

MICROSOFT CORP
Form 10-K
August 03, 2007
Table of Contents

United States Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED JUNE 30, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER 0-14278

MICROSOFT CORPORATION

WASHINGTON
(STATE OF INCORPORATION)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

91-1144442
(I.R.S. ID)

(425) 882-8080

Securities registered pursuant to Section 12(b) of the Act:

COMMON STOCK

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Edgar Filing: MICROSOFT CORP - Form 10-K

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of December 31, 2006, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$251,464,010,491 based on the closing sale price as reported on the NASDAQ National Market System. As of August 1, 2007, there were 9,375,492,496 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held on November 13, 2007 are incorporated by reference into Part III.

Table of Contents

Microsoft Corporation

FORM 10-K

For The Fiscal Year Ended June 30, 2007

INDEX

PART I		
Item 1.	<u>Business</u>	3
	<u>Executive Officers of the Registrant</u>	11
Item 1A.	<u>Risk Factors</u>	12
Item 1B.	<u>Unresolved Staff Comments</u>	16
Item 2.	<u>Properties</u>	17
Item 3.	<u>Legal Proceedings</u>	17
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	17
PART II		
Item 5.	<u>Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities</u>	18
Item 6.	<u>Selected Financial Data</u>	19
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
Item 7A.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	39
Item 8.	<u>Financial Statements and Supplementary Data</u>	40
Item 9.	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	72
Item 9A.	<u>Controls and Procedures</u>	72
	<u>Report of Management on Internal Control over Financial Reporting</u>	72
	<u>Report of Independent Registered Public Accounting Firm</u>	73
Item 9B.	<u>Other Information</u>	74
PART III		
Item 10.	<u>Directors, Executive Officers and Corporate Governance</u>	74
Item 11.	<u>Executive Compensation</u>	74
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	74
Item 13.	<u>Certain Relationships and Related Transactions, and Director Independence</u>	74
Item 14.	<u>Principal Accounting Fees and Services</u>	74
PART IV		
Item 15.	<u>Exhibits and Financial Statement Schedules</u>	75
	<u>Signatures</u>	77

PAGE

2

Table of Contents

Part I

Item 1

Note About Forward-Looking Statements

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, plan, may, should, will, would, likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section entitled Risk Factors (refer to Part I, Item 1A). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

PART I

ITEM 1. BUSINESS

GENERAL

Our mission is to enable people and businesses throughout the world to realize their full potential. Since our founding in 1975, we have worked to achieve our mission by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, and solutions that we believe deliver new opportunities, greater convenience, and enhanced value to people's lives. We do business throughout the world and have offices in more than 100 countries.

We generate revenue by developing, manufacturing, licensing, and supporting a wide range of software products for many computing devices. Our software products include operating systems for servers, personal computers, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solution applications; high-performance computing applications, and software development tools. We provide consulting and product support services, and we train and certify computer system integrators and developers. We sell the Xbox 360 video game console and games, the Zune digital music and entertainment device, PC games, and peripherals. Online offerings and information are delivered through our Windows Live, Office Live, and MSN portals and channels. We enable the delivery of online advertising through our proprietary adCenter® platform.

We also research and develop advanced technologies for future software products. We believe that delivering breakthrough innovation and high-value solutions through our integrated software platform is the key to meeting our customers' needs and to our future growth. We believe that we continue to lay the foundation for long-term growth by delivering new products, creating opportunities for partners, improving customer satisfaction, and improving our internal processes. Our focus is to build on this foundation through ongoing innovation in our integrated software platforms; by delivering compelling value propositions to customers; by responding effectively to customer and partner needs; and by continuing to emphasize the importance of product excellence, business efficacy, and accountability.

OPERATING SEGMENTS

Our segments provide management with a comprehensive financial view of our key businesses. The segments provide a framework for the alignment of strategies and objectives across the development, sales, marketing, and services organizations, and for the timely and rational allocation of development, sales, marketing, and services resources within businesses. The segments also help focus strategic planning efforts on key objectives and initiatives across our businesses.

Due to our integrated business structure, operating costs included in one segment may benefit other segments. Therefore, these segments are not designed to measure operating income or loss that is directly related to the products included in each segment.

Edgar Filing: MICROSOFT CORP - Form 10-K

Inter-segment cost commissions are estimated by management and used to compensate or charge each segment for such shared costs and to motivate shared effort. Segments should not be viewed as discrete or easily separable businesses.

PAGE

3

Table of Contents

Part I

Item 1

In July 2006, we announced a change in our operating segments reflecting previously announced reorganizations. We have five operating segments: Client, Server and Tools, the Online Services Business, the Microsoft Business Division, and the Entertainment and Devices Division. Prior fiscal year information has been recast to conform to the way we internally managed and monitored performance at the business group level in fiscal year 2007. See Note 18 Segment Information of the Notes to Financial Statements (Part II, Item 8) for financial information regarding segment reporting.

Client

Client has overall responsibility for the technical architecture, engineering, and product delivery of our Windows product family, and is responsible for our relationships with personal computer manufacturers, including multinational and regional original equipment manufacturers (OEMs). The segment includes sales and marketing expenses for the Windows client operating system and product development efforts for the Windows platform. Client revenue growth is correlated with the growth of purchases of personal computers from OEMs that pre-install versions of Windows operating systems as the OEM channel accounts for over 80% of total Client revenue.

We released Windows Vista, the latest generation of the Windows operating system, in fiscal year 2007. This release concluded a major development phase that we believe resulted in a significantly more manageable and powerful PC operating system compared to prior releases. Windows Vista includes advances in security, digital media, user interfaces, and other areas that enhance the user and developer experience.

Products: Windows Vista, including Home, Home Premium, Ultimate, Business, and Enterprise Starter Edition; Windows XP Professional and Home; Media Center Edition; Tablet PC Edition; and other standard Windows operating systems.

Competition

Client faces strong competition from well-established companies with differing approaches to the PC market. Competing commercial software products, including variants of Unix, are supplied by competitors such as Apple Computer, Hewlett-Packard, IBM, and Sun Microsystems. The Linux operating system, which is also derived from Unix and is available without payment under a General Public License, has gained some acceptance as competitive pressures lead PC OEMs to reduce costs. The Windows operating system also faces competition from alternative platforms and new devices that may reduce consumer demand for traditional personal computers. Competitors such as Mozilla offer software that competes with the Internet Explorer Web browsing capabilities of Windows products. Apple Computer, Real Networks, and others compete with Windows Media Player. Our operating system products compete effectively by delivering innovative software, a familiar, easy-to-use interface, compatibility with a broad range of hardware and software applications, and the largest support network for any operating system.

Server and Tools

Server and Tools develops and markets software server products, services, and solutions. Windows Server products are integrated server infrastructure and middleware software designed to support software applications and tools built on the Windows Server operating system. Windows Server products include the server platform, database, storage, management and operations, service-oriented architecture platform, and security software. The segment also builds standalone and software development lifecycle tools for software architects, developers, testers, and project managers. Server products can be run on premise or in a hosting environment.

We offer a broad range of consulting services and provide product support services and customer industry solutions. The segment also provides training and certification to developers and information technology professionals about our Server and Client platform products. Server and Tools also includes the Enterprise Partner Group, which is responsible for sales, partner management, and partner programs for medium and large organizations, and the Public Sector sales and marketing organization.

Edgar Filing: MICROSOFT CORP - Form 10-K

Approximately 45% of Server revenue comes from multi-year licensing agreements, approximately 30% is purchased through fully packaged product and transactional volume licensing programs, and approximately 10% comes from licenses sold to OEMs. The remainder of our revenue comes from consulting and product support services.

PAGE 4

Table of Contents

Part I

Item 1

Products and Services: Windows Server operating system; Microsoft SQL Server; Microsoft Enterprise Services; product support services; Visual Studio; System Center products; Forefront Security products; Biz Talk Server; MSDN; and TechNet, among others.

Competition

Our server operating system products face intense competition from a wide variety of server operating systems and server applications, offered by companies with a variety of market approaches. Vertically integrated computer manufacturers such as Hewlett-Packard, IBM, and Sun Microsystems offer their own variant of Unix preinstalled on server hardware. Nearly all computer manufacturers offer server hardware for the Linux operating system. Linux's competitive position has also benefited from the large number of compatible applications now produced by many leading commercial software developers and non-commercial software developers. A number of companies supply versions of Linux, including Novell and Red Hat. Server virtualization platform providers based on Linux, such as VMWare, represent another means by which Linux competes with the Windows server operating system.

We have entered into business and technical collaboration agreements with Novell and other Linux providers to build, market, and support a series of solutions to make our products work better with their solutions, and to provide each other's customers with patent coverage for respective products.

We compete in the business of providing enterprise-wide computing solutions with several companies that provide solutions and middleware technology platforms. IBM and Sun Microsystems lead a group of companies focused on the Java 2 Platform Enterprise Edition (J2EE). Commercial software developers that provide competing server applications for PC-based distributed client/server environments include Computer Associates, IBM, and Oracle.

Numerous commercial software vendors offer competing commercial software applications for connectivity (both Internet and intranet), security, hosting, and e-business servers. System Center competes with BMC, Computer Associates, and IBM in the management of information technology (IT) infrastructures, while Forefront Security competes with McAfee, Symantec, and Trend Micro in protecting both client and server applications. Non-commercial software products, including the widely-deployed Apache Web Server, also compete with our solutions. Our products for software developers compete against offerings from Adobe, BEA Systems, Borland, IBM, Oracle, Sun Microsystems, and other companies. We believe that our server products provide customers with advantages in innovation, performance, total costs of ownership, and productivity, by delivering superior applications development tools and development environment, compatibility with a broad base of hardware and software applications, security, and manageability.

Online Services Business

The Online Services Business (OSB) provides personal communications services, such as e-mail and instant messaging, and online information offerings such as Live Search and MSN portals and channels around the world. OSB also provides a variety of online services such as MSN Internet Access, MSN Premium Web Services, and OneCare. OSB manages many of its own properties, including home page, health, auto and shopping. In addition, OSB creates alliances with third parties, such as CareerBuilder.com, Expedia.com, Foxsports.com, Match.com, and MSNBC.com. OSB generates revenue primarily from online advertising, subscriptions and transactions of online paid services, as well as MSN narrowband Internet access subscriptions. In fiscal year 2006, OSB launched adCenter, our proprietary advertising platform, and has since transitioned the advertising business in the U.S. and certain international markets to adCenter. In fiscal year 2007, we launched new online initiatives, including Windows Live Search and Live.com in 54 international markets, Live Local Search in the U.S. and U.K., beta versions of MSN Soapbox (expansion of the MSN Video experience), Virtual Earth 3D, Windows Live Hotmail, and others.

Products: MSN Search; MapPoint; MSN Internet Access; MSN Premium Web Services (consisting of MSN Internet Software Subscription, MSN Hotmail Plus, MSN Bill Pay, and MSN Radio Plus); Windows Live; and MSN Mobile Services.

Competition

Edgar Filing: MICROSOFT CORP - Form 10-K

OSB competes with AOL, Google, Yahoo!, and a wide array of Web sites and portals that provide content and online offerings of all types to end users. We compete with these organizations to provide advertising opportunities for merchants. OSB also competes for narrowband Internet access users with AOL, Earthlink, and other ISPs for dial-up internet access in the United States. Due to the continuing trend of consumers migrating from narrowband to broadband Internet access, we expect our narrowband Internet access subscriber base to continue to decline as we

Table of Contents

Part I

Item 1

de-emphasize this portion of our business. The Internet advertising industry has grown significantly over the past several years, and we anticipate that this trend will continue. Competitors are aggressively developing Internet offerings that seek to provide more effective ways of connecting advertisers with audiences through enhanced functionality in communication services, improvements in information services such as Internet search, and improved advertising infrastructure and support services. We have developed our own algorithmic search engine to provide end users with more relevant search results, a broader selection of content, and expanded search services. To support the growth of our advertising business, we also are investing in our communication services, technology, operations, and sales efforts. We will continue to introduce new products and services, including the Windows Live set of services that are aimed at attracting additional users through improvements in the user online experience. We believe that we can compete effectively across the breadth of our Internet services by providing users with software innovation in the form of information and communication services that help them find, discover, and experience what they want online and by providing merchants with effective advertising results through improved systems and sales support.

Microsoft Business Division

Microsoft Business Division (MBD) offerings consist of the Microsoft Office system and Microsoft Dynamics business solutions. Microsoft Office system products are designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions. Growth of revenue from the Microsoft Office system offerings, which generate over 90% of MBD revenue, depends on our ability to add value to the core Office product set and to continue to expand our product offerings in other information worker areas such as enterprise content management, collaboration, unified communications and business intelligence. Microsoft Dynamics products provide business solutions for financial management, customer relationship management, supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises.

We evaluate our results based upon the nature of the end user in two primary parts business revenue which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue, and consumer revenue which includes revenue from retail packaged product sales, OEM revenue, and sales of pre-installed versions of Office in Japan. Approximately 75% of MBD revenue is generated from sales to businesses. Revenue from this category generally depends upon the number of information workers in a licensed enterprise and is therefore relatively independent of the number of PCs sold in a given year. Approximately 25% of MBD revenue is derived from sales to consumers. Most of this revenue is generated from new licenses acquired through fully packaged products and licenses sold through OEMs for new PCs and are generally affected by the level of PC shipments and product launches.

Products: Microsoft Office; Microsoft Project; Microsoft Visio; Microsoft Office SharePoint Server; Microsoft Exchange Server; Microsoft Exchange Hosted Services; Microsoft Office Live Meeting; Microsoft Office Communication Server; Microsoft Office Communicator; Microsoft Tellme Service; Microsoft Dynamics AX; Microsoft Dynamics CRM; Microsoft Dynamics GP; Microsoft Dynamics NAV; Microsoft Dynamics SL; Microsoft Dynamics Retail Management System; Microsoft Partner Program; and Microsoft Office Accounting.

Competition

Competitors to the Microsoft Office system include many software application vendors such as Apple, Corel, Google, IBM, Novell, Oracle, Red Hat, Sun Microsystems, and local application developers in Europe and Asia. IBM (Smartsuite) and Corel (WordPerfect Suite) have measurable installed bases with their office productivity products. Apple may distribute certain of its application software products with various models of its PCs. The OpenOffice.org project provides a freely downloadable cross-platform application that also has been adapted by various commercial software vendors to sell under their brands, including IBM, Novell, Red Hat, and Sun. Corel's suite and many local software suites around the world are aggressively priced for OEMs to preinstall on low-priced PCs. Google has launched Google Apps, a hosted messaging and productivity suite, and also provides an enterprise search offering that competes with Microsoft Office SharePoint Server for Search, our new enterprise search product. Web-based offerings such as AjaxWrite, gOffice, iNetOffice, SimDesk, ThinkFree, wikiCalc, or other small projects competing with individual applications, can also provide an alternative to Microsoft Office system products. IBM has many different points of competition with Office system products with its Notes and Workplace offerings.

Table of Contents

Part I

Item 1

Our Microsoft Dynamics products compete with well-known vendors such as Intuit and Sage in the market focused on providing solutions for small and mid-sized businesses. The market for large organizations and divisions of global enterprises is intensely competitive with a small number of primary vendors including Oracle and SAP. These vendors are positioning many of their business applications to focus more intensely on small and mid-sized businesses. Additionally Salesforce.com's on-demand customer relationship management offerings compete directly with Microsoft Dynamics CRM Live and Microsoft Dynamic CRM's on-premise offerings. We believe our products compete effectively with these vendors based on our strategy of providing interoperable, adaptable solutions that work well with technologies our customers already have.

As we continue to respond to market demand for additional functionality and products, we will compete with additional vendors, most notably in enterprise content management, collaboration tools, unified communications, and business intelligence. These competitors include SAP; IBM; Cisco, with their acquisition of WebEx; Oracle, with the acquisition of Hyperion; and other business intelligence vendors such as Business Objects and Cognos.

Entertainment and Devices Division

The Entertainment and Devices Division (EDD) is responsible for developing, producing, and marketing the Xbox video game system, including consoles and accessories, third-party games, games published under the Microsoft brand, and Xbox Live operations, as well as research, sales, and support of those products. In addition to Xbox, we offer the Zune digital music and entertainment device; PC software games; online games; Mediaroom, our Internet protocol television (IPTV) software; and other devices. EDD also leads the development efforts of our line of consumer software and hardware products including application software for Macintosh computers and Microsoft PC hardware products, and is responsible for all retail sales and marketing for Microsoft Office and the Windows operating systems. EDD also includes the mobile and embedded devices platform and is responsible for managing our company-wide sales and customer relations with device manufacturers and other communication-sector customers including network service providers and media and entertainment companies.

Products: Xbox 360 console and games; Xbox Live; Zune; Mediaroom; numerous consumer software and hardware products (such as mice and keyboards); Windows Mobile software platform; Windows Embedded device operating system; and Windows Automotive.

Competition

Entertainment and devices businesses are highly competitive, characterized by rapid product life cycles, frequent introductions of new products and titles, and the development of new technologies. The markets for our products are characterized by significant price competition. We anticipate continued pricing pressure from our competitors. From time to time, we have responded to this pressure by reducing prices on certain products. Our competitors vary in size from very small companies with limited resources to very large, diversified corporations with substantial financial and marketing resources. We compete primarily on the basis of product innovation, quality and variety, timing of product releases, and effectiveness of distribution and marketing.

Our Xbox hardware business competes with console platforms from Nintendo and Sony, both of which have a large, established base of customers. The lifecycle for video game consoles averages five to seven years. We released Xbox 360, our second generation console, in November 2005. Nintendo and Sony released new versions of their game consoles in late 2006. We believe the success of video game consoles is determined by the availability of games for the console, providing exclusive game content that gamers seek, the computational power and reliability of the console, and the ability to create new revenue sources such as advertising and downloadable content. We think the Xbox 360 is positioned well against competitive console products based on significant innovation in hardware architecture, new developer tools, expanded revenue sources, and continued strong exclusive content from our own game franchises such as Halo.

In addition to competing against software published for non-Xbox platforms, our games business also competes with numerous companies that we have licensed to develop and publish software for the Xbox consoles. Zune competes with the Apple iPod as well as other digital music and entertainment devices. Our PC hardware products face aggressive competition from computer and

Edgar Filing: MICROSOFT CORP - Form 10-K

other hardware manufacturers, many of which are also current or potential partners. Mediaroom faces competition primarily from a variety of competitors that provide elements of an IPTV delivery platform, but that do not provide end-to-end solutions for the network operator. Windows Mobile software faces substantial competition from Nokia, Openwave Systems, Palm, QUALCOMM, Research In Motion, and Symbian. The embedded operating system business is highly fragmented with many competitive offerings. Key competitors include IBM, Wind River, and versions of embeddable Linux from commercial Linux vendors such as Metrowerks and MontaVista Software.

PAGE

7

Table of Contents

Part I

Item 1

OPERATIONS

To serve the needs of customers around the world and to improve the quality and usability of products in international markets, we localize many of our products to reflect local languages and conventions. Localizing a product may require modifying the user interface, altering dialog boxes, and translating text.

Our operational centers support all operations in their regions, including customer contract and order processing, credit and collections, information processing and vendor management and logistics. The regional center in Ireland supports the European, Middle Eastern, and African region; the center in Singapore supports the Japan, Greater China and Asia-Pacific region; and the centers in Fargo, Puerto Rico, Redmond, and Reno support Latin America and North America.

We contract most of our manufacturing activities to third parties who produce the Xbox 360, Zune, various retail software packaged products, and Microsoft hardware. Our products may include some components that are available from only one or limited sources. Our Xbox 360 console includes certain key components that are supplied by a single source. The central processing unit is purchased from IBM and the graphics chips and embedded dynamic random access memory chips for the graphics processing unit are purchased from Taiwan Semiconductor Manufacturing Company and NEC Corporation, respectively. Although we have chosen to initially source these key Xbox 360 components from a single supplier, we are under no obligation to exclusively source components from these vendors in the future. Beyond the exceptions noted, we generally have the ability to use other custom manufacturers if the current vendor becomes unavailable. We generally have multiple sources for raw materials, supplies, and components, and are often able to acquire component parts and materials on a volume discount basis.

PRODUCT DEVELOPMENT

During fiscal years 2007, 2006, and 2005, research and development expense was \$7.12 billion, \$6.58 billion, and \$6.10 billion, respectively. These amounts represented 14%, 15%, and 15%, respectively, of revenue in each of those years. We plan to continue to make significant investments in a broad range of research and product development efforts.

While most of our software products are developed internally, we also purchase technology, license intellectual property rights, and oversee third-party development and localization of certain products. We believe we are not materially dependent upon licenses and other agreements with third parties relating to the development of our products. Internal development allows us to maintain closer technical control over our products. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. Generally, we also create product documentation internally. We strive to obtain information at the earliest possible time about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing.

Business and Product Development Strategy. Innovation is a key factor affecting Microsoft's growth. Our model for growth is based on broad adoption of innovation, willingness to enter new markets, and embracing and acting on disruptive trends. We continue our long-term commitment to research and development, including advanced work aimed at innovations, in a wide spectrum of technologies, tools, and platforms; communication and collaboration; information access and organization; entertainment; business and e-commerce; and devices. Increasingly, we are taking a global approach to innovation. While our main research and development facilities are located in Redmond, Washington, we also operate research facilities in other parts of the United States and around the world, including China, Canada, Denmark, England, India, Ireland, and Israel. This global approach will help us remain competitive in local markets and attract top talent wherever it resides.

Based on our broad focus on innovation and long-term approach to new markets, we see the following key opportunities for growth:

Consumer technology. To build on our strength in the consumer marketplace with Windows Vista, the 2007 Microsoft Office System, Xbox 360, Microsoft Windows Live, Windows Mobile, and Zune, we are focused on delivering products that we believe are compelling and cutting edge in terms of design as well as features and functionality. To succeed in consumer technologies, we also

Edgar Filing: MICROSOFT CORP - Form 10-K

are working to define the next era of consumer electronics. In the past, consumer electronics was a hardware-centric business; today, the innovation in consumer electronics devices lies in the software that powers them. This is creating new opportunities for us to deliver end-to-end experiences.

PAGE 8

Table of Contents

Part I

Item 1

Software plus services. Underlying our opportunities in consumer technologies, and in all of our businesses, is a company-wide commitment to fully embrace software plus services. The ability to combine the power of desktop and server software with the reach of the Internet represents an opportunity across every one of our businesses. As we continue to build out our services platform, we will bring a broad range of new products and service offerings to market that target the needs of large enterprises, small and medium-sized businesses, and consumers.

Expanding our presence on the desktop and server. While we enjoyed success in fiscal year 2007 with the launches of Windows Vista and the 2007 Microsoft Office System, we see potential for growth by delivering more value per customer. With the planned releases in fiscal year 2008 of Windows Server 2008, SQL Server 2008, and Visual Studio 2008, and the possibility to provide additional value in security, messaging, systems management, and collaboration, we believe we are well-positioned to build on our strength with businesses of all sizes. We will continue to pursue new opportunities in high performance computing, unified communications, healthcare, and business intelligence. Emerging markets are also an important opportunity for us. In fiscal year 2007, we announced the expansion of our Unlimited Potential program as the foundation for our efforts to reach the five billion people around the globe who do not have access to PCs and digital technology today.

DISTRIBUTION, SALES AND MARKETING

We distribute our products primarily through the following channels: OEM; distributors and resellers; and online.

OEM. Our operating systems are licensed primarily to OEMs under agreements that grant the OEMs the right to build computing devices based on our operating systems, principally PCs. Under similar arrangements, we also market and license certain server operating systems, desktop applications, hardware devices, and consumer software products to OEMs. We have OEM agreements covering one or more of our products with virtually all of the major PC OEMs, including Acer, Dell, Fujitsu, Fujitsu Siemens Computers, Gateway, Hewlett-Packard, Lenovo, NEC, Samsung, Sony, and Toshiba. A substantial amount of OEM business is also conducted with system builders, which are low-volume customized PC vendors operating in local markets.

Distributors and Resellers. We license software to organizations under arrangements that allow the end-user customer to acquire multiple licenses of products. Organizations license our products primarily through large account resellers (LARs), direct market resellers, and value-added resellers (VARs). Many organizations that license products through enterprise agreements (EAs) transact directly with us, with sales support from our Enterprise Software Advisor channel partners. These Enterprise Software Advisors typically are also authorized as LARs and operate as resellers for our other licensing programs. Although each type of reselling partner reaches organizations of all sizes, LARs are primarily engaged with large organizations and VARs typically reach the breadth of small- and medium-sized organizations. Some of our distributors include Ingram Micro and Tech Data, and some of our largest resellers include CDW, Dell, Insight Enterprises, Software House International, and Software Spectrum. Our Dynamics software offerings are licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services. We distribute our finished goods products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets. Individual consumers obtain our products primarily through retail outlets, including Best Buy, Target, and Wal-Mart. We have a network of field sales representatives and field support personnel that solicits orders from distributors and resellers and provides product training and sales support.

Our arrangements for organizations to acquire multiple licenses of products are designed to provide them with a means of doing so without having to acquire separate packaged product through retail channels. In delivering organizational licensing arrangements to the market, we use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include:

Open. Designed primarily for small-to-medium organizations (5 to over 250 licenses), this program allows customers to acquire perpetual licenses and, at the customer's election, rights to future versions of software products over a specified time period (generally two years). The offering that conveys rights to future versions of certain software product over the contract period is called Software Assurance. Software Assurance also provides support, tools, and training to help customers deploy and use software efficiently. Under the Open program, customers can acquire licenses only, or licenses with Software Assurance. They can also renew Software Assurance upon the expiration of existing volume licensing agreements.

Table of Contents

Part I

Item 1

Select. Designed primarily for medium-to-large organizations (greater than 250 licenses), this program allows customers to acquire perpetual licenses and, at the customer's election, Software Assurance, which consists of rights to future versions of certain software products, support, tools, and training over a specified time period (generally three years). Similar to the Open program, customers can acquire licenses only, acquire licenses with Software Assurance, or renew Software Assurance upon the expiration of existing volume licensing agreements.

Enterprise Agreement. The Enterprise Agreement is targeted at medium and large organizations that want to acquire perpetual licenses to software products for all or substantial parts of their enterprise, along with rights to future versions of certain software products, support, tools, and training over a specified time period (generally three years).

Online. We distribute online content and services through MSN and other online channels. OSB delivers Internet access and various premium services and tools to consumers. OSB also delivers online e-mail and messaging communication services and information services such as online search, advertising, and premium content. EDD operates the Xbox Live service which allows customers to participate in the gaming experience with other subscribers online. We operate and deliver the Microsoft Small Business Center portal. This portal provides tools and expertise for small-business owners to build, market, and manage their businesses online. Other services delivered online include Microsoft Developer Networks subscription content and updates, periodic product updates, and online technical and practice readiness resources to support our partners in developing and selling our products and solutions.

CUSTOMERS

Our customers include individual consumers, small and medium-sized organizations, enterprises, governmental institutions, educational institutions, Internet Service Providers, application developers, and OEMs. Consumers and small- and medium-sized organizations obtain our products primarily through resellers and OEMs. No sales to an individual customer accounted for more than 10% of fiscal year 2007 revenue. Sales to Dell and its subsidiaries accounted for approximately 11% and 10% of fiscal year 2006 and 2005 revenue, respectively. These sales were made primarily through our OEM and volume licensing channels and cover a broad array of products including Windows PC operating systems, Microsoft Office, and server products. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

Table of ContentsPart I

Item 1

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of August 3, 2007 were as follows:

Name	Age	Position with the Company
William H. Gates III	51	Chairman of the Board
Steven A. Ballmer	51	Chief Executive Officer
Robert J. (Robbie) Bach	45	President, Entertainment and Devices Division
Lisa E. Brummel	47	Senior Vice President, Human Resources
Kevin R. Johnson	46	President, Platforms and Services Division
Christopher P. Liddell	49	Senior Vice President and Chief Financial Officer
Jeffrey S. Raikes	49	President, Microsoft Business Division
Bradford L. Smith	48	Senior Vice President; General Counsel and Secretary
Brian Kevin Turner	42	Chief Operating Officer

Mr. Gates co-founded Microsoft in 1975 and served as its Chief Executive Officer from the time the original partnership was incorporated in 1981 until January 2000, when he resigned as Chief Executive Officer and assumed the position of Chief Software Architect. In June 2006, Mr. Gates stepped down as Chief Software Architect and announced a two-year plan to transition out of a day-to-day role in the Company. Mr. Gates has served as Chairman since our incorporation.

Mr. Ballmer was appointed Chief Executive Officer in January 2000. He served as President from July 1998 to February 2001. Previously, he had served as Executive Vice President, Sales and Support since February 1992. He joined Microsoft in 1980.

Mr. Bach was named President, Entertainment and Devices Division in September 2005. He had been Senior Vice President, Home and Entertainment since March 2000. Before holding that position, he had been Vice President, Home and Retail since March 1999, Vice President, Learning, Entertainment and Productivity since 1997, and Vice President, Desktop Applications Marketing since 1996. Mr. Bach joined Microsoft in 1988.

Ms. Brummel was named Senior Vice President, Human Resources in December 2005. She had been Corporate Vice President, Human Resources since April 2005. From 1995 to April 2005, she had been Corporate Vice President of the Home & Retail Division. Since joining Microsoft in 1989, Ms. Brummel has held a number of management positions at Microsoft, including general manager of the Consumer Productivity business and product unit manager of several product lines.

Mr. Johnson was named President, Platforms and Services Division in January 2007. He had been Co-President of the Platforms and Services Division since September 2005. He held the position of Group Vice President, Worldwide Sales, Marketing and Services since March 2003. Before that position, he had been Senior Vice President, Microsoft Americas since February 2002 and Senior Vice President, U.S. Sales, Marketing, and Services since August 2001, and prior to assuming that role, he had been Vice President, U.S. Sales, Marketing and Services. He joined Microsoft in 1992.

Mr. Liddell was named Senior Vice President and Chief Financial Officer of the Company in May 2005. Mr. Liddell served as Senior Vice President and Chief Financial Officer of International Paper Company from March 2003 through April 2005, and prior to becoming Chief Financial Officer, he held the positions of Vice President-Finance and Controller. Mr. Liddell served as Chief Executive Officer of Carter Holt Harvey Limited, an affiliate of International Paper, from 1999 to 2002 and Chief Financial Officer from 1995 to 1998.

Mr. Raikes was named President, Microsoft Business Division in September 2005. He had been Group Vice President, Information Worker Business since June 2004. Before that position, he had been Group Vice President, Productivity and Business Services since August 2000 and Group Vice President, Sales and Support since July 1998. Mr. Raikes joined Microsoft in 1981.

Edgar Filing: MICROSOFT CORP - Form 10-K

Mr. Smith was named Senior Vice President, General Counsel, and Secretary in November 2001. Mr. Smith was also named Chief Compliance Officer effective July 2002. He had been Deputy General Counsel for Worldwide Sales and previously was responsible for managing the European Law and Corporate Affairs Group, based in Paris. He joined Microsoft in 1993.

Mr. Turner was named Chief Operating Officer in September 2005. Before joining Microsoft, he was Executive Vice President and President and Chief Executive Officer of the Sam's Club division of Wal-Mart Stores, Inc. From September 2001 to August 2002, he served as Executive Vice President and Chief Information Officer of Wal-Mart's Information Systems Division. From March 2000 to September 2001, he served as its Senior Vice President and Chief Information Officer of the Information Systems Division.

PAGE

11

Table of Contents

Part I

Item 1, 1A

EMPLOYEES

As of June 30, 2007, we employed approximately 79,000 people on a full-time basis, 48,000 in the United States and 31,000 internationally. Of the total, 31,000 were in product research and development, 24,000 in sales and marketing, 13,000 in product support and consulting services, 3,000 in manufacturing and distribution, and 8,000 in general and administration. Our success is highly dependent on our ability to attract and retain qualified employees. None of our employees are subject to collective bargaining agreements.

AVAILABLE INFORMATION

Our Internet address is www.microsoft.com. There we make available, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with or furnish it to the Securities and Exchange Commission (SEC). Our SEC reports can be accessed through the investor relations section of our Web site. The information found on our Web site is not part of this or any other report we file with or furnish to the SEC.

ITEM 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and trading price of our common stock.

Challenges to our business model may reduce our revenues and operating margins. Our business model has been based upon customers paying a fee to license software that we developed and distributed. Under this license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. In recent years, certain open source software business models have evolved into a growing challenge to our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not have to bear the full costs of research and development for the software. A prominent example of open source software is the Linux operating system. Although we believe our products provide customers with significant advantages in security, productivity, and total cost of ownership, the popularization of the open source software model continues to pose a significant challenge to our business model, including continuing efforts by proponents of open source software to convince governments worldwide to mandate the use of open source software in their purchase and deployment of software products. To the extent open source software gains increasing market acceptance, sales of our products may decline, we may have to reduce the prices we charge for our products, and revenue and operating margins may consequently decline.

Another development is the software-as-a-service business model, by which companies provide applications, data, and related services over the Internet. Providers use primarily advertising or subscription-based revenue models. Recent advances in computing and communications technologies have made this model viable and enabled the rapid growth of some of our competitors. We are devoting significant resources toward developing our own competing software plus services strategies. It is uncertain whether these strategies will prove successful.

We face intense competition. We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio are a competitive advantage, our competitors that are focused on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products. In response to competition, we are developing

versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive

PAGE 12

Table of Contents

Part I

Item 1A

pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins and operating income.

We may not be able to adequately protect our intellectual property rights. Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights or additional compliance burdens could both adversely affect revenue.

Third parties may claim we infringe their intellectual property rights. From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. To resolve these claims we may enter into royalty and licensing agreements on less favorable terms, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code. Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. This could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code could also increase the security risks described in the next paragraph.

Security vulnerabilities in our products could lead to reduced revenues or to liability claims. Maintaining the security of computers and computer networks is a critical issue for us and our customers. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products. Although this is an industry-wide problem that affects computers across all platforms, it affects our products in particular because hackers tend to focus their efforts on the most popular operating systems and programs and we expect them to continue to do so. We devote significant resources to address security vulnerabilities through:

engineering more secure products;

enhancing security and reliability features in our products;

helping our customers make the best use of our products and services to protect against computer viruses and other attacks;

improving the deployment of software updates to address security vulnerabilities;

Edgar Filing: MICROSOFT CORP - Form 10-K

investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed; and

providing customers online automated security tools, published security guidance, and security software such as firewalls, anti-virus, and other security software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will be held effective under applicable laws and judicial decisions.

PAGE

13

Table of Contents

Part I

Item 1A

We are subject to government litigation and regulatory activity that affects how we design and market our products. As a leading global software maker, we receive close scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers to assert claims of anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in November 2001 and a Final Judgment entered in November 2002. These proceedings imposed various constraints on our Windows operating system businesses. These include limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. Some of these rules will expire in November 2007; others will stay in force until November 2009 or later. Although we believe we are in full compliance with these rules, if we fail to comply with them, additional restrictions could be imposed on us that would adversely affect our business.

In March 2004, the European Commission ordered us to create new versions of Windows that do not include certain multimedia technologies to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. The design of these special versions of Windows and the terms on which we make our protocol technology available are closely regulated by the Commission. The product design aspect of the Commission decision may limit our ability to innovate in Windows in the future, diminish the developer appeal of the Windows platform and increase our product development costs. The availability of protocol licenses may enable competitors to develop software products that better mimic the functionality of Microsoft's own products which could result in a reduction in sales of our products. Pending resolution of Microsoft's appeal, there will remain uncertainty about the legal principles that govern product design and intellectual properties for future releases of Microsoft products in Europe.

In February 2006, the Korean Fair Trade Commission (KFTC) issued a decision requiring us to offer two versions of Windows PC operating systems, one with Windows Media Player and instant messaging software removed and another with those functionalities included but also including promotional links to competing software products. If upheld on appeal, these remedies could adversely affect the utility and competitive position of Windows PC operating systems in Korea.

Government regulatory actions and court decisions may hinder our ability to provide the benefits of our software to consumers and businesses, thereby reducing the attractiveness of our products and the revenues that come from them. New legal actions could be initiated at any time, either by these or other governments or private claimants including with respect to new versions of Windows or other Microsoft products. The outcome of such legal actions could adversely affect us in a variety of ways, including:

We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to meet mandated government specifications, which may entail removing functionality that customers want or developers rely on.

Creating mandated alternative versions of our products may cause confusion that harms our reputation, including among consumers and with software and Web site developers who rely on the functionality removed from these alternative versions.

Government agencies may require that we make available licenses to our proprietary protocol technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.

Edgar Filing: MICROSOFT CORP - Form 10-K

If not reversed or limited on appeal, the rulings described above may be cited as a precedent in other proceedings that seek to limit our ability to continue to improve Windows by adding new functionality in response to consumer demand or to build our own software development efforts.

Our software and services online offerings are subject to government regulation of the Internet domestically and internationally in many areas including user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear and sometimes may conflict. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop doing the alleged noncompliant activity.

Our business depends largely on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our

PAGE 14

Table of Contents

Part I

Item 1A

industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

Delays in product development schedules may adversely affect our revenues. The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could adversely affect our revenue.

We make significant investments in new products and services that may not be profitable. We have made and will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including Windows Vista, the 2007 Microsoft Office system, Xbox 360, Live Search, Windows Server, Zune, and Windows Live. Investments in new technology are inherently speculative. Commercial success depends on many factors including innovativeness, developer support, and effective distribution and marketing. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

Adverse economic conditions may harm our business. Inflation, softness in corporate information technology spending, or other changes in general economic conditions that affect demand for computer hardware or software could adversely affect our revenue or our investment portfolio. If overall market demand for PCs, servers, and other computing devices declines significantly, or consumer or corporate spending for such products declines, our revenue will be adversely affected. In addition, our revenue would be unfavorably impacted if customers reduce their purchases of new software products or upgrades because new offerings such as Windows Vista and the 2007 Microsoft Office system are not perceived as providing significant new functionality or other value to prospective purchasers.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of the claims pending against us may result in significant monetary damages or injunctive relief against us that could adversely affect our ability to conduct our business. Although management currently believes that resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial position, results of operations, or cash flows, the litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. There exists the possibility of a material adverse impact on our financial position, results of operations, and cash flows for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

We may have additional tax liabilities. We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our income tax provision, net income or cash flows in the period or periods for which that determination is made.

Our consumer hardware products may experience quality or supply problems. Our hardware products such as the Xbox 360 console are highly complex and can have defects in design, manufacture or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing or warranty repairs.

Edgar Filing: MICROSOFT CORP - Form 10-K

We obtain some components of our hardware devices from sole suppliers. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain replacement supplies on a timely basis, resulting in reduced sales. Either component shortages or excess inventory may require us to record charges to cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenues and operating margins.

PAGE

15

Table of Contents

Part I

Item 1A, 1B

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment; changes in regulatory requirements for software; social, political, labor or economic conditions in a specific country or region; and difficulties in staffing and managing foreign operations. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our operating results could be adversely affected. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries or operating costs. These conditions may lend additional uncertainty to the timing and budget for technology investment decisions by our customers.

Acquisitions and joint ventures may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don't realize a satisfactory return on the investment we make, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management's attention from our other businesses. These factors could adversely affect our operating results or financial condition.

Improper disclosure of personal data could result in liability and harm our reputation. We store and process significant amounts of personally identifiable information. It is possible that our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information. Such disclosure could harm our reputation and subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products also enable our customers to store and process personal data. Perceptions that our products do not adequately protect the privacy of personal information could inhibit sales of our products.

Other risks that may affect our business. Other factors that may affect our performance may include sales channel disruption, such as the bankruptcy of a major distributor, and our ability to implement operating cost structures that align with revenue growth.

ITEM 1B. UNRESOLVED STAFF COMMENTS

We have received no written comments regarding our periodic or current reports from the staff of the SEC that were issued 180 days or more preceding the end of our fiscal year 2007 that remain unresolved.

Table of Contents

Part I

Item 2, 3, 4

ITEM 2. PROPERTIES

Our corporate offices consist of approximately 11 million square feet of office space located in King County, Washington: 8 million square feet of owned space that is situated on approximately 500 acres of land we own at our corporate campus and approximately 3 million square feet of space we lease. We own approximately 1 million square feet of office space domestically (outside of the Puget Sound corporate campus) and lease many sites domestically totaling approximately 3 million square feet of office space.

We occupy many sites internationally, totaling approximately 8 million square feet that is leased and approximately 1 million square feet that is owned. These facilities include our European Operations Center in Dublin, Ireland, a disk duplication facility in Humacao, Puerto Rico, and a facility in Singapore for our Asia Pacific Operations Center and Regional headquarters. Leased office space includes the following locations: Tokyo, Japan; Unterschleissheim, Germany; Les Ulis, France; Reading, England; and Mississauga, Canada. In addition to the above locations, we have various product development facilities, both domestically and internationally, as described in [Product Development](#) above.

Our facilities are fully used for current operations o