**To our shareholders, customers, partners, and employees:**

Fiscal 2008 was a successful year for Microsoft that saw the company deliver outstanding financial results, introduce significant innovations across the breadth of our product portfolio, and make key investments that position the company for strong future growth.

Thanks to the continued success of our core Windows and Office businesses, and double-digit growth in all of our business groups, revenue jumped to $60.4 billion in fiscal 2008, an increase of 18 percent compared with the previous fiscal year. Operating income grew by 21 percent, reaching $22.5 billion for the year. Earnings per share reached $1.87. We returned $16.5 billion to shareholders through stock buybacks and dividends.

Throughout fiscal 2008 we saw strong adoption of Windows Vista, which has sold more than 180 million licenses, and the 2007 Microsoft Office system, which has sold more than 120 million licenses. Microsoft Office SharePoint Server 2007 passed the 100 million mark for licenses sold and recorded more than $1 billion in revenue.

During the year, we brought a wide range of new innovations to market. We launched Microsoft Windows Server 2008 and Microsoft Visual Studio 2008. We released Windows Vista Service Pack 1 and introduced advances in our search and online advertising technologies. We rolled out Surface—a groundbreaking new device that transforms a tabletop into a computing surface that enables people to interact with digital content using gestures, touch, and physical objects—in a number of retail and hotel locations. We unveiled new products and services for the healthcare industry. We announced important changes to our technology and business practices to increase the openness of our products and drive greater interoperability and choice for developers, partners, customers, and competitors.

We also announced important strategic acquisitions to strengthen our offerings in key markets and add to our broad innovation portfolio. The acquisitions of AdECN, Rapt, and YaData, for example, bring leading-edge capabilities for advertisers and publishers to our advertising platform. With the acquisitions of Multimap, Fast Search & Transfer, and Farecast, we added important new technologies to our consumer and enterprise search services. As part of our mobile computing initiatives, we acquired Musiwave, a leading provider of mobile music entertainment services; Danger, which provides software and services that power consumer handsets; and MobiComp, a pioneer in mobile data backup and restoration. By acquiring Calista Technologies and Kidaro, we continue to position ourselves as a leader in the critical market for virtualization.

In February 2008, we submitted a proposal to acquire Yahoo!. The proposed transaction was designed to accelerate our strategy in online search and advertising. After careful consideration, we determined that the economics of the deal terms demanded by Yahoo! and the need to move forward quickly in partnership on regulatory review and to integrate the two companies meant that the deal was no longer in the best interest of our shareholders. Although we withdrew our offer, we remain committed to being a leader in online search and advertising—we have the right people in place and we continue to make investments that will enable us to succeed.

**Transformation Through Innovation**

At the heart of our success lies our commitment to innovation. No company in our industry invests more in research and development or has the same depth and breadth of talented researchers, scientists, and engineers working across the globe to create new technology breakthroughs.

In 2008, we invested $8.2 billion in research and development, an increase of almost 15 percent compared with fiscal 2007. During the year, we opened a new software development center in Vancouver, British Columbia; established the Microsoft Embedded Systems Development Center in Aachen, Germany; and launched the Internet Services Research Center within Microsoft Research in Redmond, Wash. We also opened Microsoft Research New England in Cambridge, Mass. The company’s sixth major research facility, Microsoft Research New England brings computer scientists and social scientists together to develop new computing and online experiences.

Across our products and technologies, we introduced compelling innovations in fiscal 2008 that deliver valuable new capabilities to our customers. With the release of Windows Server 2008, we introduced Microsoft Hyper-V, a technology that enables multiple operating systems to run on a single computer. Called virtualization, this approach is helping companies reduce costs and energy consumption and it is transforming the way computing capabilities are delivered and managed.

The availability of Hyper-V is just one of the ways we made significant strides toward realizing our vision for dynamic IT systems that have the flexibility and intelligence to automatically adjust to changing business conditions. New Microsoft Systems Center products released in fiscal 2008 are helping IT organizations optimize business processes and improve the delivery of computing services.

We also continue to focus on the companywide effort to embrace software plus services and deliver breakthroughs that combine the power of desktop and server software with the flexibility of Internet-based services. In fiscal 2008, we made significant improvements to our core search technology through advances in our search algorithms, better query refinement, and enhanced understanding of query intent. New vertical search categories improve search results for commerce, entertainment, shopping, local search, and health queries. Live Search for Windows Mobile added new features for mobile users, such as voice input and dynamic rerouting of driving directions based on real-time traffic information. Microsoft Search Server Express 2008 optimizes search for business data.

Our efforts in software plus services extend far beyond search. In fiscal 2008 we announced a new set of Online Services that provide mission critical services-enabled products for organizations with advanced IT capabilities. Our Online Services—including Microsoft Exchange Online, Microsoft SharePoint Online, Microsoft Office Communications Online, and Microsoft Dynamics CRM Online—provide customers with the flexibility to deploy and manage business application internally, or have them hosted by Microsoft partners or by Microsoft.

To help developers and Web designers create the next generation of experiences and applications for the Web and for Windows, we also rolled out Microsoft Expression 2 and released a beta version of Microsoft Silverlight 2 in 2008.

Other innovative products introduced in fiscal 2008 included Microsoft Windows HPC Server 2008, a server operating system designed for the fast-growing high-performance computing market, and WorldWide Telescope, a Web application that enables people to explore the universe through their computers.

**Emerging Opportunities and Markets**

Fiscal 2008 saw strong growth across our businesses as we continue to focus on important new opportunities in a wide range of markets. For example, revenue from our Entertainment and Devices Division grew by 34 percent as investments in consumer technologies yielded strong benefits. For the year, Entertainment and Devices operating revenue reached $8.1 billion, thanks to excellent momentum from the Xbox 360 console, which has sold more than 19 million units, and Xbox Live, which has more than 12 million members. “Halo 3” topped $300 million in sales in just its first week of availability.

We see important opportunities in the digitization of communications and we introduced new unified communications software including Microsoft Office Communications Server 2007, Microsoft Office Communicator 2007, and Microsoft Live Meeting to help companies streamline workplace communications. We launched Microsoft Office PerformancePoint Server 2007, which delivers new technologies that make business intelligence accessible and easy to use for people at every level of an organization.

Healthcare is another important opportunity and in fiscal 2008 we introduced Microsoft HealthVault and the Microsoft Amalga Family of Health Enterprise Systems. HealthVault provides a platform for services and applications that will enable people to better manage their health information. Amalga is a portfolio of enterprise-class solutions that span clinical, operational, and financial functions within healthcare. Together, these products position Microsoft as a leader in the market for digital technology innovations that improve healthcare delivery.

Online services and online advertising represent enormous opportunities for the company as well, and we continue to invest in research and development as we work to reinvent search through innovations in the user experience and in business models, with initiatives such as Microsoft Live Search cashback, which offers ad-funded rebates to consumers. During fiscal 2008, the acquisition of aQuantive and improvements to our advertiser and publisher solutions resulted in a 31 percent increase in online advertising revenue.

One of our great strengths is the global nature of our business and we saw significant growth in a number of key emerging markets. In the BRIC nations (Brazil, Russia, India, and China), revenue was up 54 percent. In addition to Russia, we saw strong growth across Central and Eastern Europe, where revenue increased 64 percent in fiscal 2008. Driven by positive results in Brazil, Latin America recorded an increase of nearly 30 percent. We also saw strong revenue growth in many developed countries, including Norway, Spain, Australia, Canada, and Germany, which all recorded revenue growth of 25 percent or more. All told, we saw 25 percent growth or better in 45 countries in fiscal 2008.

**Supporting Communities and Diversity**

Using the power of technology to help communities thrive and enable people around the world to achieve their potential remains central to our mission. In 2007, we announced the expansion of Unlimited Potential as the focus of our efforts to help close the digital divide for the estimated 5 billion people who are not yet realizing the benefits of information technology. One example of the progress we made in fiscal 2008 was the announcement that our Partners in Learning program has reached more than 100 million teachers and students in 101 countries.

Diversity and inclusion are also core values at Microsoft. Across the company, we seek to promote diversity at every level and in everything we do. We’re working to encourage women and minorities to enter the technology industry through programs such as DigiGirlz, which help high school girls learn about careers in technology. And we’re committed to working with minority- and women-focused organizations such as the National Society of Black Engineers to help bring technology to diverse communities.

**Strong Leadership Focused on Future Growth**

As we head into a new fiscal year, we believe that Microsoft is ideally positioned to drive strong growth in 2009 and beyond. We have excellent momentum and a great pipeline of products and technologies. Even more important, we have great people at every level, including strong leaders who have the experience and strategic insight to turn the opportunities that lie ahead of us into even greater success in the future.

With Chief Software Architect Ray Ozzie and Chief Research and Strategy Officer Craig Mundie guiding the company’s technical strategy and a new generation of leaders stepping up to lead in areas such as online advertising, search, business strategy, and marketing, we look forward to delivering innovative products and services that improve people’s lives and create new opportunities for Microsoft, our customers, and our partners.

For more than 30 years, Microsoft has enjoyed tremendous success by delivering key innovations that have revolutionized the way people communicate, share ideas, manage their businesses, and much more. Today, we’re in the midst of one of the most exciting periods in the history of our industry. Computing continues to become more powerful, more portable, and more affordable. Content, communications, and media are shifting entirely to digital formats. The combination of software plus services is transforming the way we create and deliver computing experiences.

We are inspired by the opportunities we have to use the power of digital technology to continue to change the world for the better. It is your support that enables us to pursue these incredible opportunities. Thank you.

William H. Gates III

Chairman of the Board

Steven A. Ballmer

Chief Executive Officer