Trading Market. Prior to this offering there has been no public market for the Common Stock. Consequently the initial public offering price has been determined by negotiations among the Company, the Selling Stockholders, and the Representatives of the Underwriters. See “Underwriting” for factors considered in determining the initial public offering price.

USE OF PROCEEDS

The net proceeds to be received by the Company from the sale of the Common Stock offered by the Company are estimated to be $38,928,000 ($44,835,000 if the Underwriters’ over-allotment option is exercised in full). The net proceeds are expected to be used for general corporate purposes, principally working capital, product development, and capital expenditures. The Company presently has no specific plans for any significant portion of the proceeds. Proceeds may also be used to acquire companies, products, or expertise which complement the business of Microsoft. No such transactions are being planned or actively negotiated as of the date of this Prospectus. Pending such uses, the proceeds will be invested in marketable securities. The Company will not receive any of the proceeds from the sale of the shares of Common Stock being sold by the Selling Stockholders. See “Principal and Selling Stockholders.”

DIVIDEND POLICY

The Company has never paid cash dividends on its Common Stock. The Company presently intends to retain earnings for use in its business and therefore does not anticipate paying any cash dividends in the foreseeable future. Payment of any cash dividends will be dependent upon the earnings and financial condition of the Company, tax considerations discussed under “Certain Factors,” and any other factors deemed relevant by the Board of Directors.

CAPITALIZATION

The following table sets forth the capitalization of the Company as of December 31, 1985, and as adjusted to reflect the sale of 2,000,000 shares of Common Stock by the Company.

	December 31, 1985	
	Actual	As Adjusted(1)
	(Unaudited, in thousands)	
Long-term debt	$ —	$ —
Stockholders' equity:		
Common stock — $.001 par value, 60,000,000 shares authorized, 22,715,113 shares outstanding, 24,715,113 shares outstanding as adjusted (2) (3)	23	25
Paid-in capital	5,281	44,207
Retained earnings	67,092	67,092
Translation adjustment	(551)	(551)
Total stockholders' equity	71,845	110,773
Total capitalization	$71,845	$110,773

(1) Assumes the Underwriters' over-allotment option is not exercised. See "Underwriting."

(2) Assumes conversion of the Company's outstanding Preferred Stock into 1,000,000 shares of Common Stock.

(3) Excludes 2,771,757 shares of Common Stock reserved for issuance under the Company's 1981 Stock Option Plan (the "Option Plan"), under which options for 2,667,861 shares were outstanding at December 31, 1985, and 300,000 shares of Common Stock reserved for issuance under the Company's 1986 Employee Stock Purchase Plan (the "Purchase Plan"). See Note 7 of Notes to Consolidated Financial Statements.

DILUTION

The net tangible book value of the Company at December 31, 1985 was $71,210,000, or $3.14 per share. "Net tangible book value per share" represents the amount of total tangible assets less total liabilities, divided by the number of shares of Common Stock outstanding, after giving effect to the automatic conversion of all outstanding Preferred Stock into Common Stock. After giving effect to the sale by the Company of 2,000,000 shares of Common Stock (at the initial public offering price and before deduction of offering expenses and the Underwriters' discount), the pro forma net tangible book value of the Company at December 31, 1985, would have been $113,210,000, or $4.58 per share, representing an immediate increase in net tangible book value of $1.44 per share to existing stockholders and an immediate dilution of $16.42 per share to the persons purchasing shares at the initial public offering price ("New Investors"). The following table illustrates the per share dilution in net tangible book value per share to New Investors:

Price to public		$21.00
Net tangible book value at December 31, 1985	$ 3.14	
Increase attributable to New Investors	1.44	
Pro forma net tangible book value		4.58
Dilution to New Investors		$16.42

The following table summarizes at December 31, 1985 the difference between existing stockholders and New Investors with respect to the number of shares purchased from the Company, the total consideration paid to the Company and the average price paid per share (for New Investors, at the initial public offering price):

	Shares Purchased (1)		Total Consideration Paid to Company		Average Price
	Number	Percent	Amount	Percent	Per Share
Existing stockholders	22,715,113	91.9%	$ 6,100,000	12.7%	$ .27
New Investors	2,000,000	8.1	42,000,000	87.3	21.00
Total	24,715,113	100.0%	$48,100,000	100.0%	

(1) Sales by the Selling Stockholders in the offering will cause the number of shares held by existing stockholders to be reduced to 21,920,113 or 88.7% of the total shares of Common Stock to be outstanding after the offering. See "Principal and Selling Stockholders."

The above computations assume no exercise of the Underwriters' over-allotment option or of outstanding employee stock options. See "Underwriting" and "Management—1981 Stock Option Plan."

SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data set forth below with respect to the Company's income statements for the years ended June 30, 1983, 1984, and 1985 and the Company's balance sheets at June 30, 1984 and 1985 are derived from the audited Consolidated Financial Statements included elsewhere in this Prospectus and should be read in conjunction with those financial statements and footnotes thereto. The selected income statement data for the year ended June 30, 1982 and the selected balance sheet data at June 30, 1982 and 1983 are derived from audited consolidated financial statements which are not included in this Prospectus. The selected consolidated financial data for the six month periods ended December 31, 1984 and 1985 are unaudited, but in the opinion of the Company include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation thereof. The results for the six months ended December 31, 1985 are not necessarily indicative of the results to be expected for the full fiscal year. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Quarterly Results."

	(In thousands, except per share amounts)					
	Year Ended June 30,				Six Months Ended December 31,	
	1982	1983	1984	1985	1984	1985
					(Unaudited)	
Income Statement Data:						
Net revenues……………………	$ 24,486	$ 50,065	$ 97,479	$140,417	$ 62,837	$ 85,050
Costs and expenses:						
Cost of revenues…………..…	8,647	15,773	22,900	30,447	15,507	18,270
Research and development……………..…	3,597	7,021	10,665	17,108	7,414	8,720
Sales and marketing…………	4,009	11,916	26,027	42,512	18,268	24,429
General and administrative….	3,037	4,698	8,784	9,443	3,831	6,980
Total costs and expenses….	19,290	39,408	68,376	99,510	45,020	58,399
Income from operations………...	5,196	10,657	29,103	40,907	17,817	26,651
Non-operating income (loss) …..	399	407	(1,073)	1,936	402	2,397
Income before income taxes……	5,595	11,064	28,030	42,843	18,219	29,048
Provision for income taxes….….	2,088	4,577	12,150	18,742	8,223	11,930
Net income……………………...	$ 3,507	$ 6,487	$ 15,880	$ 24,101	$ 9,996	$ 17,118
Net income per share……….…..	$ .17	$ .29	$ .69	$ 1.04	$ .43	$ .72
Shares used in computing net income per share………..…	21,240	22,681	22,947	23,260	23,253	23,936

	June 30,				December 31, 1985
	1982	1983	1984	1985	
					(Unaudited)
Balance Sheet Data:					
Working capital……………………..…	$ 5,305	$ 9,952	$ 21,458	$ 41,442	$ 57,574
Total assets……………………………	14,784	24,328	47,637	65,064	94,438
Total long-term debt…………………..	—	—	705	650	—
Stockholders' equity…………………..	8,299	14,639	30,712	54,440	71,845

(1) See Note 4 of Notes to Consolidated Financial Statements for information concerning personal holding company tax.

MANAGEMENT'S DISCUSSION AND

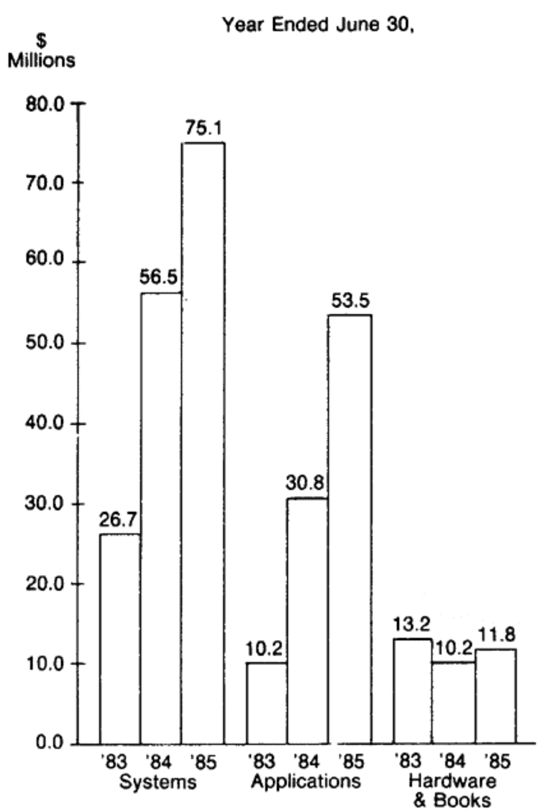
ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

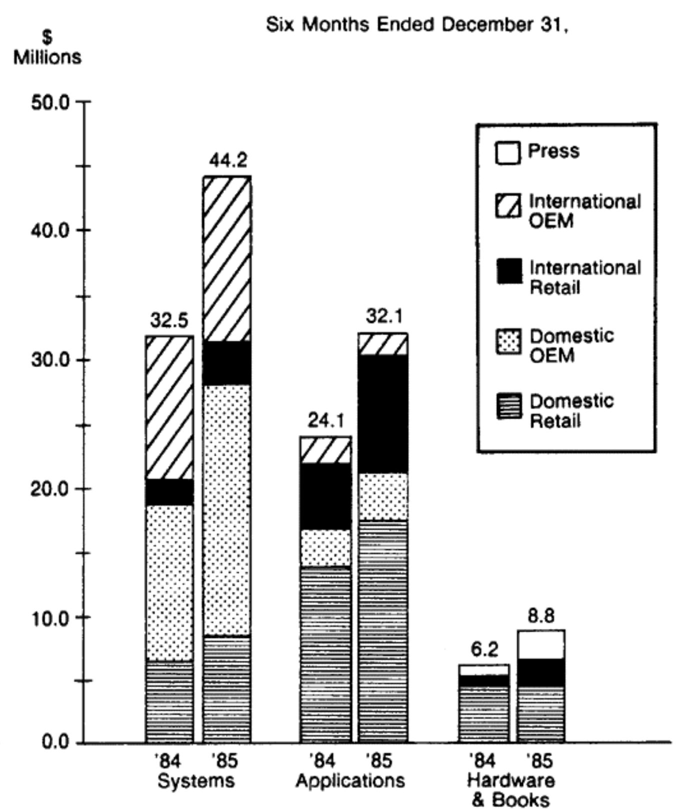
Results of Operations

The following table sets forth consolidated results of operations as a percentage of net revenues.

	Percentage of Net Revenues For Year Ended June 30,			Percentage of Net Revenues For Six Months Ended December 31,	
	1983	1984	1985	1984	1985
Net revenues	100%	100%	100%	100%	100%
Costs and expenses:					
Cost of revenues	32	23	22	25	22
Research and development	14	11	12	12	10
Sales and marketing	24	27	30	29	29
General and administrative	9	9	7	6	8
Total costs and expenses	79	70	71	72	69
Income from operations	21	30	29	28	31
Non-operating income (loss)	1	(1)	1	1	3
Income before income taxes	22	29	30	29	34
Provision for income taxes	9	13	13	13	14
Net income	13%	16%	17%	16%	20%

The following charts show net revenues by product group for the years ended June 30, 1983, 1984, and 1985 and by product group and distribution channel for the six months ended December 31, 1984 and 1985.





Revenue growth for the years ended June 30, 1984 and 1985 and the six months ended December 31, 1985 resulted from several factors, including the introduction of new products, the expansion of the market for microcomputer software, and the expansion of the Company's operations to new geographic market areas. As the microcomputer software industry and market mature it should not be expected that the Company's growth will continue at or approach the rate which occurred from 1983 to the present.

International net revenues for the years ended June 30, 1983, 1984, and 1985 were $10 million, $29.5 million, and $44.7 million and for the six months ended December 31, 1984 and 1985 were $22.1 million and $29.0 million. These amounts represented 20%, 30%, 32%, 35%, and 34% of net revenues for the respective periods. This growth is primarily the result of the establishment of additional foreign subsidiaries. Profit margins on international sales are similar to profit margins on domestic sales. For additional information concerning international sales and operations for the years ended June 30, 1983, 1984 and 1985, see Note 8 of Notes to Consolidated Financial Statements. The recent termination of an exclusive sales representative in Japan could adversely affect net revenues in Japan. See "Business - Marketing and Distribution - International OEM Distribution."

The reduction in cost of revenues for the years ended June 30, 1984 and 1985 and the six months ended December 31, 1985 was principally the result of a shift in the sales mix from lower margin hardware products to higher margin software products and, to a lesser degree, a decrease in the percentage of revenue attributable to Microsoft XENIX which has lower margins. Research and development expenses have increased, although not as dramatically as net revenues, as a result of planned software development staff increases and expenditures to create development tools. Sales and marketing expenses as a percentage of net revenues have increased as a result of (i) expanding the Company's domestic and international sales and marketing staff, (ii) the opening of local, regional, and international sales facilities, (iii) higher advertising and related expenditures, and (iv) increases in the provision for doubtful OEM accounts, primarily in 1985. During 1984 and 1985, and the six months ended December 31, 1985, the Company's general and administrative expenses were $8,784,000, $9,443,000, and $6,980,000, respectively. Such expenses increased as operations expanded.

Non-operating income includes interest income of $407,000, $427,000, and $952,000 for the years ended June 30, 1983, 1984, and 1985, and $402,000 and $1,151,000 for the six months ended December 31, 1984 and 1985. In addition, in 1984 the Company realized a short term capital loss of $1,500,000 from the write-off of the entire value of a minority interest in a closely held company. In 1985 the Company realized a short term capital gain of $984,000 upon the sale of marketable equity securities. During the six months ended December 31, 1985 the Company realized a foreign currency transaction gain of $1,245,000 resulting from the repayment of debt from certain international subsidiaries.

The effective tax rates for the years ended June 30, 1983, 1984, and 1985 were 41.4%, 43.3%, and 43.7%, and for the six months ended December 31, 1984 and 1985 were 45.1% and 41.1%, respectively, of income before income taxes. For an analysis of the differences between the statutory and the effective income tax rates for the years ended June 30, 1983, 1984, and 1985, see Note 4 of Notes to Consolidated Financial Statements. The effective tax rate for the six months ended December 31, 1985 was affected by foreign operating profits with no associated income tax expense due to the usage of foreign operating loss carryforwards.

See Note 4 of Notes to Consolidated Financial Statements for information concerning personal holding company tax.

Quarterly Results

The following table contains selected unaudited consolidated financial results for the six quarters ended December 31, 1985. In management's opinion this unaudited information has been prepared on the same basis as the audited information and includes all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information for the periods presented.

	Quarter Ended (Unaudited)					
	September 30, 1984	**December 31, 1984**	**March 31, 1985**	**June 30, 1985**	**September 30, 1985**	**December 31, 1985**
	(In thousands, except per share data)					
Net revenues	$26,004	$36,833	$40,662	$36,918	$35,153	$49,897
Total costs and expenses …..……	18,911	26,108	25,323	29,168	25,190	33,209
Income from operations..………	7,093	10,725	15,339	7,750	9,963	16,688
Non-operating income ..………...	128	273	148	1,387	553	1,844
Income before income taxes…….	7,221	10,998	15,487	9,137	10,516	18,532
Provision for income taxes…..…	3,259	4,964	6,990	3,529	4,346	7,584
Net income…….…	$ 3,962	$ 6,034	$ 8,497	$ 5,608	$ 6,170	$10,948
Net income per share…………	$ .17	$ .26	$ .37	$ .24	$ .26	$ .46
Shares used in computing net income per share...	23,253	23,253	23,261	23,272	23,926	23,946

Historically, the Company's operating results have been influenced by the timing of new product introductions, holiday season purchases, the signing of license agreements with OEMs, the calendar year cycle of distributor and dealer contracts, and the mix of revenues between retail and OEM. Operating results for the quarter ended March 31, 1985 were influenced by the introduction of new products for the Apple Macintosh (Microsoft Word, Microsoft File, and Microsoft Business Pack) and the introduction of Microsoft Word 2.0 for the IBM PC and IBM compatible computers. Operating results for the quarter ended June 30, 1985 were affected by the mix of revenue which resulted in significant commission expense, bonuses awarded under the Company's bonus program, and significant discretionary expenditures, primarily advertising and contract product development. The quarter ended December 31, 1985 was a record quarter for the Company and included significant revenue from new product introductions, principally Microsoft Excel for the Apple Macintosh, and from the receipt of orders from distributors prior to the Company's reduction of distributor discounts in calendar year 1986. The Company does not expect results for the quarter ending March 31, 1986 to equal the results for the quarter ended December 31, 1985.

Liquidity and Capital Resources

Since its inception, the Company has funded its activities almost entirely from funds generated from operations. The Company's cash and short-term investments balance at December 31, 1985 was $38.2 million. The Company believes that the proceeds of this offering, together with existing cash balances and funds generated from operations, will be sufficient to meet its cash requirements through fiscal 1987.

BUSINESS

Microsoft designs, develops, markets, and supports a product line of systems and applications microcomputer software for business and professional use. The Microsoft Software Product Line chart inside the front cover of this Prospectus illustrates the evolution and diversity of the Company's product line. Microsoft markets over 40 software products, including three operating systems, computer language products in six computer languages, and business applications software in the following categories: word processing, spreadsheet, file management, graphics, communications, and project management. The Company's products are available on 8-bit, 16-bit and 32-bit microcomputers domestically and internationally, including IBM, Tandy, Apple (Macintosh and Apple II series), COMPAQ, Olivetti, AT&T, Zenith, Wang, Hewlett-Packard, DEC, Siemens, Philips, Mitsubishi, and NEC.

Microsoft MS-DOS, introduced in 1981 as a 16-bit operating system for Intel microprocessor architectures, is running on approximately four million IBM PC and IBM compatible microcomputers, according to industry publications. The Company believes that more of the widely used business applications programs run on Microsoft MS-DOS than on any other 16-bit microcomputer operating system. Microsoft XENIX, a UNIX-based multi-user 16-bit operating system for microcomputers, is designed to accommodate transaction oriented data processing tasks. The Company's first product, Microsoft BASIC Interpreter, which was introduced in 1975, and newer versions of Microsoft BASIC Interpreter are running on an estimated eight million microcomputers, according to industry publications. The Company also markets compiler products in the following computer languages: BASIC, "C", FORTRAN, COBOL, and Pascal, and machine language assembler products. Microsoft Word, a word processing program introduced in 1983, Microsoft Multiplan, an electronic spreadsheet introduced in 1982, and Microsoft Chart, a graphics product introduced in 1984, are business applications products which run on Microsoft MS-DOS-based computers and on the Apple Macintosh. Microsoft Excel, an integrated spreadsheet introduced in 1985, and Microsoft File, a file management product also introduced in 1985, run on the Apple Macintosh. Microsoft Access, a communications tool released in 1985, and Microsoft Project, a project management product introduced in 1984, are MS-DOS applications.

Microsoft develops most of its software products internally using proprietary development tools and methodology. As of December 31, 1985 the Company employed 271 persons in software product development.

Microsoft markets and distributes its software products domestically and internationally through both the OEM and retail channels. In the OEM channel Microsoft generally provides an OEM with master copies of the software and documentation and the OEM duplicates, packages, and distributes them, although there is increasing OEM marketing of Microsoft's packaged language and applications products. The Company's domestic OEM sales force of approximately 20 has an active technical and business information relationship with approximately 100 OEM customers. Domestic retail marketing involves the distribution of Microsoft's packaged software products primarily through independent distributors, large volume dealers, corporate key dealers, and other dealers, and direct marketing to corporate customers, government agencies, and colleges and universities. International OEM and retail marketing and distribution of domestic and foreign language versions of the Company's systems software and applications software are conducted through seven foreign subsidiaries and several independent sales representatives. International Operations maintains an active technical and business information relationship with approximately 80 OEM customers.

The Company also designs and markets Microsoft® Mouse pointing and editing devices. Microsoft Press has published 27 books since it commenced operations in 1983, including **Running MS-DOS®**, by Van Wolverton and **The Peter Norton Programmer's Guide to the IBM PC**, by Peter Norton.

Company Organization

Microsoft's business strategy emphasizes the development of a product line of microcomputer software marketed through multiple channels of distribution. To this end, the Company is organized into seven operating groups: Systems Software, Applications Software, Press, Hardware, OEM Sales, Retail Sales, and International Operations. The Systems Software and Applications Software groups are responsible for the design and development of products and the management of the marketing efforts for those products. Microsoft Press publishes computer books and manages the marketing and distribution. The Hardware group designs hardware products, subcontracts their production, and manages the marketing. The OEM Sales group is responsible for the marketing of systems, applications, and hardware products through the domestic OEM channel. The Retail Sales group performs marketing and distribution through the domestic retail channel, including the marketing of Microsoft Press books. The International Operations group markets and distributes systems and applications products, both domestic and foreign language versions, and hardware products in foreign countries. The Company has recently formed a new group—CD ROM Software—to pursue the research and development of this technology. See "Business—Product Development."

The following table sets forth the percentage contribution to net revenues for each of the Company's product groups and channels of distribution for the year ended June 30, 1985.

Product Groups	
Systems………………..…..	54%
Applications………….....	38
Hardware and Books.…..	8
Total…………….....	100%

Channels of Distribution	
Domestic. OEM…………….	31%
Domestic Retail………..…....	36
International OEM……….……	19
International Retail……….....	13
Press………………………..	1
Total…………….………	100%

Products

There are two basic categories of microcomputer software: systems software and applications software. Systems software can be divided into two subcategories: operating systems and languages. Operating systems control the hardware, allocate computer memory, schedule the execution of applications software, and manage the flow of information and communication among the various components of the microcomputer system. Microcomputer language programs, which contain instructions regarding the syntax and rules of a particular computer language, allow the user to write programs in a particular computer language and translate programs into a binary machine-readable set of commands which activate and instruct the hardware. Common microcomputer languages include BASIC, "C", FORTRAN, COBOL, Pascal, and machine languages.

Applications software provides the microcomputer with instructions for the performance of end user tasks. General or "horizontal," as contrasted with specific or "vertical," applications software is designed for use by a broad class of end users, regardless of business, industry, or market segment. Primary examples of general applications software are word processing programs and spreadsheet programs.

Systems Software

Operating Systems

Microsoft markets three proprietary operating systems for microcomputers: Microsoft MS-DOS, Microsoft XENIX, and Microsoft MSX-DOS®. Microsoft MS-DOS is today a single-user, single-tasking operating system designed initially for the IBM PC microcomputer with its 16-bit Intel® 8088 microprocessor chip. Since its introduction in 1981, it has been modified for newer Intel microprocessor chips, for the accommodation of additional peripheral hardware devices, and to meet the needs of applications software developers. Recent versions of MS-DOS support file sharing and networking between microcomputers. The current version of Microsoft MS-DOS includes a file system, a program loader, a memory manager, user utilities, and a BASIC Interpreter program.

Management believes that more of the widely used business applications programs run on Microsoft MS-DOS than on any other 16-bit microcomputer operating system. According to industry publications, Microsoft MS-DOS is running on over four million microcomputers as of December 31, 1985. Microsoft MS-DOS is available on IBM, Tandy, COMPAQ, Olivetti, AT&T, Zenith, Wang, Hewlett-Packard, DEC, and other IBM compatible microcomputers. Microsoft has adapted the product to support certain foreign language character types, including European, Chinese, Kanji and Hangeul.

In November 1985, Microsoft began shipping Microsoft Windows, a graphical operating environment which runs on the Microsoft MS-DOS operating system. As an extension of MS-DOS, Microsoft Windows manages such hardware as the keyboard, screen, and printer. This product allows new applications programs to present themselves in a standard and graphical manner that is independent of video or other output devices. Microsoft is encouraging independent software developers to create applications programs which will take advantage of Microsoft Windows graphical user interface features. Lotus Development recently announced its intent to pursue the development of applications products that will run on Windows. Microsoft's own new applications software will be based on Microsoft Windows. It is too early in the life of Microsoft Windows to determine what level of acceptance it will attain in the marketplace.

Microsoft Networks, shipped in 1984, is a local area networking program which enables the end user to share files, disks, printers, and other devices within a networked Microsoft MS-DOS operating system environment.

Microsoft also has developed and markets Microsoft XENIX, which is a UNIX-based multi-user microcomputer operating system designed for the type of tasks traditionally undertaken by a minicomputer system. These include transaction oriented data processing tasks such as payroll systems and accounts receivable management. Microsoft XENIX is also used in a single-user fashion by scientists, engineers and programmers. As is the case with Microsoft MS-DOS, Microsoft has modified XENIX several times since its 1980 introduction to take advantage of newer 16-bit and 32-bit microprocessors.

Microsoft introduced its third operating system, Microsoft MSX-DOS, in 1984. Microsoft MSX-DOS is a single-user operating system which works in conjunction with an 8-bit computer whose hardware and software specifications have been established by Microsoft. The MSX® computers have been sold primarily in the Japanese home computer market. The Microsoft MSX-DOS operating system runs on an optional disk drive unit which can be attached to an MSX computer.

Languages

Microsoft has developed and markets numerous microcomputer language products. These products come in the form of interpreters and compilers. An interpreter stores a condensed version of the source code in memory and interprets it each time it executes the program. A compiler translates in a line-by-line manner programs written in human readable or source code form into instructions in binary machine readable or object code form. Compiled programs run faster and generally occupy less space in memory than interpreted programs. Users can write, edit, and debug programs interactively with an interpreter and then compile the final product for faster execution.

The Company's first product, which the Company believes was the first commercially available computer language program written for a personal computer, was a BASIC Interpreter developed in 1975 for the MITS ALTAIR microcomputer. BASIC is a general-purpose microcomputer programming language. The Microsoft BASIC Interpreter has been enhanced from its original 8-bit implementation to 16-bit versions for MS-DOS and XENIX operating systems and the Apple Macintosh.

First shipped in 1979, the Microsoft BASIC Compiler has also been enhanced through the years. In 1981 the Microsoft® GW-BASIC® Compiler, with its enhanced graphics capabilities, was introduced. In 1985 the Company shipped its newest BASIC product, Microsoft QuickBASIC Compiler, which is faster than earlier versions and can take advantage of the extended features of the newer versions of MS-DOS.

"C" is a language often used by professional programmers to write operating systems and other systems software and applications programs. Microsoft began marketing a C compiler in the Spring of 1983 and in early 1985 began shipping an enhanced version of a Microsoft developed product. The Company uses its C Compiler extensively for developing its software products.

The Microsoft FORTRAN Compiler is used primarily in scientific and engineering work because of its ability to manage complicated numerical calculations. Introduced in 1977 as an OEM product and in 1980 as a retail product, Microsoft FORTRAN Compiler has been enhanced and runs on the MS-DOS and XENIX operating systems. Microsoft also markets a FORTRAN product for the Apple Macintosh.

COBOL is a programming language most often used in commercial data processing and other transaction processing applications. Microsoft introduced its Microsoft COBOL Compiler in the Fall of 1978 for 8-bit microcomputers and has developed newer versions for 16-bit systems using the MS-DOS and XENIX operating systems.

Pascal was created as a language to teach good programming practices and its greater control structures facilitate a structured programming method useful for creating larger programs. Microsoft introduced the Microsoft Pascal Compiler in 1981 and its current version, released in the Fall of 1985, runs on the MS-DOS and XENIX operating systems.

Microsoft Macro Assemblers, machine language products, allow a user to write programs in machine-readable instruction form, thus permitting flexibility in programming and utilization of a machine's particular capabilities. Microsoft markets a Macro Assembler which generates machine-readable code for Zilog Z-80® and Intel 8080 microprocessor-based machines and another which generates such code for Intel 8086/8088 and 80186/80286 microprocessor-based machines.

Applications Software

Microsoft offers general, or "horizontal," business applications software in each of six business applications categories: word processing, spreadsheet, file management, graphics, communications, and project management. Certain Microsoft business applications products running on MS-DOS can share data, such as Multiplan and Chart or Multiplan and Access. All Microsoft business applications running on the Apple Macintosh can share data with each other.

Word Processing. Microsoft Word, a graphics-based word processing product, runs on the Microsoft MS-DOS and XENIX operating systems and the Apple Macintosh. Introduced in 1983, the product is also available in seven European language versions for the MS-DOS operating system and the Apple Macintosh. Microsoft Word Version 2.0 supports the latest and most advanced output devices, including laser printers, graphics cards, and monitors. It gives the user access to multiple windows, allowing simultaneous access to more than one document. It can be used with a mouse for editing. Its formatting capabilities facilitate organization and assembly of documents. The network version of Microsoft Word allows the sharing of word processing capabilities and files among networked microcomputers.

Spreadsheets. Microsoft Multiplan is available on over 70 different microcomputers and has been translated into 13 foreign languages. It was introduced in the Summer of 1982 and over one million copies had been distributed through December 31, 1985. Microsoft Multiplan is designed to create and process large amounts of information quickly. The product can be used with a mouse pointing device, linked to Microsoft Chart to generate presentation quality graphics, and can directly read and write Lotus® 1-2-3® files. Multiplan allows the linking of several spreadsheets and offers 49 mathematical, statistical, trigonometric and financial functions. In October 1985 Microsoft began shipping Version 2.0, which has a number of new features, including a macro capability that allows users to automate complex tasks.

In October 1985 Microsoft introduced Microsoft Excel, a spreadsheet integrated with database and business graphics modules for use on the Apple Macintosh computer. Microsoft Excel's charting capabilities can be linked to its spreadsheets to allow simultaneous changes to charts as changes are made to the spreadsheets. Microsoft Excel offers 85 mathematical, statistical, trigonometric and financial functions. Its data base module has sorting and searching capabilities. Extensive formatting capabilities allow the user to highlight any entry. The product is available in European language versions as well.

File Management. Microsoft File for the Apple Macintosh allows the user to create text and graphics files, prepare reports and forms, display information from the files, and search and sort up to nine items simultaneously. Microsoft File allows the sharing of data between other Macintosh software programs such as Microsoft Multiplan, Microsoft Chart and Microsoft Word. This product was introduced in January 1985 and three European language versions were introduced in the Spring of 1985. In December 1985 the Company began distributing Microrim® Rbase 5OOO™, a data base management product, in the European market under the name Microsoft Rbase.

Graphics. Microsoft Chart offers a wide variety of chart types, patterns and colors and runs on a substantial number and variety of printers and plotters. The product can be linked to share data with widely used spreadsheet and database software programs. Microsoft Chart has been translated into two European languages for the MS-DOS operating system and into five languages for the Apple Macintosh.

Communications. Microsoft Access, a business information access program for use on MS-DOS based microcomputers, conducts electronic communications with other computers in asynchronous mode, including information retrieval systems such as Dow Jones News/Retrieval®, Compuserve®, and NewsNet®. Microsoft Access allows information sharing between computer programs and provides windows which allow the user to view information in eight spaces simultaneously. The product also provides custom menus to simplify the interface of many major commercial information services and permits the user to create menus for specialized communications. Microsoft shipped this product in August 1985.

Project Management. Microsoft Project is a critical path method ("CPM") project scheduling and resource allocation program designed for use on Microsoft MS-DOS-based computers. The product can perform as a budgeting, monitoring and cost estimating tool for large projects and as a critical path and schedule planning tool. Microsoft Project can be used with a mouse for editing and can share data with other software programs such as Microsoft Multiplan, Microsoft Chart and Lotus 1-2-3. Microsoft introduced this product in April 1984 for the IBM PC and enhanced it in December 1985 to include PERT charting and computer-based training, among other new features.

Hardware

The Company's major hardware product is the Microsoft Mouse, a handheld pointing device which facilitates editing of text on the screen. It can be used with MS-DOS based machines and works with many Microsoft applications products. It also has been adapted to be used with other companies' software products such as Lotus 1-2-3. The mouse for the IBM PC was introduced in the Spring of 1983 and several newer versions have been released.

Microsoft has marketed memory expansion boards (RAMCard®) for the Apple II and IIe and the IBM PC and PCjr and a co-processor card (SoftCard®) for the Apple II, IIe and III, but does not foresee significant future distribution of those products.

Hardware products accounted for less than 10% of the Company's revenues and earnings in fiscal 1985.

Books

Founded in 1983, Microsoft Press publishes books about the products of Microsoft and other software developers and about current developments in the microcomputer industry. The 27 books published as of December 31, 1985 include **Running MS-DOS®**, by Van Wolverton**; The Peter Norton Programmer's Guide to the IBM PC**, by Peter Norton; and **The Apple Macintosh Book**, by Cary Lu.

Books published by Microsoft Press are typically written and copyrighted by independent authors who submit their manuscripts to the Company for publication and who receive a royalty from the Company which is tied to the book's sales.

Marketing and Distribution

Microsoft markets its software and hardware products through four primary channels of distribution: domestic OEM, domestic retail, international OEM, and international retail.

Domestic OEM Distribution

The Company's operating systems are marketed primarily to OEMs, under agreements which grant the OEM the right to make copies of the product and distribute the copies with the OEM's microcomputer. The Company also markets its language and application programs to OEMs under similar arrangements. In addition, the Company sells its standard packaged products to OEMs for resale to buyers of the OEMs' computers. In almost all cases, the products are distributed under Microsoft trademarks. The OEM generally pays the Company based on the number of copies of the product it makes or the number of microcomputers it ships, with an initial minimum commitment fee. The Company has OEM agreements covering one or more of its products with virtually all of the major domestic microcomputer OEMs, including IBM, Tandy, COMPAQ, Olivetti, AT&T, Zenith, Wang, Hewlett-Packard, and DEC.

Domestic Retail Distribution

Distributors and Dealers. The Company markets its products in the retail channel through independent distributors and dealers, large volume dealers such as Computerland and Businessland, and dealers who emphasize large business customers. A majority of the Company's distribution is through five independent, non-exclusive distributors — Softsel Computer Products, First Software, Ingram Software Distribution Services, Micro D, and Gates Distributing. Certain dealers who commit to take specified actions to target large business end user customers are eligible to participate in the Company's Corporate Key Dealer Program, under which they obtain products directly from the Company and are given incentives in return for their commitments to train and support these customers.

Microsoft has a network of field sales representatives and field support personnel who solicit orders from dealers and distributors, provide product training to dealers and large business customers, and provide sales support. As of December 31, 1985, Microsoft had five regional offices in operation in the United States, staffed with 45 field sales and support personnel.

Direct Marketing. In recognition of the importance of obtaining large orders from corporate customers, Microsoft has established a National Accounts Group to coordinate with Corporate Key Dealers to market applications products directly to those customers. While several contracts have been signed recently, to date no significant revenues have been generated by the program. The Company has structured a similar program to coordinate with value added resellers to sell products to various government agencies. The Company also markets its applications products to colleges and universities. These institutions can market the products to their students, professors, and other employees. The Company had entered into agreements with 30 colleges and universities as of December 31, 1985.

International OEM Distribution

The Company distributes to and maintains an active business and technical information relationship with a number of Japanese microcomputer manufacturers, including NEC, Mitsubishi, Matsushita, Tokyo Sanyo, Fujitsu, Kyocera, Epson, and Toshiba. In fiscal 1985, customers in Japan accounted for approximately 12% of the Company's net revenues, mostly from Japanese OEMs who shipped Microsoft products with their microcomputers. The Company markets its products in Japan and South Korea through exclusive sales representative arrangements. The Company's independent sales agent in Japan is ASCII Corporation ("ASCII"), and in South Korea it is QNIX Microsoft, A former officer and director of the Company is a major shareholder and officer of ASCII. See "Certain Transactions." The agents receive commissions for sales in their respective territories. ASCII represents the Company for both OEM and retail sales, while QNIX Microsoft handles only OEM sales.

The Company's exclusive sales representative agreement with ASCII terminates on or before March 17, 1986. Microsoft formed a wholly-owned subsidiary in Japan, Microsoft K.K., in February 1986 involving start-up costs of approximately $2,000,000. The subsidiary will handle the existing OEM business and potential retail business in Japan. The Company and ASCII have entered into an agreement for retail business during a transition period ending June 30, 1986 and are negotiating for a transition agreement for OEM business. It is possible that this transition will cause a disruption in the Company's Japanese business which will adversely affect net revenues in Japan.

OEM marketing, and business and technical relations with European OEMs, including Siemens, Philips, Ericsson, Triumph Adler, ACT, Bull Mircal, and SMT Goupil, are primarily handled by the Microsoft subsidiaries in their respective territories, who are assisted by the International Operations group at Company headquarters. Headquarters personnel also handle the Company's OEM marketing efforts to Southeast Asia, Latin America, and other markets.

The Company bills its international OEM customers in U.S. dollars and therefore payment is not subject to currency exchange fluctuations.

International Retail Distribution

In general, retail distribution has been the Company's larger source of revenue in Europe, Canada, and Australia and only a relatively minor revenue generator in the Far East and other areas. Microsoft has a practice of "localizing" its retail products, including user messages and documentation, for distribution in those countries. Thus, in France all user messages and documentation are in French and all monetary references are in French francs, and in the United Kingdom monetary references are in pounds and user messages and documentation reflect certain British conventions. Various Microsoft products have also been localized for distribution in West Germany, Italy, Spain, Portugal, Scandinavia, the Netherlands and Latin America. See the Microsoft Software Product Line chart inside the front cover page of this Prospectus for an indication of which products have been localized.

The Company has established marketing, distribution, and support subsidiaries in Canada, the United Kingdom, West Germany, France, and Australia and has marketing and support subsidiaries in Sweden and Italy. In addition to retail marketing activities, the subsidiaries also deal directly with OEMs in their territories, as discussed in the preceding section. Another subsidiary operates a manufacturing facility in Dublin, Ireland which supplies packaged products for the Company's European operations. The Irish manufacturing facility shipped its first products in December 1985.

The Company's international operations, both OEM and retail, are subject to certain risks common to foreign operations in general, such as governmental regulations and import restrictions. For further information with respect to the Company's international revenues, see Note 8 of the Notes to Consolidated Financial Statements.

Microsoft Press

Microsoft Press contracts with an independent commercial printer for the manufacture of its books. Harper & Row Publishers, Inc. acts as the Company's fulfillment house in the United States, maintaining the majority of the inventory of Microsoft Press books. Books are marketed to the traditional book trade by independent sales representatives and by Microsoft Press sales personnel. Sales to non-traditional channels — primarily computer stores — are handled by the Company's software retail sales force. Internationally, Microsoft Press has agreements with publishers in France, Germany, Italy, the Netherlands, Sweden, Spain, and Japan for the worldwide distribution of its books in the respective foreign languages. Microsoft Press has granted to a publisher in England the right to distribute English language versions of its books in all countries except the U.S. In most cases, Microsoft Press provides each publisher with a book's manuscript and the publisher arranges for its translation, and the printing, distribution, and marketing of the translated version.

Customers

The Company believes that most of its end user customers are individuals in businesses, both small and large, representing a variety of industries, government agencies, and educational institutions. These end users obtain Microsoft products primarily through distributors, dealers, and OEMs who include certain Microsoft products with their hardware. See "Business — Marketing and Distribution." No single customer accounted for more than 10% of the Company's revenues in fiscal 1985.

Product Development

The microcomputer software industry is characterized by rapid technological change, which requires a continuous high level of expenditures for the enhancement of existing products and the development of new products. The Company is committed to the creation of new products and intends to continue the enhancement of its existing products.

Most of the Company's software products are developed internally. Product documentation is also created internally. Internal development enables Microsoft to maintain closer technical control over the products and gives the Company the freedom to designate which modifications and enhancements are most important and when they should be implemented. The Company has created a substantial body of proprietary development tools and has evolved a development methodology for the creation and enhancement of its products. These tools and methodology are also designed to simplify a product's portability among different operating systems or computers.

The Company believes that a crucial factor in the success of a new product is getting it to market quickly to respond to a new user need or an advance in hardware design, without compromising product quality. The Company strives to become as fully informed as possible at the earliest possible time about technological advances and changing usage patterns. The Company recently hired a Vice President, CD ROM Software to direct the Company's exploration of the potential of CD ROM (Compact Disk Read Only Memory) technology in the microcomputer industry. See "Management—Certain Transactions." CD ROM technology may never generate revenue or profit for the Company, but may allow the Company to produce products incorporating that technology if and when such a market emerges.

As of December 31, 1985, the Company employed 271 persons engaged full time in software development. During fiscal 1983, 1984 and 1985, the Company spent approximately $7,021,000, $10,665,000, and $17,108,000, respectively, on product development and enhancement activities. Those amounts represented approximately 14%, 11%, and 12%, respectively, of net revenues in each of those years. Management presently anticipates that product development and enhancement expenditures will continue at approximately the present level as a percentage of net revenues.

When the Company licenses a software product from an independent author, it typically pays the author a percentage royalty based on net revenues generated by the product. Royalties to independent software authors totaled $3,222,000, $2,801,000, and $3,736,000 in fiscal 1983, 1984, and 1985, respectively. The bulk of those payments related to the XENIX operating system and the Company's Flight Simulator game product. Microsoft XENIX is based on AT&T's UNIX operating system, which the Company licenses from AT&T. Microsoft has customized UNIX for, primarily, Intel microprocessor architecture and enhanced it for office use.

The specifications for the Company's hardware products are typically created internally, while production is subcontracted.

Employees

As of December 31, 1985, the Company employed 998 people, 840 domestically and 158 internationally. Of the total, 326 were in product development, 402 in sales, marketing and support, 113 in manufacturing and distribution, and 157 in finance and administration. Microsoft's success is highly dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be successful in the future. None of the Company's employees is subject to collective bargaining agreements. The Company believes that relations with its employees are good.

Competition

The microcomputer software market is highly competitive and has been subject to rapid change, which can be expected to continue. The Company's competitors include many independent software vendors, such as Lotus Development, Ashton-Tate, Software Publishing, and Borland International, as well as a number of microcomputer manufacturers which are devoting significant resources to creating microcomputer software, notably IBM, AT&T, and Apple Computer. Many of the Company's competitors have financial, marketing, and technological resources which exceed those of the Company.

Microsoft markets its operating systems products primarily to OEMs. The Company competes for that business with other independent systems software vendors, such as Digital Research and AT&T, and with the OEMs themselves to the extent that they may be developing their own systems software. The Company believes that the principal competitive factors in marketing to OEMs are the product's reputation, product features and functions, timeliness of delivery, product reliability, and availability and quality of support services.

Microsoft's language products are primarily marketed through the retail distribution channel. Most of the Company's language products, including Microsoft FORTRAN, Microsoft C, and Microsoft BASIC Compilers, are relatively high-priced in relation to languages offered by competitors, and are directed at end users who demand a high degree of functionality from a language product and will pay for the extra features. There is and will continue to be price pressure on these products as lower priced competing offerings become more fully featured. Other language products, such as Macro Assembler, QuickBASIC, and MacBASIC, are lower priced versions for end users who do not need all of the features available in the Company's other language products. The market for these products is quite price sensitive.

The Company's application products are also marketed primarily through the retail channel. All of the Company's applications products are opposed in the marketplace by competing products offering many similar features. The Company believes that the principal competitive factors in the applications products market include product features and functions, ease of understanding and operating the software, product reliability, price/performance characteristics, name recognition, and availability and quality of support and training services.

To date price competition has not been a major factor in the microcomputer software market. It seems likely to management, however, that price competition, with its attendant reduced profit margins, will emerge in the next few years as a significant consideration. The recent increase of "site licenses" (permitting copying of the program and documentation) and discount pricing for large volume retail customers is evidence of such competition.

Microsoft also competes with other companies in the microcomputer software market for distributors, dealers, and other channels of product distribution. In addition to the factors listed above, the principal considerations for distributors and dealers in determining which products to offer include profit margins, product support and service, and credit terms.

Manufacturing

The Company has manufacturing facilities located in the United States and the Republic of Ireland. The Company's manufacturing operations involve the duplication of diskettes, assembly of purchased parts, and final packaging. Quality control tests are performed on purchased parts, duplicated diskettes, and finished products. The chief materials and components used in Microsoft products include diskettes, plastic boxes, binders, and multi-color printed materials. The Company is often able to acquire component parts and materials on a volume discount basis. The Company has multiple sources for raw materials, supplies, and components.

Disk duplicating and labeling are highly automated. Final assembly of the products is labor intensive. All manufacturing operations are equipped with computerized inventory, manufacturing, management, and financial control systems.

Properties

The Company's executive offices are located at 16011 NE 36th Street, Redmond, Washington, in four adjacent leased buildings having a total of 240,000 square feet of space. The land and buildings are leased under a 15 year lease, with two five-year options to renew. The Company also has a 73,000 square foot manufacturing, assembly, and shipping facility at another site in Bellevue, a 25,000 square foot product distribution center in nearby Kirkland, Washington, and a 36,000 square foot manufacturing, assembly, and shipping facility in Dublin, Ireland. All of these facilities are leased.

In addition, the Company leases office space in 24 locations in the United States and in 7 foreign countries (Australia, Canada, England, France, Italy, West Germany and Sweden). These locations function primarily as sales, training, and field service centers for their regions.

All of the Company's properties are leased from unaffiliated third parties.

The Company believes that its new headquarters complex is adequate for its present needs. A contiguous site is under option for expansion.

See Note 6 of Notes to Consolidated Financial Statements for information regarding the Company's obligations under leases.

Product Protection

Microsoft regards its software as proprietary and attempts to protect it with copyrights, trade secret laws, and internal nondisclosure safeguards, as well as restrictions on disclosure and transferability that are incorporated into its software license agreements. The Company licenses its software products to customers rather than transferring title. Despite these restrictions, it may be possible for competitors or users to copy aspects of the Company's products or to obtain information which the Company regards as trade secrets. Computer software generally has not been patented, and existing copyright laws afford limited practical protection. Monitoring and identifying unauthorized use of such a broadly disseminated product as microcomputer software is difficult, and software piracy can be expected to be a persistent problem for the packaged software industry. These problems may be particularly acute in international markets. For that reason, most of the Company's products distributed internationally have electronic copy protection methods embedded in the disks.

Microsoft seeks patent protection on new products in appropriate circumstances, and has two patent applications pending.

Legal Proceedings

Microsoft was served in January 1986 with a summons and complaint in an action commenced by Seattle Computer Products, Inc. ("SCP") in the Superior Court for King County, Washington. This action arises out of an agreement entered into in 1981 under which SCP sold to Microsoft SCP's rights in a disk operating system which Microsoft developed into MS-DOS. SCP seeks the following relief: (i) a judicial declaration that under the agreement SCP has an assignable, perpetual, royalty-free worldwide license from Microsoft for MS-DOS in its current and future versions; (ii) an injunction against Microsoft prohibiting alleged interference with SCP's attempts to sell its business and requiring Microsoft to honor SCP's interpretation of the agreement; and, in the alternative, (iii) judgment against Microsoft for damages "believed to exceed $20,000,000" or $60,000,000 when trebled or a rescission of the agreement, a return of the rights granted thereunder, and an accounting for the payment to SCP of all revenues received from Microsoft's marketing of MS-DOS. The Company believes that SCP's interpretation of the agreement is erroneous and intends to vigorously defend this action. In the opinion of the Company, were

SCP to prevail on its requested declaratory or injunctive relief (see items (i) and (ii) above), such a result would not have a material adverse effect on the Company's financial condition or results of operations. Although the outcome of litigation can never be predicted with certainty, the Company further believes that it is unlikely that SCP could obtain the relief sought with respect to damages or rescission of the contract (see item (iii) above).

MANAGEMENT

Directors and Executive Officers

The directors and executive officers of the Company are as follows:

Name	Age	Position With Company
William H. Gates III	30	Chairman of the Board, Chief Executive Officer
Jon A. Shirley	47	President and Chief Operating Officer; Director
Francis I. Gaudette	50	Vice President, Finance and Administration, Chief Financial and Administrative Officer
Steven A. Ballmer	29	Vice President, Systems Software
Ida S. Cole	38	Vice President, Applications Software
James W. Harris	42	Vice President, OEM Sales
Thomas M. Lopez	42	Vice President, CD ROM Software
William H. Neukom	44	Vice President, Law & Corporate Affairs
Scott D. Oki	37	Vice President, International Operations
Jean D. Richardson	49	Vice President, Corporate Communications
Gerald A. Ruttenbur	42	Vice President, Retail Sales
Portia Isaacson	43	Director
David F. Marquardt	37	Director

All directors hold office until the next annual meeting of stockholders and the election and qualification of their successors. Directors receive no compensation for serving on the Board except for reimbursement of reasonable expenses incurred in attending meetings. Officers are elected annually by the Board of Directors and serve at the discretion of the Board.

Mr. Gates was a founder of the Company and has been its Chief Executive Officer and Chairman of the Board since the Company's predecessor partnership was incorporated in 1981. From 1975 to 1981, Mr. Gates was a partner with Paul Allen, Microsoft's other founder, in the predecessor partnership. Mr. Gates is responsible for technical development including product design and internal development and review.

Mr. Shirley joined Microsoft as President, Chief Operating Officer, and a director in August 1983, after 25 years with Tandy Corporation. At Tandy, Mr. Shirley was Vice President, Computer Merchandising, from 1978 until 1983, and prior to 1978 held a variety of positions at Tandy in sales, merchandising, manufacturing, and international operations. Tandy Corporation is a leading supplier of personal computers and consumer electronics products.

Mr. Gaudette joined Microsoft in September 1984 as Vice President, Finance and Administration. Mr. Gaudette joined Microsoft from C3, Inc., where he served as Vice President, Finance and Administration from 1981 to 1984. Prior to C3, Gaudette was with Informatics General, where he served as Vice President, Business Operations, of the Information Services Group. In addition, he has held senior management positions with Computer Network Corporation (COMNET); Rexnord, Inc.; Rockwell International; and Frito-Lay, Inc.

Mr. Ballmer has been Vice President, Systems Software since 1984. Since joining the Company in 1980, Mr. Ballmer has also served as Assistant to the President, Vice President, Corporate Staffs, and Vice President, Marketing. Before coming to Microsoft, Mr. Ballmer worked in marketing for The Procter & Gamble Company.

Ms. Cole joined Microsoft as Vice President, Applications Software in February 1985. Prior to joining the Company, Ms. Cole spent four years at Apple Computer. At Apple, her most recent position was Director of New Product Development, and she also served as Director of Marketing for Apple II and III product lines, Director, Applications Software, and Manager, Applications Software Development.

Mr. Harris joined Microsoft in January 1983 as General Manager, OEM Sales and was promoted to Vice President, OEM Sales shortly thereafter. Prior to joining the Company, Mr. Harris was Marketing Manager in the Software Distribution and Support Operation at Intel Corporation, a position he held from 1980 to 1982. From 1982 to 1983, Mr. Harris was chairman of Intel's Strategic Business Section, where he was responsible for strategic business and product planning.

Mr. Lopez joined the Company in January 1986. From November 1984 until joining Microsoft, Mr. Lopez was President and founder of Cytation, Inc., which was involved in the development of CD ROM applications products. From 1981 until 1984, Mr. Lopez was employed by Activision, Inc., first as Vice President, Editorial Development and later as Senior Vice President. Prior to that, he was Director of Strategic Planning for J. Walter Thompson Company, an advertising agency.

Mr. Neukom joined the Company in December 1985 as Vice President, Law and Corporate Affairs. Mr. Neukom formerly was a member of the Seattle law firm of Shidler MeBroom Gates & Lucas, the Company's general counsel. He served as the Company's senior outside counsel from 1979 until 1985. He engaged in the private practice of law from 1968 until joining the Company.

Mr. Oki has served as the Company's Vice President, International Operations since 1983. He was hired by Microsoft in 1982 as Marketing Manager, Special Accounts. From 1980 to 1982, Mr. Oki was Vice President for Product Development with Sequoia Group, Inc., a developer of turnkey computer systems for physicians. Six months after Mr. Oki joined Microsoft, Sequoia Group filed a petition in bankruptcy. Prior to 1980, he held marketing positions with Hewlett-Packard.

Ms. Richardson joined Microsoft as Vice President, Corporate Communications in February 1985 after eight years with Apple Computer. Ms. Richardson joined Apple in 1978 as Marketing Services Manager and was responsible for the creation of its Marketing Communications Group. In 1982 she became Apple's Director of Marketing Communications.

Mr. Ruttenbur joined Microsoft in March 1984 as Vice President, Retail Sales. Mr. Ruttenbur came to Microsoft from Koala Technologies Corporation, a producer of hardware and software for microcomputers, where he was Vice President of Sales from 1983 to 1984. From 1982 to 1983, Mr. Ruttenbur was Director of National Sales for Atari's Home Computer Division. Prior to 1982, Mr. Ruttenbur spent 12 years with M&M Mars Distributing in various sales and marketing positions.

Ms. Isaacson has been a director of the Company since December 1985. She is currently Chairman and Chief Executive Officer of Intellisys Corporation, a home automation software system company and is also head of Isaacson, Incorporated, a merger and acquisition firm. In 1981 Ms. Isaacson founded Future Computing, a market research company, and was its Chief Executive Officer until October 1985, when she became its Vice Chairman of the Board.

Mr. Marquardt has been a director of the Company since 1981. Since 1980, Mr. Marquardt has been a general partner of TVI Management, TVI Management-2, and TVI Management-3, which are general partners of Technology Venture Investors, Technology Venture Investors-2, and Technology Venture Investors-3, venture capital limited partnerships. He has been with TVI Management since 1980. He is also a director of Archive Corporation and Sun Microsystems, Inc.

Executive Compensation

The following table sets forth the cash compensation paid by the Company to its five highest paid executive officers, and to all executive officers as a group, during the year ended December 31, 1985:

Name	Capacity in Which Served	Cash Compensation (1)
Jon A. Shirley	President and Chief Operating Officer; Director	$ 228,000
William H. Gates III	Chairman of the Board, Chief Executive Officer	133,000
Francis J. Gaudette	Vice President, Finance and Administration, Chief Financial and Administrative Officer	109,000
William S. Roland (2)	Vice President/General Manager, Peripherals and Hardware Development	96,000
Steven A. Ballmer	Vice President, Systems Software	88,000
All executive officers as a group (12 persons) (3)		$1,127,000

(1) Includes bonuses awarded under a bonus program for salaried employees. Messrs. Shirley and Gates do not participate in the bonus program. Bonuses of up to 15% (20% in the case of one executive officer) of base earnings are awarded on a discretionary basis.

(2) Mr. Roland has resigned effective February 1986.

(3) Includes two persons whose employment with the Company ended in March 1985.

1981 Stock Option Plan

All present and future employees who, at the time the options are granted, are regular full-time employees of the Company are eligible to participate in the Option Plan. As of January 15, 1986, there were options outstanding to purchase 2,681,457 shares of Common Stock and 39,896 shares remained available for future grants. At its January 28, 1986 meeting the Board of Directors voted to increase shares available for future grants by 200,000. The option price is determined by the Board of Directors, subject to the provisions of the Option Plan. For incentive stock options, the option price cannot be less than the fair market value of the stock on the date of grant. For one year following the date of this Prospectus, the Company has agreed not to grant stock options at a price less than 85% of the fair market value of the Common Stock on the date of grant. The Board of Directors determines the size of each option and the vesting schedule. Options expire five years after grant, or following termination of employment.

An option may be exercised by paying the option price in cash, in shares of Common Stock, or in any combination of cash and shares. When a non-qualified option is exercised, the option holder must also pay related taxes.

In calendar year 1985, the following executive officers were granted stock options under the Option Plan for the indicated number of shares: Jon A. Shirley, 150,000 shares at an average exercise price of $5.50 per share; Francis J. Gaudette, 15,000 shares, average exercise price of $5.50 per share; all executive officers as a group (12 persons), 302,499 shares, average exercise price of $4.51 per share.

In calendar year 1985, the following executive officers exercised stock options granted under the Option Plan. The dollar amounts in parentheses indicate the net value of the shares purchased (market value as of the exercise date less option price): Jon A. Shirley, 22,500 shares (net value of $65,000); all executive officers as a group (12 persons), 45,312 shares (net value of $99,218).

1986 Employee Stock Purchase Plan

The 1986 Employee Stock Purchase Plan allows all full-time employees to authorize payroll deductions at a rate of 2, 4, 6, 8, or 10% of base pay (including bonuses) to be applied toward purchases of Common Stock. There are 300,000 shares of Common Stock reserved for issuance under the Purchase Plan. The Purchase Plan will end on December 31, 1990.

Each offering period is six months, and new offerings commence on January 1 and July 1 of each year. An employee must authorize a payroll deduction before the start of an offering in order to participate in that offering, and if the employee has not withdrawn from the offering before its last business day he will be deemed to have exercised the option to purchase as many shares as his payroll deductions will allow, at the option price. The option price is the lesser of 85% of (i) the fair market value of the Common Stock on the first business day of the offering, or (ii) the fair market value on the last business day of the offering.

The Company anticipates that the first offering under the Purchase Plan will commence on or after July 1, 1986.

Certain Transactions

In 1981, an executive officer and certain employees of the Company purchased Common Stock from the Company at a price less than the fair market value on the purchase date. The Company made loans to these individuals to enable them to pay their income tax liability on the below-market purchases. The loans bear interest at 7% per annum and are due and payable in July 1988. The following table includes Mr. Ballmer's obligation to the Company pursuant to such a loan.

Certain executive officers of the Company have entered into stock purchase agreements with the Company whereby they have purchased Common Stock from the Company at the then-current fair market value, as determined by independent appraisal, with the purchase price due and payable seven years from the date of the agreement. The unpaid purchase price bears interest at 9% per annum. The following table includes Mr. Shirley's obligation under such a stock purchase agreement.

Since January 1, 1985, the following directors and executive officers have purchased the indicated number of shares of Common Stock at the indicated prices: Ida S. Cole, Scott D. Oki, and Jean D. Richardson, 16,667 shares, 6,667 shares, and 11,667 shares, respectively, at $3.00 per share; Portia Isaacson, Thomas M. Lopez, and Jean D. Richardson, 10,000 shares, 7,500 shares, and 8,000 shares, respectively, at $5.50 per share, and William H. Neukom, 35,000 shares at $17.50 per share. In all cases, the purchase price was determined by independent appraisal.

The Company has made loans to employees for the purchase of stock and for the payment of taxes in connection with stock purchases, and at times has made loans to new employees, primarily for the purpose of assisting in the employee's relocation. The following executive officers owed the Company in excess of $60,000 at some time since the beginning of fiscal 1983:

Name of Executive Officer	Largest Amount Owed from 7/1/82 to 12/31/85	Balance Owed at 12/31/85	Interest Rates (%)
Jon A. Shirley	$810,751	$608,501	9
Francis J. Gaudette	143,888	89,664	9, 12
Steven A. Ballmer	533,711	533,711	7
Scott D. Oki	198,711	56,211	9, 12
Jean D. Richardson	305,170	55,170	9, 12
Gerald A. Ruttenbur	131,723	23,241	9, 12

Kazuhiko Nishi, a former director and executive officer of the Company, owed the Company $509,850 as of December 31, 1985, pursuant to loans in the principal amounts of $100,000 and $275,000 made in 1981 and 1983. Both loans bear interest at 12% per annum. The Company doubts repayment and has accordingly fully provided for the uncollectibility of these loans. Mr. Nishi is a principal of ASCII Corporation ("ASCII"), the Company's exclusive sales representative in Japan. The Company is in the process of terminating that relationship. See "Business — Marketing and Distribution — International OEM Distribution." The Company's agreement with ASCII, which has been in effect for a number of years, provides for the payment to ASCII of a 30% commission on OEM sales in its territory. Until recently, ASCII's territory was the Far East, but it was limited to only Japan in September 1985. ASCII also handles the retail distribution, including manufacturing, of Microsoft products in its territory and pays Microsoft 30% of those revenues. In fiscal 1983, 1984, and 1985, Microsoft paid OEM commissions to ASCII in the amount of $2,090,000, $4,377,000, and $5,179,000, respectively, and received less than $1,000,000 in each of those years as its portion of ASCII's retail Microsoft product revenues.

On January 6, 1986, when the Company hired Thomas M. Lopez as its Vice President, CD ROM Software, it purchased from Mr. Lopez and one other individual all of the outstanding stock of a two-employee CD ROM research and development company founded by Mr. Lopez. The acquired company's major asset was a CD ROM-related product which is in development. Mr. Lopez received $81,600 for his stock, plus 1.8% of the revenues earned by Microsoft on any sales of the acquired company's product during the four years ending January 5, 1990. Mr. Lopez is entitled to a minimum of $30,000 in royalties during the four-year period.

Mr. Gates' father is a member of Shidler McBroom Gates & Lucas, the Company's general counsel since 1978. In fiscal 1983, 1984, and 1985, the law firm received legal fees and reimbursement of expenses from the Company in the amounts of $154,833, $216,932, and $536,532.

Loans outstanding at the present time have been approved by the majority of the disinterested and independent directors. All future loans to officers, directors or employees will be approved by a majority of the disinterested and independent directors. In the future the Company will not enter into any transactions with affiliated parties unless the disinterested and independent directors determine that the terms of such transactions are at least as favorable to the Company as if made with unaffiliated parties.

PRINCIPAL AND SELLING STOCKHOLDERS

The following table sets forth certain information regarding the ownership of the Company's Common Stock as of January 15, 1986, (i) by each person who is known by the Company to own beneficially more than 5% of the outstanding shares of the Common Stock, (ii) by each of the Company's directors, (iii) by all directors ard officers as a group, and (iv) by each Selling Stockholder. Unless otherwise indicated below, the person or persons named have sole voting and investment power:

Directors, Officers, and 5% Stockholders	Shares Beneficially Owned Prior to Offering		Shares To Be Sold	Shares Beneficially Owned After Offering (1)	
	Number	Percent		Number	Percent
William H. Gates III (2) (3) Microsoft Corporation 16011 NE 36th Street Redmond, WA 98073-9717	11,222,000	49.2%	80,000	11,142,000	44.8%
Paul G. Allen (3) Asymetrix Corporation 110-110th Avenue NE Suite 617 Bellevue, WA 98004	6,390,000	28.0	200,000	6,190,000	24.9
Steven A. Ballmer Microsoft Corporation 16011 NE 36th Street Redmond, WA 98073-9717	1,710,001	7.5	30,000	1,680,001	6.8
Technology Venture Investors 1, 2 & 3 3000 Sand Hill Road Menlo Park, CA 94025	1,378,901 (4)	6.1	294,893	1,084,008 (4)	4.4
Jon A. Shirley	400,000	1.8	60,000	340,000	1.4
David F. Marquardt (5)	21,099 (5)	.1	5,107	15,992 (5)	.1
Portia Isaacson	10,000	—	—	10,000	—
All Officers and Directors as a Group (13 Persons)	13,521,099 (5)(6)	59.1	175,107	13,345,992 (5)(6)	53.6
Other Selling Stockholders					
William H. and Mary M. Gates	114,000 (7)	.5	33,000	81,000 (7)	.3
William H. Neukom, Trustee for Kristianne Gates	20,000	.1	20,000	—	—
Charles Simonyi	305,667	1.3	10,000	295,667	1.2
Gordon Letwin	293,850	1.3	40,000	253,850	1.0
Frederic H. Ballmer	36,666	.2	15,000	21,666	.1
Merritt Family Trust	34,000	.1	7,000	27,000	.1

(1) Assuming no exercise of the Underwriters' over-allotment option.

(2) By reason of his position with the Company and his beneficial ownership of Common Stock, Mr. Gates may be deemed to be a "parent" of the Company within the meaning of the Securities Act of 1933.

(3) Messrs. Gates and Allen were partners in the Company's predecessor partnership, and may be deemed to be "promoters" of the Company within the meaning of the Securities Act of 1933. They received their Common Stock in exchange for their transfer to the Company of all of the assets and liabilities of the predecessor partnership. Mr. Allen was the Company's Executive Vice President from its inception until 1983, and also served as a director from inception through April 1985.

(4) The shares listed for Technology Venture Investors 1, 2 and 3 takes into account the automatic conversion of Preferred Stock into 985,710 shares of Common Stock as of the date of this Prospectus.

(5) Mr. Marquardt is a general partner in TVI Management 1, 2, and 3 which are the general partners in the limited partnerships Technology Venture Investors 1, 2, and 3. The shares listed opposite Mr. Marquardt's name takes into account the automatic conversion of Preferred Stock into 14,290 shares of Common Stock. All shares listed for Mr. Marquardt are owned by TVI Management 1, 2, and 3.

(6) Includes 77,914 shares subject to options which are exercisable within 60 days of January 15, 1986.

(7) Includes 40,000 shares held in trust for the benefit of Mr. and Mrs. Gates.

SHARES ELIGIBLE FOR FUTURE SALE

Immediately after the offering pursuant to this Prospectus, 21,996,017 shares of Common Stock will continue to be held by existing stockholders. All such shares of Common Stock, and shares to be issued under outstanding stock options, were or will be acquired in reliance upon the "private placement" exemption under the Securities Act of 1933 (the "Act") (such outstanding shares of Common Stock being referred to as "Restricted Shares"). Of those Restricted Shares, 20,542,086 shares are owned by persons who may be deemed to be affiliates of the Company. Restricted Shares may not be sold unless they are registered under the Act or are sold pursuant to an applicable exemption from registration, including an exemption under Rule 144. Beginning 90 days after the date of this Prospectus, Restricted Shares may be sold in accordance with Rule 144 if the conditions of that Rule have been met. Restricted Shares may not be sold under Rule 144 unless they have been fully paid for and held for two years. After such two-year holding period, the shares may be sold in brokers' transactions in an amount in any three months not in excess of the greater of 1% of the number of shares of Common Stock then outstanding or the average weekly trading volume for a four-week period prior to each such sale. After they have been paid for and held for more than three years, Restricted Shares held by persons who are not affiliates of the Company may be sold without limitation. However, under Rule 144, Restricted Shares held by affiliates must continue, after the three-year holding period, to be sold in brokers' transactions subject to the volume limitations described above. The above is a summary of Rule 144 and is not intended to be a complete description thereof. Approximately 230,000 Restricted Shares will be eligible for sale pursuant to Rule 144 as of the date of this Prospectus.

A total of 2,921,353 shares of Common Stock are reserved for issuance under the Option Plan. See "Management — 1981 Stock Option Plan." In addition, 300,000 shares of Common Stock are reserved for issuance under the Purchase Plan. See "Management — 1986 Employee Stock Purchase Plan." The Company intends to file registration statements under the Act to register shares to be issued pursuant to such plans approximately 90 days after the date of this Prospectus, to become effective as promptly thereafter as practicable. Shares issued upon exercise of outstanding stock options under the Option Plan and Purchase Plan after the effective date of such registration statement generally may be sold in the open market.

The Company, and the Selling Stockholders, officers, and directors, holding in the aggregate approximately 21,070,000 shares of Common Stock, have agreed with the Underwriters not to offer, sell, or otherwise dispose of any shares of Common Stock for a period of 120 days after the date of this Prospectus without the prior written consent of the Representatives, except that the Company may, without such consent, grant options, or issue stock upon exercise of outstanding options, pursuant to the Option Plan, and issue stock pursuant to the Purchase Plan.

Prior to this offering, there has been no market for the Common Stock, and no precise predictions can be made of the effect, if any, that market sales of shares or the availability of shares for sale will have on the market price prevailing from time to time. Nevertheless, sales of substantial amounts of the Common Stock in the public market could adversely affect prevailing market prices.

DESCRIPTION OF COMMON STOCK

The Company is authorized to issue up to 60,000,000 shares of Common Stock, par value $.001 per share. As of January 15, 1986, there were 22,791,017 shares of Common Stock outstanding, held of record by 181 stockholders. The Common Stock is not entitled to any preemptive rights. The Common Stock is neither redeemable nor convertible. Upon liquidation, the holders of Common Stock are entitled to share ratably in the entire net assets of the Company, after payment in full to all creditors of the Company. All outstanding Common Stock is, and all Common Stock offered hereby will be, when issued, fully paid and nonassessable. The holders of the Common Stock are entitled to dividends when and as declared by the Board of Directors, out of funds legally available therefor. Each holder of Common Stockis entitled to one vote for each share of Common Stock held of record on all matters submitted to a vote of stockholders, including the election of directors.

Registrar and Transfer Agent

The registrar and transfer agent for the Common Stock is The First Jersey National Bank, Jersey City, New Jersey.

UNDERWRITING

Subject to the terms and conditions set forth in the Underwriting Agreement, the Company and the Selling Stockholders have agreed to sell to each of the Underwriters named below, and each of the Underwriters, for whom Goldman, Sachs & Co. and Alex. Brown & Sons Incorporated are acting as Representatives, has severally agreed to purchase from the Company and the Selling Stockholders the respective number of shares of Common Stock set forth opposite its name below.

Underwriter	Number of Shares
Goldman, Sachs & Co.	440,500
Alex. Brown & Sons Incorporated	440,500
ABD Securities Corporation	15,000
Advest, Inc.	15,000
Allen & Company Incorporated	15,000
Arnhold and S. Bleichroeder, Inc.	15,000
Robert W. Baird & Co. Incorporated	15,000
Baker, Watts & Co.	6,000
Banque de Neuflize, Schlumber, Mallet	15,000
Barclays Merchant Bank Limited	6,000
Bateman Eichler, Hill Richards Incorporated	15,000
Bear, Stearns & Co. Inc.	42,000
Sanford C. Bernstein & Co., Inc.	15,000
Birr, Wilson & Co., Inc.	6,000
William Blair & Company	15,000
Blunt Ellis & Loewi Incorporated	15,000
Boettcher & Company, Inc.	15,000
J. C. Bradford & Co., Incorporated	15,000
Brean Murray, Foster Securities Inc.	6,000
Butcher & Singer Inc.	15,000
Cable, Howse & Ragen	42,000
Carolina Securities Corporation	6,000
Cazenove Inc.	6,000
The Chicago Corporation	6,000
Cowen & Co.	15,000
Credit Commercial de France	15,000
Dain Bosworth Incorporated	15,000
Daiwa Securities America Inc.	6,000
D.A. Davidson & Co. Incorporated	6,000
Deutsche Bank Capital Corporation	15,000
R. G. Dickinson & Co.	6,000
Dillon, Read & Co. Inc.	42,000
Doft & Co., Inc.	6,000
Donaldson, Lufkin & Jenrette Securities Corporation	42,000
Drexel Burnham Lambert Incorporated	42,000
Eberstadt Fleming Inc.	15,000
A. G. Edwards & Sons, Inc.	15,000
Eppler, Guerin & Turner, Inc.	15,000
EuroPartners Securities Corporation	15,000
First Albany Corporation	6,000
The First Boston Corporation	42,000
First Manhattan Co.	6,000
First Southwest Company	15,000
Furman Selz Mager Dietz & Birney Incorporated	15,000
Gruntal & Co., Incorporated	15,000
Hambrecht & Quist Incorporated	42,000
Hill Samuel & Co. Limited	15,000
J. J. B. Hilliard, W. L. Lyons, Inc.	6,000
Hoare Govett Limited	6,000
Howard, Weil, Labouisse, Friedrichs Incorporated	15,000
E. F. Hutton & Company Inc.	42,000
Interstate Securities Corporation	15,000
Investment Corporation of Virginia	6,000
Janney Montgomery Scott Inc.	15,000
Johnson, Lane, Space, Smith & Co., Inc.	6,000
Johnston, Lemon & Co. Incorporated	6,000
Josephthal & Co. Incorporated	15,000
Kidder, Peabody & Co. Incorporated	42,000
Kleinwort, Benson Incorporated	15,000
Ladenburg, Thalmann & Co. Inc.	15,000
Cyrus J. Lawrence Incorporated	6,000
Lazard Frères & Co.	42,000
Legg Mason Wood Walker Incorporated	15,000
McDonald & Company	15,000
Merrill Lynch, Pierce, Fenner & Smith Incorporated	42,000
Montgomery Securities	42,000
Moore & Schley Capital Corporation	6,000
Morgan Grenfell & Co. Limited	15,000
Morgan Keegan & Company, Inc.	6,000
Morgan Stanley & Co. Incorporated	42,000
Moseley, Hallgarten, Estabrook & Weeden Inc.	15,000
Needham & Company, Inc.	6,000
Neuberger & Berman	6,000
W. H. Newbold’s Son & Co., Inc.	6.000
Newhard, Cook & Co. Incorporated	6,000
The Nikko Securities Co. International, Inc.	6,000
Nomura Securities International, Inc.	6,000
The Ohio Company	15,000
Oppenheimer & Co., Inc.	15,000
PaineWebber Incorporated	42,000
Parker/Hunter Incorporated	6,000
Pictet & Cie	6,000
Piper, Jaffray & Hopwood Incorporated	15,000
Prescott, Ball & Turben, Inc.	15,000
Prudential-Bache Securities Inc.	42,000
Rauscher Pierce Refsnes, Inc.	15,000
Raymond, James & Associates, Inc.	6,000
Robertson, Colman & Stephens	42,000
The Robinson-Humphrey Company, Inc.	15,000
Rotan Mosle Inc.	15,000
Rothschild Inc.	15,000
L. F. Rothschild, Unterberg, Towbin, Inc.	42,000
R. Rowland & Co., Incorporated	6,000
Sal. Oppenheim Jr. & Cie.	6,000
Salomon Brothers Inc.	42,000
J. Henry Schroder Wagg & Co. Limited	15,000
Seidler Amdec Securities Inc.	6.000
Shearson Lehman Brothers Inc.	42,000
Sogen Securities Corporation	15,000
Stephens Inc.	15,000
Stifel, Nicolaus & Company, Incorporated	15,000
Sutro & Co. Incorporated	15,000
Swergold, Chefitz & Sinsabaugh, Inc.	6,000
Swiss Bank Corporation International Securities Inc.	15,000
Thomson McKinnon Securities Inc.	15,000
Tucker, Anthony & R. L. Day, Inc.	15,000
UBS Securities Inc.	15,000
Underwood, Neuhaus & Co. Incorporated	15,000
Vereins-und Westbank A.G.	6,000
Wedbush, Noble, Cooke, Inc.	6,000
Wertheim & Co., Inc.	42,000
Wheat, First Securities, Inc.	15,000
Dean Witter Reynolds Inc.	42,000
Yamaichi International (America), Inc.	6,000
Total	2,795,000

Excluding shares subject to the over-allotment option, each of the Underwriters is to purchase from the Company and each of the Selling Stockholders, respectively, that number of shares which bears the same proportion to the total number of shares to be sold by the Company and the Selling Stockholders as the total number of shares to be purchased by such Underwriters bears to the total number of shares to be purchased by all of the Underwriters.

Under the terms and conditions of the Underwriting Agreement, the Underwriters are committed to purchase all the shares offered hereby, if any are purchased.

There has been no previous market for any of the Company's securities. The major factors considered by the Company, the Selling Stockholders, and the Representatives in determining the public offering price of the Common Stock, in addition to prevailing market conditions, were historical performance, estimates of the business potential and earnings prospects of the Company, the present state of the Company's development, an assessment of the Company's management, and the consideration of the above factors in relation to market valuations of comparable companies. Based on the initial public offering price, and assuming that the Underwriters' over-allotment option is not exercised, the aggregate market value of shares outstanding after the offering will be approximately $519,017,373.

The Underwriters propose to offer the shares in part directly to the public at the initial public offering price set forth on the cover page of this Prospectus and in part to certain securities dealers at such price less a concession of $0.75 per share. The Underwriters may allow, and such dealers may reallow, a concession not in excess of $0.10 per share to certain brokers and dealers. After the shares are released for sale to the public, the public offering price and other selling terms may from time to time be varied by the Representatives.

The Company has granted the Underwriters an option exercisable for 30 days after the date of this Prospectus to purchase up to an aggregate of 300,000 additional shares of Common Stock to cover over-allotments, if any. If the Underwriters exercise their over-allotment option, the Underwriters have severally agreed, subject to certain conditions, to purchase approximately the same percentage thereof that the number of shares to be purchased by each of them as shown in the foregoing table bears to the 2,795,000 shares of Common Stock offered hereby. The Underwriters may exercise such option only to cover over-allotments made in connection with the sale of the 2,795,000 shares of the Common Stock offered hereby.

The Representatives have informed the Company that they do not expect sales to discretionary accounts by the Underwriters to exceed five percent of the total number of shares of Common Stock offered by them hereby and that sales to discretionary accounts by the Representatives will be less than one percent of the total number of shares of Common Stock offered by them hereby.

The Company, and the Selling Stockholders, officers, and directors, holding in the aggregate approximately 21,070,000 shares of Common Stock, have agreed not to offer, sell, or otherwise dispose of any shares of Common Stock for a period of 120 days after the date of this Prospectus without the prior written consent of the Representatives, except that the Company may, without such consent, grant options, or issue stock upon exercise of outstanding options, pursuant to the Option Plan, and issue stock pursuant to the Purchase Plan.

The Company and the Selling Stockholders have agreed to indemnify the Underwriters against certain civil liabilities, including liabilities under the Act.

LEGAL MATTERS

The validity of the shares of Common Stock offered hereby will be passed upon for the Company by Shidler McBroom Gates & Lucas, Seattle, Washington, and for the Underwriters by Sullivan & Cromwell, Los Angeles, California. Sullivan & Cromwell may rely upon the opinion of Shidler McBroom Gates & Lucas as to matters of Washington law. Members of Shidler McBroom Gates & Lucas beneficially owned 114,000 shares of Common Stock prior to this offering. See "Management—Certain Transactions" and "Principal and Selling Stockholders."

EXPERTS

The consolidated financial statements included in this Prospectus, and the related supplemental schedules included elsewhere in the Registration Statement as of June 30, 1984 and 1985 and for each of the three years in the period ended June 30, 1985, and the consolidated financial statements as of June 30, 1982 and 1983 and for the year ended June 30, 1982, from which the Selected Consolidated Financial Data included in this Prospectus have been derived, have been examined by Deloitte Haskins & Sells, independent public accountants, as stated in their opinions appearing herein and elsewhere in the Registration Statement. Such consolidated financial statements, supplemental schedules, and Selected Consolidated Financial Data have been so included in reliance upon such opinions given upon the authority of that firm as experts in accounting and auditing.

ADDITIONAL INFORMATION

The Company has filed with the Securities and Exchange Commission, Washington, D.C., a Registration Statement under the Act, as amended, with respect to the Common Stock offered hereby. This Prospectus does not contain all of the information set forth in the Registration Statement and the exhibits and schedules thereto. For further information with respect to the Company and the Common Stock, reference is hereby made to such Registration Statement, exhibits, and schedules, copies of which may be obtained from the Commission's principal office in Washington, D.C., upon payment of the fees prescribed by the Commission.

OPINION OF INDEPENDENT PUBLIC ACCOUNTANTS

Microsoft Corporation:

We have examined the consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1984 and 1985, and the related consolidated statements of income, stockholders' equity, and changes in financial position for each of the three years in the period ended June 30. 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of Microsoft Corporation and subsidiaries at June 30, 1984 and 1985 and the results of their operations and the changes in their financial position for each of the three years in the period ended June 30, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

We have also previously examined, in accordance with generally accepted auditing standards, the consolidated balance sheets as of June 30, 1982 and 1983 and the related consolidated statements of income, stockholders' equity, and changes in financial position for the year ended June 30, 1982 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the four years in the period ended June 30, 1985 appearing on page 9 is fairly stated in all material respects in relation to the consolidated financial statements from which it has been derived.

DELOITTE HASKINS & SELLS

Bellevue, Washington
August 15,1985
(January 29, 1986 as to Notes 4 and 9)

MICROSOFT CORPORATION

CONSOLIDATED BALANCE SHEETS

ASSETS

	June 30, 1984	June 30, 1985	December 31, 1985 (Unaudited)
	(In thousands, except share data)		
Current assets:			
Cash and short-term investments	$ 3,282	$18,948	$38,158
Trade accounts receivable — net of allowance for doubtful accounts of $1,964, $2,288 and $2,860	23,566	25,273	33,893
Inventories (Note 2)	9,770	5,919	5,730
Other (Note 7)	1,329	1,926	2,386
Total current assets	37,947	52,066	80,167
Property and equipment — net (Note 3)	8,076	11,190	12,661
Other assets	1,614	1,808	1,610
	$47,637	$65,064	$94,438

LIABILITIES AND STOCKHOLDERS' EQUITY

	June 30, 1984	June 30, 1985	December 31, 1985 (Unaudited)
Current liabilities:			
Accounts payable	$ 4,954	$ 2,497	$ 4,533
Customer deposits	3,709	2,757	3,892
Royalties and commissions payable	1,460	1,315	3,220
Deferred income taxes	4,108	1,251	6,872
Other	2,258	2,804	4,076
Total current liabilities	16,489	10,624	22,593
Long-term debt (Note 5)	436	—	—
Commitments and contingencies (Notes 4, 6 and 9)			
Stockholders' equity (Note 7):			
Convertible Preferred Stock - $.01 par value; shares authorized and outstanding 500,000; liquidation preference $1,000,000; to be automatically converted to 1,000,000 shares of Common Stock upon completion of a public offering of the Company's Common Stock	5	5	5
Common Stock — $.001 par value; shares authorized 60,000,000; issued and outstanding before 1,000,000 shares from conversion of preferred stock — 21,260,227, 21,533,353 and 21,715,113	21	22	22
Paid-in capital	4,873	5,101	5,277
Retained earnings	25,873	49,974	67,092
Translation adjustment	(60)	(662)	(551)
Total stockholders' equity	30,712	54,440	71,845
	$47,637	$65,064	$94,438

See accompanying notes.

MICROSOFT CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended June 30,			Six Months Ended December 31,	
	1983	1984	1985	1984	1985
				(Unaudited)	
	(In thousands, except per share data)				
Net revenues	$ 50,065	$ 97,479	$140,417	$ 62,837	$ 85,050
Costs and expenses:					
Cost of revenues	15,773	22,900	30,447	15,507	18,270
Research and development	7,021	10,665	17,108	7,414	8,720
Sales and marketing	11,916	26,027	42,512	18,268	24,429
General and administrative	4,698	8,784	9,443	3,831	6,980
Total costs and expenses	39,408	68,376	99,510	45,020	58,399
Income from operations	10,657	29,103	40,907	17,817	26,651
Non-operating income (loss) (Note 1)	407	(1,073)	1,936	402	2,397
Income before income taxes	11,064	28,030	42,843	18,219	29,048
Provision for income taxes (Note 4)	4,577	12,150	18,742	8,223	11,930
Net income	$ 6,487	$ 15,880	$ 24,101	$ 9,996	$ 17,118
Net income per share	$ .29	$ .69	$ 1.04	$ .43	$ .72
Shares used in computing net income per share	22,681	22,947	23,260	23,253	23,936

See accompanying notes.

MICROSOFT CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Preferred Stock		Common Stock				Treasury Stock			
	Shares	**Amount**	**Shares**	**Amount**	**Paid-In Capital**	**Retained Earnings**	**Shares**	**Amount**	**Translation Adjustment**	**Total Stockholders' Equity**
					(In thousands, except share data)					
Balance, June 30, 1982…..	500,000	$ 5	21,830,566	$22	$4,766	$ 3,506				$ 8,299
Sale of stock to employees..	—	—	1,000	—	—	—				
Purchase of treasury stock…	—	—	—	—	—	—	(997,366)	$ (732)		(732)
Amortization of deferred compensation………..….	—	—	—	—	573	—	—	—		573
Net income for year ended June 30, 1983………...…	—	—	—	—	—	6,487	—	—		6,487
Foreign currency translation adjustment…..	—	—	—	—	—	—	—	—	$ 11	11
Balance, June 30, 1983…...	500,000	5	21,831,566	22	5,339	9,993	(997,366)	(73)	11	14,638
Sale of stock to employees..	—	—	426,027	—	26	—	—	—	—	26
Retirement of treasury stock…………………….	—	—	(997,366)	(1)	(732)	—	997,366	732	—	(1)
Amortization of deferred compensation……..……..	—	—	—	—	240	—	—	—	—	240
Net income for year ended June 30, 1984……..…….	—	—	—	—	—	15,880	—	—	—	15,880
Foreign currency translation adjustment………………	—	—	—	—	—	—	—	—	(71)	(71)
Balance, June 30, 1984…….	500,000	5	21,260,227	21	4,873	25,873	—	—	(60)	30,712
Sale of stock principally to employees……………....	—	—	273,126	1	145	—	—	—	—	146
Amortization of deferred compensation………..….	—	—	—	—	83	—	—	—	—	83
Net income for year ended June 30, 1985………..….	—	—	—	—	—	24,101	—	—	—	24,101
Foreign currency translation adjustment…..	—	—	—	—	—	—	—	—	(602)	(602)
Balance, June 30, 1985…….	500,000	5	21,533,353	22	5,101	49,974	—	—	(662)	54,440
Sale of stock principally to employees (Unaudited)..	—	—	181,760	—	176	—	—	—	—	176
Net income for the six months ended December 31, 1985 (Unaudited)………..……	—	—	—	—	—	17,118	—	—	—	17,118
Foreign currency translation adjustment (Unaudited)…………...	—	—	—	—	—	—	—	—	111	111
Balance, December 31, 1985 (Unaudited)…...…..	500,000	$ 5	21,715,113	$22	$5,277	$67,092	—	—	$ (551)	$71,845

See accompanying notes.

MICROSOFT CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year Ended June 30,			Six Months Ended December 31,	
	1983	1984	1985	1984	1985
					(Unaudited)
			(In thousands)		
Working capital provided:					
Operations:					
Net income	$ 6,487	$15,880	$24,101	$ 9,996	$17,118
Depreciation	1,007	2,068	3,462	1,423	2,403
Other	1,190	(684)	83	—	—
Total from operations	8,684	17,264	27,646	11,419	19,521
Common stock issued	—	591	368	43	207
Long-term borrowings	—	848	—	—	—
Total working capital provided	8,684	18,703	28,014	11,462	19,728
Working capital used:					
Additions to property and equipment — net	3,230	5,837	6,576	3,531	3,874
Reduction of long-term debt	—	413	436	—	—
Loans to stockholders — net	(159)	534	213	19	52
Purchase of treasury stock	732	—	—	—	—
Translation adjustment	(11)	72	602	635	(111)
Other	245	341	203	19	(219)
Total working capital used	4,037	7,197	8,030	4,204	3,596
Increase in working capital	$ 4,647	$11,506	$19,984	$ 7,258	$16,132
Changes in elements of working capital:					
Current assets – increase (decrease):					
Cash and short-term investments	$ 15	$ 53	$15,666	$ 7,460	$19,210
Trade accounts receivable	5,789	13,518	1,707	4,537	8,620
Inventories	1,341	5,225	(3,851)	(2,964)	(189)
Other	89	438	597	804	460
Current liabilities — (increase) decrease	(2,587)	(7,728)	5,865	(2,579)	(11,969)
Increase in working capital	$ 4,647	$11,506	$19,984	$ 7,258	$16,132

See accompanying notes.

MICROSOFT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES

Business — The Company's principal business activity is the design, development and distribution of microcomputer software along with the distribution of related books and hardware peripheral devices.

Principles of Consolidation — The consolidated financial statements include the accounts of Microsoft and its wholly-owned subsidiaries. Significant intercompany transactions and balances have been eliminated.

Revenue Recognition — Revenue from sales of software and hardware consumer products to distributors or retail dealers is recognized when the product is shipped.

Software products are sold to original equipment manufacturers under license agreements which generally provide for a commitment fee payable over a minimum commitment period of one to three years. When the product is accepted, the commitment fee is recognized as revenue ratably over the minimum commitment period or on a per-system or per-copy basis if sales exceed the commitment fee level. Subsequent to the minimum commitment period, revenue based upon the number of systems shipped or copies sold is recognized as earned. Commitment fees received prior to product acceptance are recorded as customer deposits.

Short-term Investments — Short-term investments are carried at cost which approximates market.

Inventories — Inventories are valued at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property and Equipment — Property and equipment are stated at cost and depreciated using straight-line and declining-balance methods over their estimated useful lives of from 5 to 7 years.

Warranties and Exchanges — The Company warrants certain products against certain defects and has policies permitting dealers and distributors to exchange products under certain circumstances. The Company's policies do not permit return of products for credit or refund. Estimated liabilities for warranties and exchanges at June 30, 1984 and 1985 and December 31, 1985 were not material.

Software Research and Development Costs — The majority of the Company's products are developed internally. Costs related to research and development and to production of software product masters are expensed as incurred. In August 1985, the Financial Accounting Standards Board issued a statement requiring capitalization of certain costs of producing software product masters beginning in the Company's year ending June 30, 1987. Had these new guidelines been applicable to the accompanying financial statements, income from operations may have been higher than amounts reported by an indeterminable amount.

Cost of revenues include royalties paid to authors of certain software products made under license agreements. Such royalties, which are based on net revenues were $3,222,000, $2,801,000, and $3,736,000 for the years ended June 30, 1983, 1984 and 1985 and $2,037,000 and $2,684,000 for the six months ended December 31, 1984 and 1985.

Non-operating income — Non-operating income includes interest income of $407,000, $427,000 and $952,000 for the years ended June 30, 1983, 1984 and 1985 and $402,000 and $1,151,000 for the six months ended December 31, 1984 and 1985. In addition, in 1984 the Company realized a short-term capital loss of $1,500,000 from the write-off of the entire value of a minority interest in a closely held company. In 1985 the Company realized a short-term capital gain of $984,000 upon the sale of marketable equity securities. During the six months ended December 31, 1985 the Company realized a foreign currency transaction gain of $1,245,000 resulting from the repayment of debt from certain international subsidiaries.

Income Taxes — Certain items of income and expense included in the financial statements are reported in different years in the tax returns in accordance with applicable income tax laws. The resulting difference between the financial statement income tax provision and income taxes currently payable is reported in the financial statements as deferred income taxes. Investment and other tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable (flow-through method).

Foreign Currency Translation — Assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Revenues, costs, and expenses are translated using an average rate. Translation adjustments are shown separately in stockholders' equity.

Net Income Per Share — Net income per share is computed on the basis of the weighted average number of common and common equivalent shares outstanding and is adjusted for the assumed conversion of preferred shares and shares issuable upon exercise of stock options. The computation assumes the proceeds from the exercise of stock options were used to repurchase common shares at the independently appraised value of the Company's common stock in each period. Had the computation been made assuming that Common Stock issued during the twelve months ended December 31, 1985 was outstanding in all periods and assuming that proceeds from the exercise of stock options issued during the twelve months ended December 31, 1985 were used to repurchase common shares at the price of shares offered for sale by this Prospectus, net income per share would not have been significantly less than that presented for each period.

Interim Financial Information — The financial statements at December 31, 1985 and for the six month periods ended December 31, 1984 and 1985 are unaudited but, in management's opinion, reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation.

2. INVENTORIES

Inventories at June 30, 1984 and 1985, and at December 31, 1985 were as follows:

	June 30,		December 31,
	1984	1985	1985
	(In thousands)		
Finished goods	$1,507	$3,414	$3,398
Raw materials	8,263	2,505	2,332
Total	$9,770	$5,919	$5,730

MICROSOFT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. PROPERTY AND EQUIPMENT

Property and equipment at June 30, 1984 and 1985, and at December 31, 1985 were as follows:

	June 30, 1984	June 30, 1985	December 31, 1985
		(In thousands)	
Computer equipment	$7,007	$11,574	$14,241
Office furniture and equipment	2,899	4,306	5,143
Leasehold improvements	1,658	2,260	2,630
	11,564	18,140	22,014
Less accumulated depreciation	3,488	6,950	9,353
Property and equipment — net	$8,076	$11,190	$12,661

4. INCOME TAXES

The provision for income taxes is composed of:

	Year Ended June 30, 1983	1984	1985
		(In thousands)	
Current	$3,325	$11,549	$17,363
Deferred	1,252	601	1,379
Total	$4,577	$12,150	$18,742
The provision for deferred income taxes is composed of:			
Cash basis tax accounting	$ 35	$ 2,270	$ 2,309
Deferred compensation	(264)	(111)	(38)
Inventory adjustment	—	(850)	(714)
DISC	1,323	(12)	(282)
Other-net	158	(696)	104
Total	$1,252	$ 601	$ 1,379

MICROSOFT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company's effective tax rate differs from the federal rate as follows:

	1983		1984		1985	
	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income
			(In thousands)			
Federal income taxes at statutory rate	$5,090	46.0%	$12,893	46.0%	$19,708	46.0%
State income taxes net of federal tax benefit	—	—	500	1.8	1,194	2.8
Unrealized tax benefit of foreign operating losses	251	2.3	534	1.9	516	1.2
Unrealized (realized) tax benefit of capital loss carryforward	—	—	690	2.5	(453)	(1.1)
DISC/IFSC benefit	—	—	(1,754)	(6.3)	(1,247)	(2.9)
Tax credits	(846)	(7.6)	(1,368)	(4.9)	(2,007)	(4.7)
Other-net	82	.7	655	2.3	1,031	2.4
Total	$4,577	41.4%	$12,150	43.3%	$18,742	43.7%

In 1984 the Company reversed Domestic International Sales Corporation (DISC) deferred taxes as a result of federal legislation to permanently exempt certain DISC earnings from taxation.

At June 30, 1985 the Company had capital loss carryforwards of $516,000 which expire in 1989 and unused foreign operating loss carryforwards of $2,906,000, available to offest future foreign taxable income, which expire as follows: 1988, $354,000; 1989, $602,000; 1990, $591,000; 1991, $133,000; 1992, $380,000; indefinitely, $846,000.

In the course of a current examination of the years ended June 30, 1983 and 1984 by the Internal Revenue Service, a field agent has proposed that the Company is subject to the personal holding company ("PHC") tax. The PHC penalty tax applies to a corporation that meets two tests: (1) more than 50% of the outstanding stock is owned by five or fewer individuals, and (2) at least 60% of its adjusted ordinary gross income, as defined in Section 543 of the Internal Revenue Code, is from passive sources such as interest, dividends, rents, and royalties. The law was designed to discourage the accumulation of passive income by closely-held corporations and is generally not applied to active operating corporations. However, in September 1984 the Internal Revenue Service issued a private letter ruling holding that income from license fees and maintenance fees received by a developer of custom software which it licensed, relying on trademark and trade secret protection, to a limited number of large companies and governmental agencies was "personal holding company income" under Section 543 of the Internal Revenue Code. The Company meets the stock ownership requirement and is expected to continue to meet that test after the offering. However, the Company believes that its business significantly differs from the corporation discussed in the private letter ruling and that its retail sales of mass produced packaged software products are sales of tangible personal property and should not be classified as PHC income.

The PHC tax is 50% of after-tax income and through December 31, 1985 could be as much as approximately $30,000,000 plus interest. At its option, a corporation subject to the PHC tax may declare a "deficiency dividend" to its stockholders of record at the time such a dividend is declared in an amount equal to the corporation's undistributed PHC income. For the Company this could be as much as approximately $60,000,000 as of December 31, 1985. The payment of a deficiency dividend avoids a PHC tax to the corporation (but not the related interest) but is taxable to the shareholders. If a PHC tax were to be assessed and the Company elected to pay the tax, the payment of tax would be recorded as a charge to operations and would reduce net income accordingly. If a PHC tax were to be assessed and the Company elected to declare a deficiency dividend, retained earnings would be reduced by the amount of such a dividend.

The 1985 Tax Reform Bill passed by the House of Representatives in December 1985 and currently under consideration in the Senate, contains a safe-harbor provision specifically for software royalty income. Congress has amended the PHC tax provisions at least 20 times, generally to alleviate harsh treatment of an active industry that happened to fall within the mechanical test of the PHC tax. In a few instances, the amendment has been retroactive. Retroactive enactment of the computer software provision is actively supported by some members of Congress. If passed, the proposed change would remove the Company from personal holding company status. Regardless of whether corrective legislation is passed and regardless of whether such legislation is retroactive, the Company believes that its retail sales are greater than 40% of adjusted ordinary gross income for all significant periods through December 31, 1985 and that such sales are not PHC income, and intends to vigorously contest any PHC tax assessment.

Although management and counsel presently believe that there is a small risk that the Company might have to either pay the PHC tax or declare a deficiency dividend, they believe that it is more likely than not that neither payment of a material tax nor a material deficiency dividend will be required. Because the total amount of any PHC tax that might be assessed could vary significantly based upon the specific year for which such an assessment might occur and other facts and circumstances and because management and counsel presently believe that it is more likely than not that neither a material payment of a PHC tax nor a material deficiency dividend will be required, management has not formulated specific intentions as to how the Company will proceed in the event such a tax is assessed.

5. LONG-TERM DEBT

	June 30,	
	1984	**1985**
	(In thousands)	
12% Long-term note payable	$705	$650
Less current portion	269	650
Total	$436	—

The current portion of long-term debt is included in other current liabilities in the financial statements. At December 31, 1985 the Company had no long-term debt.

6. LEASES

In July 1985, the Company entered a lease for a new corporate campus. The Company will occupy the facility upon completion of construction scheduled for the Spring of 1986. The noncancelable operating lease expires in 2001 with renewal options through 2011. The Company also leases various other facilities and equipment under operating leases that expire through 1988. Rental expense was approximately $926,000, $2,373,000 and $3,012,000 for the years ended June 30, 1983, 1984 and 1985 and $1,210,000 and $1,925,000 for the six months ended December 31, 1984 and 1985.

Minimum lease commitments including the new corporate campus, for years subsequent to June 30, 1985, are as follows: 1986, $4,329,000; 1987, $4,244,000; 1988, $3,900,000; 1989, $3,383,000; 1990, $3,485,000; thereafter, $55,874,000.

7. STOCKHOLDERS' EQUITY

Authorized Capital and Common Stock Split — During 1984, the number of shares of authorized $.001 par value common stock was increased from 20,000,000 to 60,000,000 and a 2 for 1 common stock split was effected in the form of a stock dividend. All share and per share information has been restated to give effect to the stock split.

Preferred Stock — Preferred stock is convertible into 1,000,000 shares of common stock (subject to adjustment in certain events) at the option of the holder, or automatically upon sale of the Company's common stock in a public offering in which aggregate cash proceeds are at least $5,000,000. The Company has reserved 1,000,000 shares of common stock for conversion. Preferred stock is redeemable in whole, but not in part, at the option of the Company at any time after receipt of written consent from the holders of two-thirds of the then outstanding preferred stock or at any time after May 1, 1986. The redemption price is $2 per share plus declared but unpaid dividends (none to date) to the date of redemption. In the event of voluntary or involuntary liquidation, holders of preferred stock are entitled to $2 per share plus declared but unpaid dividends.

Preferred shares have the same voting rights as common stock and are entitled to dividends as declared by the Board of Directors. No dividends may be paid on common stock unless the preferred stock, at the same time or prior thereto, receives a dividend of an equal or larger amount per share.

Employee Stock Purchases — In 1982, certain shares of common stock were sold to employees at prices below fair value as independently appraised. The excess was charged to compensation during the period that related services were performed. At June 30,1984 unamortized deferred compensation expense of $83,000 was recorded as an offset to paid-in-capital. Such deferred compensation was fully amortized during the year ended June 30, 1985. Other assets included 7% loans to stockholders of $746,000 and $736,000 at June 30, 1984 and 1985 and $757,000 at December 31, 1985 originally made to employees to enable them to pay personal income taxes arising from this transaction. Stock purchase agreements with these employees provide the Company with the right of first refusal to repurchase employee's shares and, in 1983, 997,366 shares of common stock were purchased from terminated employees.

During the years ended June 30, 1984 and 1985 and the six months ended December 31, 1985, 353,335, 58,335 and 8,000 shares of common stock were issued to employees at independently appraised fair values for 9% notes receivable of $540,000, $175,000 and $44,000. Such notes have been recorded as a reduction of paid-in-capital. Payments under these notes, due from 1991 to 1993, will be credited to paid-in-capital as received.

Employee Stock Purchase Plan — In January 1986, the Company established an employee stock purchase plan for all employees. Employees may contribute up to 10% of their compensation to purchase the Company's common stock at fair market value. The Plan will commence in July 1986 and terminate December 1990. The Company has reserved 300,000 shares of common stock for the plan.

Stock Option Plan — The Company has a stock option plan for officers and key employees which provides for nonqualified and incentive options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. The options generally expire five years from the date of grant and are exercisable over the period stated in each option.

MICROSOFT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Reserved Shares	Outstanding Options Number	Outstanding Options Price Per Share
Balance, June 30, 1982	3,020,000	900,598	$ .475
Granted	—	532,000	$ 1.50
Exercised	(1,000)	(1,000)	$ .475
Expired	—	(54,342)	$ .475
Balance, June 30, 1983	3,019,000	1,377,256	$.475–$1.50
Granted	—	733,615	$1.50–$3.00
Exercised	(72,692)	(72,692)	$.475–$l.50
Expired	—	(109,464)	
Balance, June 30, 1984	2,946,308	1,928,715	$.475–$3.00
Granted	—	652,715	$ 3.00
Exercised	(214,153)	(214,153)	$.475–$3.00
Expired	—	(219,726)	$.475–$3.00
Balance, June 30, 1985	2,732,155	2,147,551	$.475–$3.00
Additional shares reserved	200,000	—	
Granted	—	848,865	$3.00–$5.50
Exercised	(160,398)	(160,398)	$.475–$3.00
Expired	—	(168,157)	$.475–$5.50
Balance, December 31, 1985	2,771,757	2,667,861	$.475–$5.50

Of the options granted during the six months ended December 31, 1985, 150,000 were nonqualified options. All other options granted were incentive options.

At December 31, 1985, options for 547,118 shares were exercisable and 103,896 shares were available for future grants under the Plan.

MICROSOFT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. FOREIGN SALES AND OPERATIONS

	United States	Foreign Subsidiaries	Eliminations	Consolidated
		(In thousands)		
Year ended June 30, 1983:				
Net revenues:				
United States	$ 39,944	$ —	$ —	$ 39,944
International	9,635	637	(151)	$ 10,121
Total	$ 49,579	$ 637	$ (151)	$ 50,065
Income from operations	$ 11,289	$ (552)	$ (80)	$ 10,657
Identifiable assets	$ 24,556	$ 281	$ (509)	$ 24,328
Year ended June 30, 1984:				
Net revenues:				
United States	$ 75,576	$ —	$ (7,572)	$ 68,004
International	22,469	8,555	(1,549)	29,475
Total	$ 98,045	$ 8,555	$ (9,121)	$ 97,479
Income from operations	$ 29,204	$ (1,169)	$ 1,068	$ 29,103
Identifiable assets	$ 49,093	$ 8,152	$ (9,608)	$ 47,637
Year ended June 30, 1985:				
Net revenues:				
United States	$109,612	$ —	$ (13,895)	$ 95,717
International	27,972	19,745	(3,017)	44,700
Total	$137,584	$ 19,745	$ (16,912)	$140,417
Income from operations	$ 42,937	$ (378)	$ (1,652)	$ 40,907
Identifiable assets	$ 71,163	$ 12,119	$ (18,218)	$ 65,064

Cost of revenues includes commissions of $2,090,000, $4,377,000 and $5,179,000 during the years ended June 30, 1983, 1984 and 1985 and $2,544,000 and $2,453,000 for the six months ended December 31, 1984 and 1985 paid to a foreign company whose major stockholder is a former director of the Company. The Company is in the process of terminating its relationship with this foreign company.

9. SUBSEQUENT EVENT

Subsequent to December 31, 1985 Microsoft was served with a summons and complaint in an action commenced by Seattle Computer Products, Inc. ("SCP") in a Washington state court. This action arises out of an agreement entered into in 1981 under which SCP sold to Microsoft SCP's rights in a disk operating system which Microsoft developed into MS-DOS. The complaint, which has not yet been filed with the court, seeks the following relief: (i) a judicial declaration that under the agreement SCP has an assignable, perpetual, royalty-free worldwide license from Microsoft for MS-DOS in its current and future versions; (ii) an injunction against Microsoft prohibiting alleged interference with SCP's attempts to sell its business and requiring Microsoft to honor SCP's interpretation of the agreement; and, in the alternative, (iii) judgment against Microsoft for damages "believed to exceed $20,000,000" or $60,000,000 when trebled or a rescission of the agreement, a return of the rights granted thereunder, and accounting for the payment to SCP of all revenues received from Microsoft's marketing of MS-DOS. The Company believes that SCP's interpretation of the agreement is erroneous and intends to vigorously defend this action. In the opinion of the Company, were SCP to prevail on its requested declaratory or injunctive relief (see items (i) and (ii) above), such a result would not have a material adverse effect on the Company's financial condition or results of operations. Although the outcome of litigation can never be predicted with certainty, the Company further believes that it is unlikely that SCP could obtain the relief sought with respect to damages or rescission of the contract (see item (iii) above).

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Until June 11, 1986 (90 days after the date of this Prospectus) all dealers effecting transactions in the registered securities, whether or not participating in this distribution, may be required to deliver a Prospectus. This is in addition to the obligation of dealers to deliver a Prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

2,795,000 Shares

Microsoft Corporation
Common Stock

MICROSOFT®

Goldman, Sachs & Co.
Alex. Brown & Sons
Incorporated