TO OUR SHAREHOLDERS, CUSTOMERS, PARTNERS, AND EMPLOYEES

A year ago in my 2009 annual letter to shareholders, I reflected on the impact of the global recession and the difficulties that all businesses faced in responding to one of the most challenging economic environments in the past 80 years.

Now, just 12 months later, I’m gratified to report that fiscal 2010 was a year of remarkable accomplishments. We reported record revenue and earnings per share, showed outstanding momentum across all our businesses, maintained a disciplined approach to controlling costs, and proved our deep commitment to smart investments in technology innovation.

As I look back on fiscal 2010, there are three critical areas that lay the foundation for long-term growth and sustained future success:

1. Our commitment to cloud computing
2. A product portfolio that is stronger than ever
3. Our record-setting financial performance

**Leading the Cloud Transformation**

Throughout the history of the computing industry, we have seen long stretches of steady incremental improvement, punctuated by waves of intense transformation and change. Key breakthroughs — the microprocessor in the 1970s, the graphical user interface in the 1980s, and the Internet in the 1990s — revolutionized the role that information technology plays in how we manage information, run our businesses and share experiences, bringing dramatic positive change to the lives of hundreds of millions of people.

Today, with the emergence of cloud computing, we’re in the midst of the next great wave of transformation and change.

The cloud is revolutionizing computing by linking the computing devices people have at hand to the processing and storage capacity of massive datacenters, transforming computing from a constrained resource into a nearly limitless platform for connecting people to the information they need, no matter where they are or what they are doing. This has profound implications for the way people use technology across their lives to work, learn, communicate, and have fun.

With our unique position in the industry, it’s not enough just to ride this great wave — we intend to grow it and shape it. This is why we’ve made a company-wide commitment to Microsoft’s solutions, bringing the benefits of the cloud to the billion people who use computing today and the billions more who will gain access to digital technology for the first time in the years ahead. In fiscal 2010, Microsoft invested $8.7 billion in research and development, with most of that devoted to cloud technologies. Today, roughly 70 percent of Microsoft’s 40,000 engineers work on cloud-related products and services, and in fiscal 2011 that number will grow to nearly 90 percent.

With the first version of Hotmail®, Microsoft started investing in cloud computing more than 15 years ago. Today, our consumer cloud technologies and services support hundreds of millions of customers around the globe. More than 300 million people use Windows Live® Hotmail and Windows Live Messenger to send nearly 10 billion messages every day. This year, our Xbox LIVE® subscription base surpassed 25 million subscribers, a growth of over 20 percent from last year.

On the business side, not only are we offering online versions of our products, such as Microsoft Dynamics® CRM Online, Microsoft® Office 2010, SharePoint® Online, Exchange Online and Office Communications Online, but we are delivering entirely new cloud computing platform innovations such as Windows Azure™, SQL Azure™ and Windows Intune™. The Windows Azure Platform Appliance is a groundbreaking product that will enable service providers, large enterprises and governments to achieve breakthrough datacenter efficiency through innovative power, cooling and automation technologies.

Currently, over 10,000 corporate customers have adopted Windows Azure and thousands of business and government entities representing millions of people have purchased Microsoft’s online productivity services to improve productivity and reduce costs. Customers include 13 of the top 20 global telecom firms, 15 of the top 20 global banks and 16 of the top 20 global pharmaceutical companies. Together, these technologies, products, and services enable us to do something no other company can do — deliver cloud solutions that span the complete range of business needs our customers have.

At Microsoft, we firmly believe the impact of cloud computing will be as big as — or bigger than — the previous waves of technology change. The opportunities cloud computing will create for our customers, our partners and our company will be immense.

When it comes to the cloud, “we’re all in.”

**Delivering New Advances Across Our Product Portfolio**

Fiscal 2010 was one of the strongest years in company history for the range and quality of the product advances that we delivered.

At the top of the list is Windows® 7. Faster, simpler, and easier to use, it enables people to work the way they want to and more easily than ever before. Windows 7 has already sold 175 million copies, making it the fastest-selling operating system in history. Fiscal 2010 also saw updates of many of our Windows Live cloud services, which are redefining how people socialize, communicate and share experiences.

Late in fiscal 2010, we released Office 2010 with Office Web Apps. This newest version of our world-leading productivity software provides a unified experience that enables people to connect to their work and each other across the PC, phone and browser so they can get things done from almost anywhere. Even before its official launch date, Office 2010 had been downloaded by more than 9 million beta customers.

In our Server & Tools Business, Windows Server®, SQL Server™ and Visual Studio® product advances all help IT professionals save time, reduce costs and build dynamic and efficient data centers.

In our Online Services Division, we delivered several innovation advances in Bing™ throughout the year. Bing gained over 4 points of share during the year and feedback from customers and industry analysts has been positive. We are well along the way on the Yahoo/Bing search integration we announced last July and expect the U.S. integration to be completed this fiscal year.

Along with these releases, in fiscal 2010 we laid the groundwork for several products that will continue to deliver innovation over the next year. This holiday season we’ll roll out Kinect™ for Xbox 360®, a new experience that incorporates video and audio sensors to empower people to use gestures and voice commands to play games and enjoy other kinds of TV entertainment — all without the need for a controller.

We’ll also launch Windows® Phone 7, a completely new interface for phones that focuses on simplicity and a smart design that brings together the Web, apps and services into an integrated experience. This year, we’ll deliver the latest version of our browsing technology, Internet Explorer® 9, which is already winning rave reviews for its speed and performance.

These products join a comprehensive portfolio of products that improve people’s lives and help businesses succeed.

**Record Financial Performance**

Our combination of focus, discipline and commitment in fiscal 2010 enabled us to achieve record financial results.

For the year, revenue reached a record of $62.5 billion, an increase of 7 percent compared with the previous fiscal year. Operating income grew by 18 percent to $24.1 billion. Diluted earnings per share jumped 30 percent to $2.10 and we returned almost $16 billion to shareholders through stock buybacks and dividends.

These outstanding results reflect the strong product momentum across the entire company, and we achieved double-digit growth in every business segment during the fourth quarter of fiscal 2010. In addition, we grew operating income more quickly than overall revenue during each quarter of fiscal 2010, which shows that Microsoft has maintained a tight focus on controlling expenses.

More than 35 years ago, Microsoft helped launch the first great wave of information technology transformation by creating the software that made the PC revolution possible. Today, with your support and our industry-leading cloud solutions, exciting product portfolio and strong financial performance, we’re playing a key role in delivering the tools and technologies that are making information technology more powerful, more useful, more affordable and more accessible.

We’re thrilled and humbled to be a part of this process and we look forward to seeing the transformation that results.

Thank you.

Steven A. Ballmer

Chief Executive Officer September 3, 2010