

CANON INC  
Form 20-F  
March 28, 2008

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 20-F

- o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934 OR
- p ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2007 OR
- o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from \_\_\_\_\_ to \_\_\_\_\_ OR
- o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 Date of event requiring this shell company report \_\_\_\_\_

Commission file number 001-15122

CANON KABUSHIKI KAISHA  
(Exact name of Registrant in Japanese as specified in its charter)  
CANON INC.

(Exact name of Registrant in English as specified in its charter)  
**JAPAN**

(Jurisdiction of incorporation or organization)  
30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501, Japan  
(Address of principal executive offices)

Katsuhito Yanagibashi, +81-3-3758-2111, +81-3-5482-9680, 30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501, Japan

(Name, Telephone, Facsimile number and Address of Company Contact Person)  
Securities registered or to be registered pursuant to Section 12(b) of the Act.

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
(1) Common Stock (the shares )	New York Stock Exchange*
(2) American Depositary Shares ( ADSs ), each of which represents one share	New York Stock Exchange
Securities registered or to be registered pursuant to Section 12(g) of the Act.	
None	
(Title of Class)	

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Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None

(Title of Class)

\* Not for trading, but only for technical purposes in connection with the registration of ADSs.

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2007, 1,261,047,782 shares of common stock, including 73,640,348 ADSs, were outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

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

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. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17  Item 18

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financial Reporting Standards as issued by the International Accounting Standards Board

Other

If "other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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**CERTAIN DEFINED TERMS, CONVENTIONS AND PRESENTATION OF FINANCIAL INFORMATION**

All information contained in this Annual Report is as of December 31, 2007 unless otherwise specified.

References in this discussion to the Company are to Canon Inc. and, unless otherwise indicated, references to the financial condition or operating results of Canon refer to Canon Inc. and its consolidated subsidiaries.

On March 21, 2008, the noon buying rate for yen in New York City as reported by the Federal Reserve Bank of New York was ¥99.40 = U.S.\$1.

The Company's fiscal year end is December 31. In this Annual Report fiscal 2007 refers to the Company's fiscal year ended December 31, 2007, and other fiscal years of the Company are referred to in a corresponding manner.

**FORWARD-LOOKING INFORMATION**

This Annual Report contains forward-looking statements and information relating to Canon that are based on beliefs of its management as well as assumptions made by and information currently available to Canon Inc. When used in this Annual Report, the words anticipate, believe, estimate, expect, intend, may, plan, project and show expressions, as they relate to Canon or its management, are intended to identify forward-looking statements. Such statements, which include, but are not limited to, statements contained in Item 3. Key Information Risk Factors, Item 5. Operating and Financial Review and Prospects and Item 11. Quantitative and Qualitative Disclosures about Market Risk, reflect the current views and assumptions of the Company with respect to future events and are subject to risks and uncertainties. Many factors could cause the actual results, performance or achievements of Canon to be materially different from any future results, performance or achievements that may be expressed or implied by such forward-looking statements, including, among others, changes in general economic and business conditions, changes in currency exchange rates and interest rates, introduction of competing products by other companies, lack of acceptance of new products or services by Canon's targeted customers, inability to meet efficiency and cost reduction objectives, changes in business strategy and various other factors, both referenced and not referenced in this Annual Report. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated, expected, intended, planned or projected. Canon Inc. does not intend or assume any obligation to update these forward-looking statements.



**Table of Contents****PART I****Item 1. Identity of Directors, Senior Management and Advisers**

Not applicable.

**Item 2. Offer Statistics and Expected Timetable**

Not applicable.

**Item 3. Key Information****A. Selected financial data**

The following selected consolidated financial data has been derived from the consolidated financial statements of Canon as of each of the dates and for each of the periods indicated below. This information should be read in conjunction with and qualified in its entirety by reference to the Consolidated Financial Statements of Canon Inc. and subsidiaries, including the notes thereto, included in this Annual Report. These financial statements have been audited by Ernst & Young ShinNihon, Independent Registered Public Accounting Firm as of and for the years ended December 31, 2007, 2006, 2005 and 2004. The financial statements for periods prior to the year ended December 31, 2004 were audited by KPMG AZSA & Co., Independent Registered Public Accounting Firm.

<b>Selected financial data *1:</b>	<b>2007 *4</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(Millions of yen, except average number of shares and per share data)</b>				
Net sales	¥ 4,481,346	¥ 4,156,759	¥ 3,754,191	¥ 3,467,853	¥ 3,198,072
Operating profit	756,673	707,033	583,043	543,793	454,424
Net income	488,332	455,325	384,096	343,344	275,730
Advertising expenses	132,429	116,809	106,250	111,770	100,278
Research and development expenses	368,261	308,307	286,476	275,300	259,140
Depreciation of property, plant and equipment	309,815	235,804	205,727	174,397	168,636
Capital expenditures	428,549	379,657	383,784	318,730	210,038
Long-term debt, excluding current installments	8,680	15,789	27,082	28,651	59,260
Common stock	174,698	174,603	174,438	173,864	168,892
Stockholders' equity	2,922,336	2,986,606	2,604,682	2,209,896	1,865,545
Total assets	4,512,625	4,521,915	4,043,553	3,587,021	3,182,148
Average number of common shares in thousands *2	1,293,296	1,331,542	1,330,761	1,328,048	1,317,974
Per share data *2:					
Net income:					
Basic	¥ 377.59	¥ 341.95	¥ 288.63	¥ 258.53	¥ 209.21
Diluted	377.53	341.84	288.36	257.85	207.17
Cash dividends declared	110.00	83.33	66.67	43.33	33.33
Cash dividends declared (U.S.\$)*3	\$ 1.034	\$ 0.709	\$ 0.580	\$ 0.401	\$ 0.309

**Notes:**

1. The above financial data is prepared in accordance with U.S. generally accepted accounting principles.
2. The Company made a three-for-two stock split on July 1, 2006. The average number of common shares and the per share data for the periods presented have been adjusted to reflect the stock split.
3. Annual cash dividends declared (U.S.\$) are translated from yen based on a weighted average of the noon buying rates for yen in New York City as reported by the Federal Reserve Bank of New York in effect on the date of each semiannual dividend payment or on the latest practicable date.
4. See Note 1-(1) of Notes to Consolidated Financial Statements for information regarding accounting change.



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The following table provides the noon buying rates for Japanese yen in New York City as reported by the Federal Reserve Bank of New York expressed in Japanese yen per U.S.\$1 during the periods indicated and the high and low noon buying rates for Japanese yen per U.S.\$1 during the months indicated. On March 21, 2008, the noon buying rate for yen in New York City as reported by the Federal Reserve Bank of New York was ¥99.40 = U.S.\$1.

<b>Yen exchange rates per U.S. dollar:</b>	<b>Average</b>	<b>Term end</b>	<b>High</b>	<b>Low</b>
2003	115.83	107.13	121.42	106.93
2004	107.63	102.68	114.30	102.56
2005	110.74	117.88	120.93	102.26
2006	115.99	119.02	119.81	110.07
2007 -Year	117.45	111.71	124.09	108.17
- 1(st) half		123.39	124.09	116.01
- July		119.13	123.34	118.41
- August		115.83	119.76	113.81
- September		114.97	116.21	113.43
- October		115.27	117.71	113.94
- November		111.02	114.87	108.17
- December		111.71	114.45	109.68
2008 - January		106.74	109.70	105.42
- February		104.19	108.15	104.19

Note: The average exchange rates for the periods are the average of the exchange rates on the last day of each month during the period.

**B. Capitalization and indebtedness**

Not applicable.

**C. Reasons for the offer and use of proceeds**

Not applicable.

**D. Risk Factors**

Canon is one of the world's leading manufacturers of plain paper copying machines, digital multifunction devices, laser beam printers, bubble jet printers, cameras, steppers and aligners.

Primarily because of the nature of the business areas and geographical areas in which Canon operates and the highly competitive nature of the industries to which it belongs, Canon is exposed to a variety of risks and uncertainties in carrying out its businesses, including, but not limited to, the following:

Risks Related to Canon's Industries

*Canon has invested and will continue to invest heavily in next-generation technologies. If the market for these technologies does not develop as Canon expects or if its competitors produce these or competing technologies in a more timely or effective manner, Canon's operating results could be materially adversely affected.*

Canon has made and will continue to make investments in next-generation technology research and development initiatives. Canon's competitors may achieve research and development breakthroughs in these technologies more quickly than Canon, or may achieve advances in competing technologies that render products under development by Canon uncompetitive. In step with the continuous evolution in technologies, Canon has increased the size of its investment in development and manufacturing. If Canon's business strategies diverge from market needs, Canon may not recover some or all of its investment, lose business opportunities, or both, which may materially adversely affect Canon's operating results. In addition, Canon has sought to develop production technology and production equipment to increase the automation of its manufacturing process and in-house production of key devices. If Canon cannot effectively implement these techniques, Canon may fail to realize its cost advantages or differentiation, and lose business opportunities, which may adversely affect Canon's operating results. While differentiation in technology and product development is an important part of Canon's strategy, Canon must also accurately assess the demand for and perceived market acceptance of new technologies and products that it develops. If Canon pursues technologies or develops products that do not become commercially accepted, its operating results could be adversely affected.

It is assumed that Canon, as a matter of corporate strategy, seeks to enter into new business fields by developing next-generation technologies. If Canon enters new business fields, Canon may not be able to establish a successful business model, or may face severe competition with new competitors. If such risks arise, Canon's operating results may be adversely affected.

***If Canon does not effectively manage transitions in its products and services, its operating results may decline.***

Many of the businesses in which Canon competes are characterized by rapid technological advances in hardware performance, software functionality and product features, the frequent introduction of new products, short product life cycles, and continual improvement in product price characteristics relative to product performance. If Canon does not make an effective transition from existing products and services to new offerings, its revenue and profits may decline. Among the risks associated with the introduction of new products and services are delays in development or manufacturing, low product marketability due to poor product quality, variations in manufacturing costs, delays in customer purchases in anticipation of new introductions, difficulty in predicting customer demand for new product offerings and difficulty in effective management of inventory levels in line with anticipated demand. Canon's revenue and gross margin also may suffer due to the timing of product or service introductions by its competitors. This risk is exacerbated when a product has a short life cycle or a competitor introduces a new product just before Canon's introduction of a similar product. Furthermore, sales of Canon's new products and services may replace sales of, or result in discounting of, some of its current product offerings, sometimes offsetting the benefits derived from the introduction of a successful new product or service. Canon must also ensure that its new products are not duplicative and do not overlap with existing products and operations. Given the competitive nature of Canon's businesses, if any of these risks materialize, future demand for its products and services will be reduced and its results of operations may decline.

***Canon's digital camera business operates in a highly competitive environment.***

The recent accelerated trend towards digitalization has resulted in the entry of new competitors into the digital camera market, such as electronics manufacturers and other specialized companies which were not active during the analog camera era. If this industry develops more rapidly than initially anticipated by Canon, it may not be able to maintain its position as an industry leader in many of its business categories. Canon's success in this increasingly competitive environment will depend on its investments in research and development, ability to cut costs and commitment to continuously providing the market with attractive products offering high added-value. If Canon is unable to remain innovative while reducing costs, it may lose market share and its results of operations may be adversely affected.

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***Because the semiconductor industry is highly cyclical, Canon may be adversely affected by any downturn in the industry.***

The semiconductor industry is characterized by up and down business cycles, the timing, length and volatility of which are difficult to predict. Recurring periods of oversupply of integrated circuits have at times led to significantly reduced demand for capital equipment, including the steppers and aligners Canon produces. Despite this cyclicity, Canon must maintain significant levels of research and development expenditure in order to maintain its competitiveness. Canon's business and operating results could be materially adversely affected by future downturns in the semiconductor industry and related fluctuations in the demand for capital equipment in general, and particularly by memory manufacturers.

In addition, liquid crystal display ( LCD ) panel manufacturers are facing severe price reductions of LCD panels as a result of intense competition among makers of LCD televisions and LCD monitors used in personal computers. As a result, panel manufacturers may reduce equipment investment, which may adversely affect Canon's business operations.

***Downturns in the semiconductor industry have caused Canon's customers to change their operating strategies, which in turn may affect Canon's business.***

Many device manufacturers have changed their business models to focus on the design of semiconductors, while consigning the production of semiconductors to lower-cost foundries. Canon cannot accurately predict the future effect of these trends on its business. However, as research and development, manufacturing and sales activities become increasingly globalized in response to these trends, shifting particularly to emerging markets, unexpected global developments, such as adverse regulatory or legal changes, and unanticipated events, such as natural disasters, may adversely affect Canon's business operations.

In addition, there are only approximately ten companies in the world which produce large-sized LCD panels. If Canon is insufficiently responsive to market trends in the LCD panel industry base, including market reorganization, Canon may not be able to maintain its customer base which may materially adversely affect Canon's business operations.

***The semiconductor equipment industry is characterized by rapid technological change. If Canon does not constantly develop new products to keep pace with technological change and meet its customer requirements, Canon may lose customers and its business may suffer.***

Canon's steppers and mask aligners are affected by rapid technological change and can quickly become obsolete. Canon believes its future success in the stepper and aligner business depends on its ability to continue to enhance its existing products and develop new products using new and more advanced technologies. In particular, as semiconductor pattern sizes continue to decrease, the demand for more technologically advanced steppers is likely to increase. Canon's existing stepper and mask aligner products could become obsolete sooner than anticipated because of faster than anticipated changes in one or more of the technologies related to Canon's products or in the market demand for products based on a particular technology. Any failure by Canon to develop the advanced technologies required by its customers at progressively lower costs and to supply sufficient quantities to a worldwide customer base could adversely affect Canon's net sales and profitability.

***Growing popularity of High Definition (HD) and increased diversification of recording media may adversely affect Canon's video camcorder business.***

The video camcorder market is now almost entirely based on digital formats and the increase in High Definition television broadcasts has led to a gradual shift from the SD format to the HD format. At the same time, many products using new media formats such as MiniDV tapes, DVD (Digital Versatile Drive), HDD (Hard Disk Drive) and SD (Secure Digital) cards, have appeared at a rate that outpaces the proliferation of HD. Failure by Canon to accurately forecast demand in these increasingly diversified markets could have an adverse affect on Canon's operating results.

If the market demand shifts to new products using a new recording media format that Canon has not anticipated, Canon may be required to increase the size of its investments in research and development. The resulting increased research and development costs could adversely affect Canon's business and operating results.

**Risks Related to Canon's Business**

***Canon derives a significant percentage of its revenues from Hewlett-Packard.***

Canon depends on Hewlett-Packard for a significant part of its business. For fiscal 2007, approximately 22% of Canon's net sales were to Hewlett-Packard. As a result, Canon's business and results of operations may be affected by the policies, business and results of operations of Hewlett-Packard. Any decision by Hewlett-Packard management to limit or reduce the scope of its relationship with Canon would adversely affect Canon's business and results of operations.

***Canon depends on a limited number of suppliers for certain key components.***

Canon relies on a limited number of outside vendors which meet Canon's strict criteria for quality, efficiency and environmental friendliness for certain critical components used in its products. In some cases, Canon may be forced to discontinue its production of some or all of its products if certain vendors that supply key components across Canon's product lines experience unforeseen difficulties, or if such parts suffer from quality problems or are in short supply. Canon's reliance on a limited number of suppliers involves several risks, including a potential inability to obtain an adequate supply of required components, the risk of untimely delivery of these subassemblies and components and the risk for a substantial increase in price of these components to occur. If such problems arise, Canon's operating results will be adversely affected.

***Although competition is increasing in the market for sales of supplies and services following initial product placement, Canon maintains a high market share in sales of such supplies. As a result, Canon may be subject to antitrust-related suits, investigations or proceedings which may adversely affect its operating results or reputation.***

A portion of Canon's net sales consists of sales of supplies and the provision of services occurring after the initial equipment placement. As these supplies and services have become more commoditized, the number of competitors in these markets has increased. Canon's success in maintaining these post-placement sales will depend on its ability to compete successfully with these competitors, some of which may offer lower-priced products or services. Despite the increase in competitors, Canon currently maintains high market shares in the market for supplies. Accordingly, Canon may be subject to suits, investigations or proceedings under relevant antitrust laws and regulations. Any such suits, investigations or proceedings may lead to substantial costs and have an adverse effect on Canon's operating results or reputation.

***Increases in counterfeit Canon products may adversely affect Canon's brand image and its operating results.***

In recent years, Canon has experienced a worldwide increase in the emergence of counterfeit Canon products. Such counterfeit products may diminish Canon's brand image, particularly if purchasers of such products are unaware of their counterfeit status and attribute the counterfeit products' poor product quality to Canon. Canon has been taking measures to halt the spread of counterfeit products. However, there can be no assurance that such measures will be successful, and the continued production and sale of such products could adversely affect Canon's brand image as well as its operating results.

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***Per unit production costs are highest when a new product is introduced, and if such new products are not successful or if Canon fails to achieve cost reductions over time, Canon's gross profits may be adversely affected.***

The unit cost of Canon's products has historically been highest when they are newly introduced into production. New products have at times had a negative impact on its gross profit, operating results and cash flow. Cost reductions and enhancements typically come over time through:

- engineering improvements;
- economies of scale;
- improvements in manufacturing processes;
- improved serviceability of products; and
- reduced inventories of parts and products.

Initial shipments of new products adversely affect Canon's profit and cash flow, and if new products do not achieve sufficient sales volumes, Canon's gross profit, operating results and cash flow may be adversely affected.

***Cyclical patterns in sales of Canon's products make planning and inventory management difficult and future financial results less predictable.***

Canon generally experiences variable seasonal trends in the sale of its consumer-oriented products, which results in sales fluctuations. Canon has little control over the various factors that produce these seasonal trends. Accordingly, it is difficult to predict near-term demand which as a result places pressure on Canon's inventory management and logistics systems. If product supply from Canon is substantially greater than actual demand, there will be excess inventory, thereby putting downward pressure on selling prices and reducing Canon's revenue. Alternatively, if demand substantially exceeds the supply of products from Canon, its ability to fulfill orders may be limited, which could adversely affect net sales and increase the risk of unanticipated variations in its results of operation.

***Canon's business is subject to changes in the sales environment.***

Particularly in Europe and the United States, a substantial portion of market share is concentrated in a relatively small number of large distributors. Canon's sales of products to these distributors constitute a significant percentage of Canon's overall sales. As a result, any disruptions in its relationships with these large distributors in specific sales territories could adversely affect Canon's ability to meet its sales targets. Any increase in concentration of Canon's sales to in these large distributors could result in a reduction of Canon's pricing power and adversely affect its profits. In addition, the rapid proliferation of Internet-based businesses may render conventional distribution channels obsolete. These and other changes in Canon's sales environment could adversely affect Canon's results of operations.

***Canon is subject to financial and reputational risks due to product quality and liability issues.***

Although Canon works to minimize risks that may arise from product quality and liability issues, there can be no assurance that Canon will be able to eliminate or mitigate occurrences of these issues and consequent damages. If such factors adversely affect Canon's operating activities, generate expenses such as those for product recalls, service and compensation, or hurt its brand image, its operating results or reputation for quality products may be adversely affected.

***Canon's success depends on the value of its brand name, and if the value of the brand name is diminished, operating results and prospects will be adversely affected.***

Canon's success in its markets depends in part on its brand name and its value. Any negative publicity regarding the quality of Canon's products could have an adverse impact on operations, especially those involving consumer products. There can be no assurance that such adverse publicity will not occur or that such claims will not be made in the future. Furthermore, Canon cannot predict the impact of such adverse publicity on its business and results of operations.

***A substantial portion of Canon's business activity is conducted outside Japan, exposing Canon to the risks of international operations.***

A substantial portion of Canon's business activity is conducted outside Japan, which includes developing and emerging markets in Asia. There are a number of risks inherent in doing business in those markets, including the following:

- less developed technological infrastructure, which can affect production or other activities or result in lower customer acceptance of Canon's services;

difficulties in recruiting and retaining personnel;  
potentially adverse tax consequences;  
longer payment cycles;  
political turmoil or unfavorable economic factors; and  
unexpected legal or regulatory changes.

Canon's inability to successfully manage the risks inherent in its international activities could adversely affect its business and operating results. In order to produce Canon's products competitively and to reduce costs, Canon has several production facilities and more than ten sales bases in China and is vigorously conducting significant production and sales activities in China. Under such circumstances, unexpected events may occur, including political or legal change, labor shortage or strikes, increased personnel costs or changes in economic conditions. In particular, a large revaluation of the Chinese yuan, or a sudden significant change in the tax system or other regulatory regimes could adversely affect Canon's overall performance.

The spread of an epidemic disease, such as the avian flu transmitting to humans, in China or elsewhere in Asia could also have a negative effect on Canon's business. Canon has previously imposed on its personnel travel restrictions to and from certain countries affected by Severe Acute Respiratory Syndrome (SARS) and similar medical crises in the future may disrupt manufacturing processes and markets for Canon's products. Given the importance of Canon's sales to non-Japan Asia, production facilities and supply relationships, especially in China, Canon's business may be more exposed to this risk than to the global economy generally.

In addition, unexpected changes in the imposition of import taxes by foreign governments could adversely affect Canon's business and results of operations.

Canon may unintentionally infringe international trade laws and regulations, and any such infringement may lead to an adverse effect on its business. The extent of the effect on Canon's business will depend upon the nature of the infringement and the severity of fines or other sanctions imposed upon Canon. A major infringement could result in suspension of Canon's trading rights in one or more jurisdictions. In addition to any sanctions prescribed by law, adverse publicity regarding an alleged infringement of trade laws and regulations by Canon may also have a negative effect on the Canon brand and image.

All of the above factors regarding international operations could have an adverse impact on Canon's business results.



**Table of Contents*****Canon depends on efficient logistics services to distribute its products worldwide.***

Canon depends on efficient logistics services to distribute its products worldwide. Problems with Canon's computerized logistics system, or regional disputes or labor disputes, such as a dockworker's strike, could lead to a disruption of Canon's operations and result not only in increased logistical costs, but also in loss of sales opportunities due to delays in delivery. Also, because demand for Canon's consumer products can fluctuate throughout the year, the failure to adjust bookings of vessels and the preparation of warehouse space to reflect such fluctuations could result in either a loss of sales opportunities or the incurrence of unnecessary costs.

In addition, the increasingly higher levels of precision required of semiconductor production equipment like steppers and mask aligners and the resulting increase in the value and the size of this equipment in recent years have resulted in a concurrent increase in the need for sensitive handling and transportation of these products. Due to their precise nature, even a minor shock to these products during the handling and transportation process could irreparably damage the entire product. If unforeseen accidents during the handling and transportation process render a significant portion of Canon's higher-end precision products unmarketable, costs will increase and Canon may lose sales opportunities and the trust of its customers.

Substantially higher crude oil prices have led to increases in the cost of airfreight in the form of fuel surcharges. Continued or further increases in crude oil prices could adversely affect Canon's results of operations.

Canon is endeavoring to reduce carbon dioxide emissions by increasing its use of railroad transportation and ocean transportation to ship its products. Failure by Canon to meet its targets may adversely affect Canon's brand and image and its business.

***Economic trends in Canon's major markets may adversely affect its results of operations.***

Economic downturns and declines in consumption in Canon's major markets, including Japan, the United States, Europe and non-Japan Asia, may affect the levels of both corporate and consumer sales. Demand for Canon's consumer products, such as cameras and printers, is discretionary. A decline in the level of consumption caused by the weakening of general economic conditions could adversely affect Canon's results of operations.

Canon's operating results are also affected by levels of business activity of its customers, which in turn are affected by levels of economic activity in the industries and markets that they serve. Declines in levels of business activity of Canon's customers caused by the weakening of the global economy could adversely affect Canon's results of operations.

**Risks Related to Environmental Issues*****Canon's business is subject to environmental laws and regulations.***

Canon is subject to certain Japanese and foreign environmental requirements in areas such as energy resource conservation, reduction of hazardous substances, collection and recycling of products, clean air, water protection and waste disposal. A violation of these regulations by Canon could have an adverse effect on Canon's operating results. Canon cannot predict whether any pending or future legislation will be adopted or what effect such legislation would have on it.

In some cases, mainly in the European Union, such as with the Directive on the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment or the Directive establishing a framework for the setting of EcoDesign requirements for Energy-using Products, detailed implementation standards responsive to environmental requirements have not yet been determined. Canon intends to implement such standards as they are determined and adopted. If Canon's measures do not meet such standards when they are adopted, Canon may be required to take further action and incur additional costs to comply with these regulations.

***Environmental clean-up and remediation costs relating to Canon's properties and associated litigation could decrease Canon's net cash flow, adversely affect its results of operations and impair its financial condition.***

Canon is subject to potential liability for the investigation and clean-up of environmental contamination at each of the properties that it owns or operates, at certain properties Canon formerly owned or operated and at off-site locations where Canon arranged for the disposal of hazardous substances. If Canon is held responsible for such costs in any future litigation or proceedings, such costs may not be covered by insurance and may be material.

In addition, Canon may face liability for alleged personal injury or property damage due to exposure to chemicals or other hazardous substances from its facilities. Canon may also face liability for personal injury, property damage or

natural resource damage, or for clean-up costs for the alleged migration of contamination or other hazardous substances from its facilities. A significant increase in the number or success of these claims and costs could adversely affect Canon's business and results of operations.

Risks Related to Intellectual Property

*Canon may be subject to intellectual property litigation and infringement claims, which could cause it to incur significant expenses or prevent it from selling its products.*

Because of the emphasis on product innovation in the markets for Canon's products, many of which are subject to frequent technological innovations, patents and other intellectual property are an important competitive factor. Canon relies primarily on technology it has developed, and Canon seeks to protect such technology through a combination of patents, trademarks and other intellectual property rights.

Canon faces the risks that:

- competitors will be able to develop similar technology independently;
- Canon's pending patent applications may not be issued;
- the steps Canon takes to prevent misappropriation or infringement of its intellectual property may not be successful; and
- intellectual property laws may not adequately protect Canon's intellectual property, particularly in some emerging markets.

In case Canon is not aware of actual or potential infringements of, or adverse claims to, its rights in such technologies, any interference in Canon's rights to use such technologies could adversely affect its operating results.

In addition, Canon may need to litigate in order to enforce its patents, copyrights or other intellectual property rights, to protect its trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement, which can be expensive and time-consuming. In the event any government agency or third party were adjudicated to have a valid claim against Canon, Canon could be required to:

- refrain from selling the affected product in certain markets;
- pay monetary damages;
- seek to develop non-infringing technologies, which may not be feasible; or
- seek to acquire licenses to the infringed technology and to make royalty payments, which may not be available on commercially reasonable terms, if at all.

Canon also licenses its patents to third parties in exchange for payment or cross-licensing. The terms and conditions of such licensing or changes in the conditions for renewals of such licenses could affect Canon's business.

Canon's businesses, company image and result of operations could be adversely affected by any of these developments.

**Table of Contents*****Disputes involving payment of remuneration for employee inventions may adversely affect Canon's brand image as well as its business.***

Canon may face disputes involving payment of remuneration given to employee inventions for which the rights have been succeeded by Canon. This risk is particularly relevant in countries such as Japan and Germany, where patent laws require companies to pay remuneration to employees for the succession of the employee's invention to the company. Canon maintains company rules on and an evaluation system for employee inventions. Canon believes it has been making adequate payments to employees for assignment of inventions based on these rules. But, there can be no assurance that disputes will not arise with respect to the amount of payments to employees. Such disputes may adversely affect Canon's brand image as well as its business.

**Other Risks*****Canon must attract and retain highly qualified professionals.***

Canon's future operating results depend in significant part upon the continued contributions of its employees. In addition, Canon's future operating results depend in part on its ability to attract, train and retain other qualified personnel in development, production, sales and management for Canon's operations. The competition for these human resources in the high-tech industries in which Canon competes has been increasingly intense in recent years. Moreover, due to the accelerating pace of technological change, the importance of training new personnel in a timely manner to meet product research and development requirements will increase. Failure by Canon to recruit and train qualified personnel or the loss of key employees could delay development or slow down production, and adversely affect Canon's business and results of operations.

Maintaining a high level of expertise in Canon's manufacturing technology is critical to Canon's business. However, it is difficult to secure the expertise required for a special skills area, such as lens processing, in a short time period. While Canon is currently undertaking a series of planning exercises in order to obtain the expertise needed for each skills area, Canon cannot guarantee that such expertise will be acquired in a timely manner and retained, and failure to do so may adversely affect Canon's business and results of operations.

***Canon's physical facilities, information systems and information security systems are subject to damage as a result of disasters, outages or similar events.***

Canon's headquarters functions, its information systems and its research and development centers are located in or near Tokyo, Japan, where the possibility of disaster or damage from earthquakes is generally higher than in other parts of the world. In addition, Canon's facilities or offices, including those for research and development, material procurement, manufacturing, logistics, sales, and services are located throughout the world and subject to the possibility of disaster or outage or similar disruption as a result of any of a number of events, including natural disasters, computer viruses and terrorist attacks. Although Canon is working to establish appropriate backup structures for its facilities and information systems, there can be no assurance that Canon will be able to completely prevent or mitigate the effect of events or developments such as the aforementioned disasters, leakage of harmful substances, shutdowns of information systems, and leakage, falsification, and disappearances of internal databases. Although Canon has implemented backup plans to permit the production of products at multiple production facilities, such plans do not cover all product models. In addition, such backup arrangements may not be adequate to maintain production quantity levels. Such factors may adversely affect Canon's operating activities, generate expenses relating to physical or personal damage, or hurt Canon's brand image, and its operating results may be adversely affected.

***Canon's operating and financing activities expose Canon to foreign currency exchange and interest rate risks that may adversely affect its revenues and profitability.***

Canon is exposed to the risks of foreign currency exchange rate fluctuations. Canon's consolidated financial statements, which are presented in Japanese yen, are affected by foreign exchange rate fluctuations. These fluctuations, in particular, the recent appreciation of the Japanese yen against the U.S. dollar and other currencies, can affect the yen value of Canon's equity investments denominated in foreign currencies and monetary assets and liabilities arising from business transactions in foreign currencies. They can also affect the costs and sales proceeds of products that are denominated in foreign currencies. In addition, as a result of translating foreign currency financial statements of Canon's foreign subsidiaries into Japanese yen, its reporting currency, assets and liabilities, and revenues and expenses will fluctuate. Canon is also exposed to the risk of interest rate fluctuations, which may affect the value

of Canon's financial assets and liabilities, long-term debt in particular.

***The cooperation and alliances with, and strategic investments in, third parties undertaken by Canon may not produce successful results. Also, unexpected emergence of strong competitors through mergers and acquisitions, may affect Canon's business environment.***

Canon carries out many activities with other companies in the form of alliances, joint ventures, and strategic investments. These activities help Canon's technological development process. However, weak business trends or disappointing performance by partners may adversely affect the success of these activities. In addition, the success of these activities may be adversely affected by the inability of Canon and its partners to successfully define and reach common objectives. An unexpected cancellation of a major business alliance may disrupt Canon's overall business plans and may also result in a delayed return-on-investment.

In addition, the unexpected emergence of strong competitors through mergers and acquisitions or the formation of business alliances may change the competitive environment of the businesses in which Canon engages, thereby affecting Canon's future results of operations.

***Canon may be adversely affected by fluctuations in the stock and bond markets.***

Canon's assets include investments in publicly traded securities. As a result, Canon's operating results and general financial position may be affected by price fluctuations in the stock and bond markets. In addition, if valuations of investment assets decrease due to conditions in, for example, stock or bond markets, additional funding and accruals with respect to Canon's pension and other obligations may be required, and such funding and accruals may adversely affect Canon's operating results and consolidated financial condition.

***Confidential information may be inadvertently disclosed which could lead to damage claims or harm Canon's reputation, and may have an adverse effect upon Canon's business.***

In connection with certain projects, Canon may receive confidential or sensitive information (such as personal information) from its customers relating to these customers or to other parties. In addition, Canon uses computer systems and electronic data in managing information relating to its employees. Although Canon makes every effort to keep this information confidential through procedures designed to prevent accidental release of confidential or sensitive information, such information may be inadvertently disclosed without Canon's knowledge. If this occurs, Canon may be subject to claims for damages from the parties or the employees affected, suffer harm to its reputation or be subject to liabilities and/or penalties under applicable statutes.

Inadvertent disclosure of secret information regarding new technology, would also have a material adverse effect upon Canon's business.

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**Item 4. Information on the Company**

**A. History and development of the Company**

Canon Inc. is a joint stock corporation (KABUSHIKI KAISHA) formed under the Corporation Law of Japan. Its principal place of business is at 30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501, Japan. The telephone number is +81-3-3758-2111.

The Company was incorporated under the laws of Japan on August 10, 1937 to produce and sell Japan's first focal plane shutter 35mm still camera, which was developed by its predecessor company, Precision Optical Research Laboratories, which was organized in 1933.

In the late 1950s, Canon entered the business machines field utilizing technology obtained through the development of photographic and optical products. With the successful introduction of electronic calculators in 1964, Canon continued to expand its operations to include plain paper copying machines, faxes, laser beam printers, bubble jet printers, computers, video camcorders and digital cameras.

The following are important events in the development of Canon's business in recent years.

In January 2003, Canon Aptex Inc. and Copyer Co., Ltd., two of Canon Inc.'s manufacturing subsidiaries in Japan, merged to become Canon Finetech Inc. The merger was conducted with the aim of concentrating and further strengthening the core competencies of the two merged companies in office equipment-related technologies.

In April 2003, Fukushima Canon Inc. was established as a wholly-owned subsidiary through the spin-off of Fukushima Plant, with the aim of establishing a high value-added manufacturing company equipped with product-launching capability.

In April 2003, Canon N.T.C.'s marketing operations were spun off and merged with Canon System & Support Inc., and its real estate operations were spun off into Canon Facility Management, Inc. Following the corporate spin-offs, Canon N.T.C.'s operations focus on development and manufacturing.

In January 2004, Canon Precision Inc., or Canon Precision, a wholly-owned subsidiary of Canon Inc., merged with Hirosaki Precision, Inc., or Hirosaki Precision, a wholly-owned subsidiary of Canon Precision. Hirosaki Precision was merged into Canon Precision, the surviving company. Canon Precision targets the improved efficiency and specialization of business operations. Since both Canon Precision and Hirosaki Precision were consolidated subsidiaries of Canon Inc., the merger had no impact on Canon's business results.

On October 15, 2004, the Company entered into an agreement with Canon Sales Co., Inc. and Canotec Co., Inc., or Canotec, joint equity shareholders of Niigata Canotec Co., Inc., or Niigata Canotec, to acquire all outstanding shares of Niigata Canotec. Therefore, on January 1, 2005, Niigata Canotec became a wholly-owned subsidiary of the Company and changed its name to Canon Imaging System Technologies Inc. By making Canon Imaging System Technologies, Inc. a wholly-owned subsidiary of the Company, Canon aims to raise the level of its technical capacity and improve development efficiency by enabling closer coordination.

On January 1, 2005, Canotec and FastNet, Inc. merged, and the merged entity changed its name to Canon Network Communications, Inc. The purpose of the merger was to increase management efficiency by consolidating the Canon group's network and Internet service operations. Canon Network Communications, Inc. aims to strengthen Information Technology Management Services, dealing with all stages from the establishment of comprehensive network systems to their operation and management.

On September 30, 2005, Canon acquired all of the issued and outstanding shares of ANELVA Corporation, which possesses advanced vacuum technology, and made it into a subsidiary. ANELVA Corporation's corporate name was changed to Canon ANELVA Corporation as of October 1, 2005. By making Canon

ANELVA Corporation a subsidiary of the Company, Canon aims to promote the in-house production of manufacturing equipment which is indispensable to differentiate Canon products from the competitors in various fields, including Canon's new display business.

On October 19, 2005, Canon acquired the shares of NEC Machinery Corporation (listed on the Second Section of the Osaka Securities Exchange Co., Ltd.), which possesses advanced automation technologies, through a tender offer, making it a subsidiary of Canon. NEC Machinery Corporation's corporate name was changed to Canon Machinery Inc. as of December 17, 2005. By making Canon Machinery Inc. a subsidiary of the Company, Canon aims to make further advances in its production reform activities, including the automation of production processes for Canon products.

On December 27, 2006, Canon Electronics Inc. acquired the shares of e-System Corporation (listed on the Hercules Section of the Osaka Securities Exchange) through a third party distribution in order to strengthen its group's information-related business and develop it into a core business, and made that company its subsidiary.

On June 21, 2007, Canon Marketing Japan Inc. acquired the shares of Argo21 Corporation through a tender offer for outstanding common stock, making it a subsidiary of Canon. In addition, Canon Marketing Japan made it into a wholly-owned subsidiary on November 1, 2007 by share exchange in order to strengthen its IT solutions business.

On December 28, 2007, Canon acquired the shares of Tokki Corporation (listed on the JASDAQ Securities Exchange Inc.) through a tender offer for outstanding common stock, making it a subsidiary of Canon. With Tokki Corporation as a subsidiary, Canon aims to accelerate the development of the display business.

In fiscal 2007, 2006, and 2005, Canon's capital expenditures were ¥428,549 million, ¥379,657 million, and ¥383,784 million, respectively. In fiscal 2007, capital expenditures were mainly used to expand production capabilities in both domestic and overseas regions, and to bolster Canon's production-technology related infrastructure. In addition, Canon has been continually investing in tools and dies for business machines, in which the amount invested is generally the same each year.

For fiscal 2008, Canon projects its capital expenditures will be approximately ¥440,000 million, mainly in Japan. This amount is expected to be spent for investments in new production plants and new facilities of Canon. Canon anticipates that the funds needed for these capital expenditures will be generated internally through operations.

**Table of Contents****B. Business overview**

Canon is one of the world's leading manufacturers of digital multifunction devices ( MFDs ), plain paper copying machines, laser beam printers, inkjet printers, cameras and steppers.

Canon sells its products principally under the Canon brand name and through sales subsidiaries. Each of these subsidiaries is responsible for marketing and distribution to retail dealers in an assigned territory. Approximately 77% of consolidated net sales in fiscal 2007 were generated outside Japan; approximately 30% in the Americas, 33% in Europe and 14% in other areas including Asia.

Canon's strategy is to develop innovative, high value-added products which incorporate advanced technologies.

Canon's research and development activities range from basic research to product-oriented research directed at keeping and increasing the technological leadership of Canon's products in the market.

Canon manufactures the majority of its products in Japan, but in an effort to reduce currency exchange risks and production cost, Canon has increased overseas production and the use of local parts. Canon has manufacturing subsidiaries in countries and regions such as the United States, Germany, France, Taiwan, China, Malaysia, Thailand and Vietnam.

As a concerned member of the world community, Canon emphasizes recycling, and has increased its use of clean energy sources and cleaner manufacturing processes. Canon has also adopted programs to collect and recycle used cartridges and to refurbish used copy machines. In addition, Canon has virtually removed all environmentally unfriendly chemicals from its manufacturing processes.

**Products**

Canon's products are divided into the following three product groups: business machines, cameras, and optical and other products.

*- Business machines -*

The business machines product group is divided into three sub-groups consisting of office imaging products, computer peripherals and business information products.

*Office imaging products*

Canon manufactures, markets and services a wide range of monochrome network digital MFDs, color network digital MFDs, office copying machines, personal-use copying machines.

The office-use market is subject to rapid change, and customer preferences have been shifting from copying machines to digital MFDs, as well as from monochrome to color products. To respond to these trends, Canon has been strengthening its lineup of digital MFDs in the imageRUNNER ( iR ) series, which have versatile functions, such as copying, printing, scanning, faxing and data-sharing functions on the Internet and intranets. Canon is also marketing diverse expansion modules, software and business solutions to increase customer value. For the development of MFDs, Canon makes effective use of a wide range of technologies from the fields of optics, mechatronics, electrophotography, chemistry and image processing. Canon has developed a high-performance image processing chip called Third generation color iR controller and an expandable and functional platform called MEAP, Multifunctional Embedded Application Platform. This controller provides easy integration with customers' IT environments together with speedy, high-quality image processing. This boosts office productivity, thereby garnering acclaim from business customers.

In 2007, sales of color office imaging products continued solid growth as the office color market continued to expand and sales of monochrome digital devices were stable. Canon has expanded its color office imaging product lineups by introducing the iRC5185 series worldwide to further increase color MFD sales. Canon has also introduced new monochrome MFD models to strengthen its industry leading monochrome MFD product lineup.

Canon offers full- color digital MFDs for users ranging from professional graphic designers to business offices. The trend in the printing industry is gradually moving away from long run printing using expensive machinery to short run printing-on-demand and variable data printing. Canon's high-end MFDs and color digital MFDs can be applied to the print-on-demand market. Canon aims to respond to the growing demand for digital color imaging in the commercial print market with its new imagePRESS C7000VP, a high-end color device with a level of quality comparable to offset printing.

Canon has a leading market share in monochrome MFDs and copying machines including machines for personal use. Despite the trend of increasing demand for color machines, the demand for monochrome machines has remained stable, supported by improved multifunction capabilities and software development.

With the evolution of digital technology and communication, MFDs that enable seamless conversion between paper documents and electronic documents have also evolved from being input-output devices to sophisticated information systems. To deliver solutions that meet the diversifying needs of customers in various industries and niche, Canon has brought to market a full offering of MEAP-enabled office MFD lines both in monochrome and color as well as software products.

The office imaging products category also includes the related sales of paper and chemicals, service and replacement parts.

#### *Computer peripherals*

Computer peripherals include laser beam printers, inkjet printers and scanners.

Developed and fostered by Canon, laser beam printers are standard output peripherals for offices. Canon's laser beam printers are relatively small in size and have high-quality printing capabilities attributable to Canon's expertise in laser beam printing and plain paper copying technologies. Canon's adoption of a user-replaceable toner cartridge system containing optical components makes its laser beam printers easy to maintain. Most of Canon's laser beam printer sales are on an OEM basis.

As for monochrome laser beam printer, Canon has expanded its production of mainly low-end models in Asian countries due to its burgeoning demand throughout the world. Canon has also expanded the production and sales of color laser beam printers. After shipments reached the 10 million units level in 2004, the production and sales of monochrome and color laser beam printers, mainly low-end products, have achieved continuous unit of growth in excess of 10% in each of fiscal 2005, 2006, and 2007.

As the inventor of bubble jet printing technology, Canon believes it continues to provide customers with the best performance the technology has to offer. Canon provides high-performance and high value added models both in multifunction printers and single function printers. In response to intense competition in the inkjet printer segment, Canon launched a new lineup of multifunction printers and single function printers from flagship to entry models in 2007. All new models feature a print head called Canon Full-photolithography Inkjet Nozzle Engineering (FINE), which boosts print speed and image quality up to 9600 x 2400 dpi with microscopic droplets as small as one picoliter, and the ChromaLife100 system, which provides high quality and long-lasting photo images. In addition to high-quality images, Canon PIXMA branded photo printers offer advanced paper handling, such as dual paper path and two-sided duplex printing, and Easy-Scroll Wheel, new Quick Start and Auto-Image Fix feature that makes operation much easier. With these advanced printer line-ups, Canon has expanded its sales volume and expects that its consumables business will expand accordingly.



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Canon markets a wide variety of scanners for a spectrum of user needs, including image scanners in the CanoScan LiDE series using Contact Image Sensor ( CIS ), and scanners with Charge-Coupled Devices ( CCD ) for high resolution in the CanoScan series. CIS is a close-contact method that allows a significant reduction in scanner weight and size. Canon has deployed its expertise to develop space-saving, energy-efficient scanners, as well as easy personal computer connections via universal serial bus interfaces. Although the scanner market has continued to shrink and shift to multifunction printers, through the introduction of new scanner models, Canon has maintained a high market share.

*Business information products*

Business information products primarily consist of personal computers, servers, document scanners, calculators and micrographic equipment.

With the movement toward digitalization, the need to scan documents into text data or image data is expanding. Canon's document scanners rapidly and efficiently digitize large volumes of information on paper. Canon offers a wide range of scanner models, including color capable compact sheet-fed types and a flatbed model suitable for book-type documents. Canon also offers a hybrid model that can create microfilm records while digitizing the information. Canon's diverse lineup seeks to meet increased demands for digitizing office documents to share across Internet or intranet platforms or to capture data from forms with optical character recognition.

Canon's calculator operations, from development to production and marketing, are centered in Hong Kong. Canon's tradition of technological innovation has been inherited by its personal information products, from calculators with printers to electronic dictionaries. Canon continues to develop distinct, appealing personal information products that reflect trends and demand.

Personal computers and servers sold by Canon are manufactured by third parties under the manufacturers' own brand names.

*-Cameras -*

Canon manufactures and markets digital cameras and film cameras. Canon also manufactures and markets digital video camcorders, lenses, and various camera accessories.

DIGIC III, an improved and upgraded new image processor, features a face detection system, and is the distinguishing feature of Canon's compact digital cameras. DIGIC III and DIGIC II both have enhanced capabilities for high-quality image reproduction, high-speed data processing, and high quality movie image processing.

In addition to aiming for the best possible image quality throughout its product lineup, Canon offers digital compact cameras that are easy to use with highly sophisticated product design. The compact digital camera market continued to grow in 2007. Canon increased sales of compact digital cameras through the introduction of 16 new compact digital camera models in 2007. In 2007, new products, such as the Digital Elph SD1000 (IXY DIGITAL 10 in Japan) and PowerShot A550, were well-received in the market worldwide, and Canon increased its market share and remained a leader in sales of compact digital cameras.

In the Compact Photo Printer segment Canon believes that it has shown significant leadership in this market. Although the majority of the compact photo printer purchasers are considered early adopters, retailers are now realizing the importance of this new business segment. In 2007, Canon introduced 5 new compact photo printers. Canon has been able to leverage the brand recognition of its cameras to attract new customers for its compact photo printers. In addition, Canon is starting to realize profits from sales of consumables, such as paper and ink cartridges, related to compact photo printers.

While the digital SLR market continues its healthy growth, Canon introduced 3 new digital SLRs in 2007 to keep refreshing its lineup. With its unique and leading digital imaging technology, such as its own Complementary Metal Oxide Semiconductor ( CMOS ) imaging sensors, Canon has the capability of meeting the requirement of various photographers ranging from professional photographers to the entry-level users. In 2007, Canon celebrated the 20th anniversary of its EOS System. In December of 2007, cumulative production of the EOS Series of film and digital cameras reached 30 million units, and production of EOS digital cameras reached 10 million units.

In the interchangeable SLR camera lens segment, the market has grown, and the aggregate sales of the interchangeable lenses have increased continuously for the past four years. Canon launched a total of 4 new interchangeable lens models to the market in 2007. Canon offers over 60 lenses in the EF series. Technological

developments, including diffractive optical elements, image stabilizers and ultrasonic motors, have helped Canon to maintain what it believes is a technical lead over other makers. These high-quality, high-performance lenses provide outstanding performance with digital cameras as well as silver-halide cameras, and have greatly contributed to Canon's sales. Canon intends to expand its lens sales and market share by introducing interchangeable lenses, designed to meet the various needs of the SLR camera users in the growing market.

Canon also provides a full line-up of digital video camcorders, ranging from versatile, compact and stylish models for consumers to its flagship models for professionals. In 2007 Canon has further improved its original full HD CMOS sensor for better sensitivity. Together with this CMOS sensor, its original HD video lens and digital imaging processor (DIGIC DV II), Canon believes that it offers the best quality HD movie image in the market.

In 2007, Canon strengthened its product line-up in the HD category for consumers by launching products with new media. In addition to the tape-based HDV camcorder HV20, Canon has introduced 2 new Advanced Video Codec High Definition ( AVCHD ) camcorders, the DVD-based HR10 and the Hard Disc Drive ( HDD )-based HG10. With these 3 consumer HD models, Canon has increased its market share in the HD camcorder market and received several awards.

Since the end of 2004, when Canon introduced the world's first compact Super eXtended Graphics Array Plus ( SXGA+ ) high resolution business-use projector SX50, the high image quality and high resolution of Canon's projectors have been well received by the professional market and these projectors have captured a high market share. In 2007, Canon launched 2 new models, SX7 and X700. Both achieve high resolution and quality and also ultra-high luminosity of 4000lm. These new brighter projectors make it possible to achieve high image quality with faithful color reproduction in larger venues, allowing Canon to maintain high market share. Canon intends to introduce more new products, differentiated by higher image quality, resolution, luminosity and system expandability, following the market trend toward the high quality even in business-use projectors.

*- Optical and other products -*

Canon's optical and other products mainly include semiconductor production equipment, mirror projection mask aligners for LCD panels, broadcasting equipment, medical equipment, large format printers, and electronic components.

While the market for semiconductor production equipment contracted slightly in fiscal 2007 compared with fiscal 2006, the Asian market, where there is a high concentration of memory manufacturers, has expanded because an increase of laptop computer, cell phone, and portable music player production boosted the demand for DRAM and NAND-type flash memories. Taiwan, Japan, and Korea represent about 70% of the entire semiconductor production equipment market. The demand for immersion lithography scanning steppers has increased and the demand for i-line steppers has also grown steadily. In 2007, Canon introduced 3 new products, the i-line stepper FPA-5510iZ, the new platform ArF-dry scanning stepper FPA-7000 AS5, and the immersion lithography scanning stepper FPA-7000 AS7, which offers new technology to meet the demands of customers in the expanding memory market.

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Due to a continued oversupply of LCD panels, manufacturers' investment in LCD production mask aligners was limited in 2007. As a result, the market of LCD production mask aligners for large panels decreased by half compared with fiscal 2006. The trend toward larger LCD televisions has continued and the 8<sup>th</sup> generation (2200 × 2500mm) mask aligners consist of more than half of the LCD production mask aligners' market. MPAsp-H700 introduced a new platform to realize higher productivity and resolution. In addition to the high performance, MPAsp-H700 shortened the installation time and received a good reputation from customers.

Based on the global sales of units, Canon is the world leader in television broadcasting lenses, which are used to capture images from sports and news events, concerts and studio broadcasts. In fiscal 2007, the market for television broadcasting lenses grew as a result of a global trend to introduce digital broadcasting equipment. In fiscal 2007, Canon launched top-end HD lenses for field production with original auto-focusing system and cost-effective HD lenses in response to the latest market demands for HD acquisition systems. Canon maintained its position as the market leader for television broadcasting lenses.

Medical equipment sold by Canon includes X-ray image sensors, retinal cameras, autorefractometers, and image-processing equipment for computerized detective systems. Canon's pioneering digital radiography system takes X-ray photography and medical detective into the digital age.

Canon expanded its large format printer (LFPs) line-up in 2007 to compete with other manufacturers. After launching 6 new models in 2006, in 2007, Canon launched 9 new LFPs, including 6 models which update the products launched in 2006, a new 24-inch wide model iPF6100 and new iPF8000S and iPF9000S that feature a newly developed 8 color ink system engine. This has successfully expanded Canon's product lineup against competitive manufacturers.

The BESTEM series die bonder produced by Canon Machinery Inc. remained popular, and the semiconductor sputtering equipment produced by Canon ANELVA Corporation also recorded strong performance.

Other products sold by Canon include electronic components, such as magnetic heads for audio and video tape recorders and micro-motors for printers and other components, which are sold primarily to equipment manufacturers.

**Marketing and distribution**

Canon sells its products primarily through subsidiaries positioned as regional marketing headquarters with responsibility for specific geographic areas: Canon Marketing Japan Inc. in Japan; Canon U.S.A., Inc. in North and South America; Canon Europe Ltd. and Canon Europa N.V. in Europe, Russia, Africa and the Middle East; Canon China Co., Ltd. in Asia outside Japan; and Canon Australia Pty. Ltd. in Oceania. Each subsidiary is responsible for its own market research and for determining its sales channels, advertising and promotional activities to provide tailor made solutions to satisfy a diverse range of unique customer needs and to advance Canon's reputation as a highly trusted brand.

In Japan, Canon sells its products primarily through Canon Marketing Japan Co., Inc., mainly to dealers and retail outlets.

In the Americas, Canon sells its products primarily through Canon U.S.A., Inc., Canon Canada, Inc. and Canon Latin America, Inc., mainly to dealers and retail outlets.

In Europe, Canon sells its products primarily through Canon Europa N.V., which sells primarily through subsidiaries or independent distributors to dealers and retail outlets in each locality. In addition, copying machines are sold directly to end-users by several subsidiaries such as Canon (U.K.) Ltd. in the United Kingdom and Canon France S.A.S. in France.

In Southeast Asia and Oceania, Canon sells its products through subsidiaries located in those areas. In addition, copying machines are sold directly to end-users by Canon Australia Pty. Ltd. in Australia.

Canon also sells laser beam printers on an OEM basis to Hewlett-Packard Company. Hewlett-Packard Company resells these printers under the HP LaserJet Printers name. During fiscal 2007, such sales constituted approximately 22% of Canon's consolidated net sales, which is equivalent to the previous fiscal year.

Canon continues to enhance its distribution system by promoting continuing education of its sales personnel and improving inventory management and business planning through the weekly analysis of Canon's sales data.

**Service**

In Japan and overseas, product service is provided in part by independent retail outlets and designated service centers that receive technical training assistance from Canon. Canon also services its products directly.

Most of Canon's business machines carry warranties of varying terms depending upon the model and the country of sale. Cameras and camera accessories carry a one-year warranty based on normal use.

Canon services its copying machines and supplies replacement drums, parts, toner and paper. Most customers enter into a maintenance service contract under which Canon provides maintenance services, replacement drums and parts in return for the stated amount of the contract plus a per-copy charge. Copying machines which are not covered by a service contract, may be serviced from time to time by Canon or local dealers for a fee.

**Seasonality**

Canon's sales for the 4th quarter are usually higher than those in the other three quarters, mainly due to strong demand for consumer products, such as cameras and inkjet printers, during the year-end holiday season. In Japan, corporate demand for office products peaks in the 1st quarter, as many Japanese companies close their books in March. Sales also tend to increase at the start of the new school year in each of the respective regions.

**Sources of supply**

Canon purchases materials such as glass, aluminum, plastic, steel, and chemicals for various product parts and in the manufacturing of products. With the development of globalization in production, Canon procures raw materials from all over the world, and selects suppliers based on a number of criteria, including environmental friendliness, quality, cost, supply stability, and financial condition.

Prices of some raw materials fluctuate according to the market. In recent years, the market for raw materials has been tight due to the financial market confusion led by the subprime loan issue and the impact of rising crude oil prices, as well as the increase in demand from China. However, Canon believes it will be able to continue to obtain sufficient quantities of raw materials to meet its needs.

Canon also places significant emphasis on the in-house development of production tools. Canon also produces many of the tuning and measuring tools needed for the development, maintenance and repair of its production equipment. Key tools such as these are not marketed for sale; they are reserved for use within Canon. Canon's ability to develop its own production tools helps establish quality control and allows for speed and flexibility when retooling is necessary—a crucial advantage in its cell production processes. Cell production is the production system in which the entire production process is undertaken by small groups of employees. In-house tool development may also help cut costs over time and prevent the leakage of Canon's core proprietary technologies.

**Table of Contents****NET SALES BY PRODUCT GROUP**

	Years ended December 31				
	2007	change	2006	change	2005
	(Millions of yen except percentage data)				
Business machines:					
Office imaging products	¥ 1,290,788	+8.8%	¥ 1,185,925	+2.8%	¥ 1,153,240
Computer peripherals	1,537,511	+9.9	1,398,408	+12.3	1,244,906
Business information products	107,243	+0.5	106,754	+2.4	104,255
	2,935,542	+9.1	2,691,087	+7.5	2,502,401
Cameras	1,152,663	+10.6	1,041,865	+18.5	879,186
Optical and other products	393,141	-7.2	423,807	+13.7	372,604
Total	¥ 4,481,346	+7.8	¥ 4,156,759	+10.7	¥ 3,754,191

**NET SALES BY GEOGRAPHIC AREA**

	Years ended December 31				
	2007	change	2006	change	2005
	(Millions of yen except percentage data)				
Japan					
Unaffiliated customers	¥ 1,048,310	+1.0%	¥ 1,037,657	+5.9%	¥ 979,748
Intersegment	2,494,251	+7.9	2,311,482	+13.0	2,046,173
Total	3,542,561	+5.8	3,349,139	+10.7	3,025,921
Americas					
Unaffiliated customers	¥ 1,329,479	+4.0%	¥ 1,277,867	+12.1%	¥ 1,139,784
Intersegment	4,608	-3.3	4,764	-35.8	7,424
Total	1,334,087	+4.0	1,282,631	+11.8	1,147,208
Europe					
Unaffiliated customers	¥ 1,499,821	+14.1%	¥ 1,313,919	+11.5%	¥ 1,178,672
Intersegment	3,496	-2.5	3,586	+62.6	2,206
Total	1,503,317	+14.1	1,317,505	+11.6	1,180,878
Others					
Unaffiliated customers	¥ 603,736	+14.5%	¥ 527,316	+15.6%	¥ 455,987
Intersegment	824,844	+4.1	792,018	+22.5	646,530
Total	1,428,580	+8.3	1,319,334	+19.7	1,102,517
Eliminations					
Unaffiliated customers	¥	%	¥	%	¥
Intersegment	(3,327,199)		(3,111,850)		(2,702,333)
Total	(3,327,199)		(3,111,850)		(2,702,333)
Consolidated					
Unaffiliated customers	¥ 4,481,346	+7.8%	¥ 4,156,759	+10.7%	¥ 3,754,191
Intersegment					
Total	4,481,346	+7.8	4,156,759	+10.7	3,754,191

Note: The segments are defined under accounting principles generally accepted in Japan ( Japanese GAAP ). In grouping of segment information by product, Japanese GAAP requires that consideration be given to similarities of product types and characteristics, manufacturing methods, sales markets, and other factors that are similar. In grouping of segment information by geographic area, Japanese GAAP requires that consideration be given to geographic proximity, as well as similarities of economic activities, interrelationships of business activities and other similar factors. Segment information by geographic area is determined by the location of the Company or its relevant subsidiary making the sale.

Total operating profit by category is discussed in Item 5A Operating Results .



**Table of Contents****Competition**

Canon encounters intense competition in all areas of its business activity throughout the world. Canon's competitors range from some of the world's major multinational corporations to smaller, highly specialized companies. Canon competes in a number of different business areas, whereas many of its competitors are relatively more focused on one or more individual industries. Consequently, Canon may face significant competition from entities that apply greater financial, technological, sales and marketing or other resources than Canon to their activities in a particular market segment.

The principal elements of competition which Canon faces in each of its markets are technology, quality, reliability, performance, price and customer service and support. Canon believes that much of its ability to compete effectively depends on conducting successful research and development activities that enable it to create new or improved products and release them on a timely basis and at commercially attractive prices.

The competitive environments in which each product group operates are described below:

*Business machines*

The markets for office imaging products, computer peripherals and business information products are highly competitive. Canon's primary competitors in these markets are Xerox Corporation/ Fuji Xerox Co., Ltd., Ricoh Company, Ltd., Konica Minolta Holdings, Inc., Hewlett-Packard Company, Lexmark International Inc., and Seiko Epson Corporation. Canon believes that it is one of the leading global manufacturers of digital MFDs, copying machines, laser beam printers, inkjet printers, image scanners, and facsimile machines. In addition to the general elements of competition described above, Canon's ability to compete successfully in these markets also depends significantly on whether it can provide effective, broad-based business solutions to its customers that solve multiple interrelated client needs. In particular, the ability to provide equipment and software that connect effectively to networks (ranging in scope from local area networks to the Internet) is often a key to Canon's competitive strength in these markets. In China, the current market leaders for business machines are Toshiba Tec Corporation, Sharp Corporation and Konica Minolta Holdings Inc. Canon hopes to join this group by introducing products tailored to the market and by strengthening sales and service channels. Also in the office color market, in addition to Ricoh and Xerox, Konica Minolta has been very aggressive with its color strategy especially in Europe and the US, and competition in this market has become fierce.

Also, as a recent trend, convergence of the copier industry and the printer industry has become apparent. Competition in the low-end segment has become especially fierce as a result of the impact of printer-based MFDs on the copier market. Canon sees this market convergence as a growth opportunity and has enhanced its printer and printer-based MFP lineups. Canon also differentiates itself from other competitors by offering comprehensive solutions to customers.

*Cameras*

Competition in the camera industry is intense, with many established market participants offering excellent products with competitive pricing. Canon's primary competitors in digital cameras are Sony Corporation, Fujifilm Co., Ltd., Olympus Corporation, Nikon Corporation, Casio Computer Co., Ltd., Matsushita Electric Industrial Co., Ltd., PENTAX Company, Samsung Electronics Co., Ltd., and Eastman Kodak Company.

In the digital SLR market, competition increased in 2007, with more newcomers using aggressive approaches entering into the growing market. Canon is committed to keep leading the digital SLR market, with aggressive investment in developing new models.

Canon's primary competitor in the lens market is Nikon Corporation, whose popular class digital SLR cameras are selling well. Another major competitor is Sigma Corporation, which sells products that are compatible with Canon's SLR camera lens.

In the compact digital cameras, the trend of declining prices is expected to continue in 2008, and it will become tougher to maintain current profit levels. Also, the market in the economically developed countries could be peaking due to high household penetration.

While Canon sees the above-mentioned challenges, Canon also sees many reasons for optimism. For instance, as China and Eastern Europe, including Russia, have shown significant growth, Canon has maintained a high market share in China and Russia. Also, Canon's cost reduction efforts have shown very positive progress utilizing the



advantages of significant economies of scale. Canon believes its compact Digital Still Camera ( DSC ) business will continue to benefit from these conditions.

Canon's primary competitors in digital video camcorders are Sony Corporation, Matsushita Electric Industrial Co., Ltd., Victor Company of Japan Ltd., Hitachi, Ltd. and Samsung Electronics Co., Ltd.

*Steppers and Aligners*

The market for steppers and aligners, used in the manufacture of semiconductor devices and LCDs, is highly competitive. The market is characterized by a relatively small number of dominant suppliers, since the development of steppers and aligners requires extremely precise design and manufacturing techniques and, as a result, very high levels of capital investment.

Canon's primary competitors in the market for steppers and aligners are Nikon Corporation and ASML Holding N.V., ( ASML ). Nikon Corporation has a reputation for its excellent technology, especially optical lenses, and Intel Corporation, the world's leading semiconductor manufacturer, is one of their major customers. ASML has in recent years improved its competitive position by taking advantage of government subsidies and by focusing on the rapidly growing foundry manufacturer industry.

Because of the substantial capital expenditures required to install and integrate equipment into a semiconductor production line, semiconductor manufacturers tend to purchase their stepper and aligner production equipment from the vendor that originally supplied the chip fabrication equipment. Canon competes principally on its ability to meet and exceed product specifications, including resolution and throughput, quality, reliability and system maintenance cost. Because of the very rapid pace of technological innovation in the semiconductor industry, Canon believes that its ability to provide new products on a timely basis is also a key competitive consideration for customers seeking to integrate stepper and aligner production systems into the planning and design of their new facilities.

**Patents and licenses**

Canon holds a large number of patents (including utility model rights), design rights and trademarks in Japan and abroad to protect its technology products that arise from its research and development and utilizes these intellectual property rights as important strategic management tools. For instance, Canon has been utilizing its intellectual property rights, such as patents, to expand its product lines and business operations and to form alliances and exchange technologies with other companies.

According to the United States patent annual list, which IFI CLAIMS® Patent Services has released, Canon has been consistently ranked as second or third in recent years in terms of the number of patents issued in the United States, as Canon maintained its reputation as a famous technology-oriented company.

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Canon has granted licenses with respect to its patents to various Japanese and foreign companies, particularly in areas such as electrophotography, laser beam printers, multifunction printers, facsimiles and cameras.

Some examples include:

Oki Electric Industry Co., Ltd.	(LED printers, multifunction printers and facsimiles)
Matsushita Electric Industrial Co., Ltd.	(electrophotography)
Ricoh Company, Ltd.	(electrophotography)
Sanyo Electric Co., Ltd.	(electronic still camera)
Samsung Electronics Co., Ltd.	(laser beam printers, multifunction printers and facsimiles)
Kyocera Mita Corporation	(electrophotography)
Konica Minolta Holding Co.,Ltd.	(business machines)
Toshiba Corporation	(business machines)
Sharp Corporation	(electrophotography)

Canon has also been granted licenses with respect to patents held by other companies.

Some examples include:

Jerome H. Lemelson Patent Incentives, Inc.	(computer systems, image recording apparatus and communication apparatus)
Energy Conversion Devices, Inc.	(solar battery)
Honeywell International Inc.	(camera and video products)
Gilbert P. Hyatt U.S. Philips Corporation	(microcomputer)
St. Clair Intellectual Property Consultants, Inc.	(Selection of digital camera's image format)

Canon has also entered into cross-licensing agreements with other major industry participants.

Some examples include:

International Business Machines Corporation	(information handling systems)
Hewlett-Packard Company	(bubble jet printers)
Xerox Corporation	(business machines)
Matsushita Electric Industrial Co., Ltd.	(video tape recorders and video cameras)
Eastman Kodak Company	(electrophotography and image processing technology)
Ricoh Company, Ltd.	(electrophotography products, facsimiles and word processors)

Canon has placed a high priority on the management of its intellectual property as part of its management strategy to enhance its global business operations. Some products which are material to Canon's operating results incorporate patented technology which is critical to the continued success of these products. Typically, these products incorporate technology reflected in dozens of different patents. Canon does not believe that its business, as a whole, is dependent on, or that its profitability would be materially affected by the revocation, termination, expiration or infringement upon, any particular patent, copyright, license or intellectual property rights or group thereof.

**Environmental regulations**

Canon is subject to a wide variety of laws and regulations as well as industry standards relating to energy and resource conservation, recycling, global warming, pollution prevention, pollution remediation, and environmental health and safety. Some of the environmental laws which affect Canon's businesses are summarized below.

1. *European Union Directive on the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (the RoHS Directive)*, and *Directive on Waste Electrical and Electronic Equipment (the WEEE Directive)*.

These directives were published in the European Union's Official Journal on February 13, 2003. Member states were required to bring into force the laws necessary to comply with these directives by August 13, 2004. Beginning July 1, 2006, companies must ensure that their electrical and electronic equipment sold in the European Union does

not contain lead, cadmium, hexavalent chromium, mercury, polybrominated biphenyls or polybrominated diphenyl ethers if placed on the market after that date. Pursuant to the RoHS Directive, Canon adapted its products so that they do not contain the prohibited hazardous substances.

The WEEE Directive requires that after August 13, 2005, companies that sell electrical and electronic equipment bearing their trade names in the European Union must arrange and pay for the collection, treatment, recycling, recovery and disposal of their equipment and achieve designated recycling rates by December 31, 2006. Pursuant to the WEEE Directive, Canon is joining a collective compliance scheme for the WEEE Directive in each member state, and achieved the recycling ratio of waste electrical and electronic equipment through these schemes by the target date.

The EU will begin to review both directives, starting from next year. After 2010, when tighter restrictions may be enforced, Canon's costs may increase due to a need to develop and adopt substitute materials or processes. Such increased costs may have an adverse effect on its results of operations.

## 2. *Soil Pollution Prevention Law of Japan*

The Soil Pollution Prevention Law of Japan, administered by the Japanese Ministry of the Environment, went into effect in February 2003. The law requires an owner of land to have the soil investigated by a designated organization for the purpose of measuring the level of soil pollution when the land is to be transferred or to be used for another purpose. The results of such investigation are reported to the prefectural governor. If the soil pollution is not within standards specified in the law, the governor will designate the land as a designated area, publicly announce such designation and make available upon request the investigation report. The substances designated in the law consist of 25 chemical groups, including substances such as lead, arsenic, and trichloro ethylene. If there is a possibility that the soil pollution of the designated area may affect human health, the governor will issue an order to the landowner to take remedial actions.

In response to the law, Canon has commenced a detailed survey and measurement of soil and groundwater to determine the existence of pollution at all of Canon's operational sites in Japan. Additional costs may arise as remedial measures become necessary. These factors may adversely affect Canon's results of operations and financial condition.

See Risk Factors Risks Related to Environmental Issues Environmental clean-up and remediation costs relating to Canon's properties and associated litigation could decrease Canon's net cash flow, adversely affect its results of operations and impair its financial condition.

**Table of Contents****3. Law for Promotion of Effective Utilization of Resources of Japan**

The Law for Promotion of Effective Utilization of Resources of Japan, administered by the Japanese Ministry of Economy, Trade and Industry ( METI ), enacted in April 2001, is currently being evaluated for a revision in 2008. This Law requires manufacturers of specified reuse-promoted products, including copiers, to promote the use of recyclable resources and recovered products (designing and manufacturing products that can be easily reused or recycled). The coverage and requirements of the law may be expanded to other products such as printers, and may have an adverse effect on Canon's results of operations.

**4. Law on Promoting Green Purchasing of Japan**

The Law on Promoting Green Purchasing of Japan, administered by the Japanese Ministry of the Environment, took effect in April 2001. The law encourages both national and local governments to procure products with low environmental burdens. Businesses are required to provide information that is necessary to determine the environmental impact of products that they manufacture.

In response to the law, Canon now promotes :

- manufacture of products that consume less electricity to prevent global warming and to conserve energy,
- use of recycled parts and recycled materials,
- reduction of the types of raw materials used in order to conserve resources, and
- acceleration of the date by which the requirements of the law are implemented to promote the elimination of hazardous substances.

The law also requires Canon to collect its used products and recycle them, establish alternative technologies for hazardous substances used in products and standardize the substances used in its products. These measures will entail additional costs and may adversely affect its results of operations and financial conditions.

**5. European Union ( EU ) Directive on Batteries and Accumulators and Waste Batteries and Accumulators**

On September 26, 2006, a new directive on batteries and accumulators and waste batteries and accumulators was published in the EU Official Journal to replace a similar existing directive. EU member states must implement the directive by September 26, 2008, and manufacturers and sellers must comply with these laws based on the new directive. Whereas the existing directive applies only to batteries with a certain mercury, cadmium and lead content, the new directive applies to all batteries and accumulators placed on the European Community ( EC ) market. After September 2008, the new directive will require specified labels on all batteries, but detailed requirements have not yet been published. In addition, it establishes specific targets for collection, treatment and recycling of batteries and accumulators. Canon expects that compliance with the new directive will increase its financial costs such as labeling, recycling fees or guarantees of batteries packed with or incorporated in products placed on the EC market.

**6. Administrative Measures on the Control of Pollution Caused by Electronic Information Products of China**

Modeled on the European Union RoHS Directive described above, the Chinese Ministry of Information Industry published Administrative Measures on the Control of Pollution Caused by Electronic Information Products on February 28, 2006. These measures regulate lead, mercury, hexavalent chromium, cadmium, polybrominated biphenyls or polybrominated diphenyl ethers in electronic information products. Step 1 was implemented for the products manufactured on and after March 1, 2007. Almost all Canon products will be covered by this regulation.

To comply with Step 1 requirements, a specified China-specific mark shall be put on all the covered products according to whether the regulated six substances are contained in them or not, and their use of the six substances must be shown on product manuals. In addition, each product's environmental protection use period ( EPUP ) must be described on its recycling mark with the production date, and packaging materials shall be shown on the boxes, etc. that pack the covered products.

As Step 2 requirements, the content of the six substances in specific electronic information products (those specified in the list for emphasized management ) would be restricted by the similar limitation as the EU RoHS Directive, and a China-specific compulsory products certification system will be introduced for such products. However, neither the standards to implement these measures nor the emphatic management list have been published yet.

These requirements will increase Canon's costs and may have an adverse affect on its results of operations and financial condition.

7. *U.S. States and Canada's Legislations concerning Waste Electric and Electronic Products and RoHS-like Regulations*

Electric and electronic equipment recycling laws have been enacted in some states such as California and Washington, and more draft recycling laws are now being discussed in about 20 states. Most states' laws cover only displays or TVs, so the impact on Canon has not been significant to date. However, there are some Canadian state laws, like the regulations of Ontario and Alberta, which require manufacturers to bear the costs of collection and recycling of printers and fax machines, and some other products made by Canon. Canon expects that compliance with the state requirements might increase its costs such as recycling fees and guarantees of products sold there.

Some draft state laws are being considered in California and other states, which would restrict certain hazardous substances in electric and electronic equipment in a manner similar to the EU RoHS Directive. If such requirements are enacted, they might increase Canon's costs.

8. *The European Framework for the management of chemical substances, or REACH Regulations*

On December 30, 2006, the REACH Regulation was published in the EU Official Journal, and was implemented on June 1, 2007. This covers almost all the chemicals (that is, products in gaseous, liquid, paste or powdery form) and the articles (products in solid state) manufactured in or imported into the European Union.

All the chemicals manufactured or imported over specific thresholds shall be registered in the European Union with information about its usage or chemical characters, etc. The registration of new chemicals will commence in June 2008. For chemical substances which have been already used, pre-registration will be accepted from June 1 to December 1, 2008. Substances that have not been pre-registered cannot be used after December 2008 until they are formally registered. Pre-registered substances will be subject to formal registration procedures according to quantity and hazardous properties. Canon uses some chemicals which are subject to pre-registration requirements, and preparations for pre-registration are underway.

Moreover, authorization shall be required when using certain substances, and the use of substances regarded as dangerous might be prohibited. From June 2011, the suppliers of articles will have to report to the EU authority when certain substances are contained in them. In addition, suppliers of article will have to provide information about such substances to all business users and consumers upon request.

These requirements of REACH will increase Canon's costs and may have an adverse effect on its results of operations and financial condition.

**Table of Contents****9. *The European Framework for the Setting of Requirements for Energy-Using Products (so-called EuP Directive )***

The European Union published a directive that establishes a framework for the setting of environmental requirements for energy-using products, the EuP Directive, on July 22, 2005. Member states were required to bring into force the laws necessary to comply with the directive concerning eco-design by August 11, 2007. This framework directive applies to all products that use energy, and under this directive, implementing measures for specific product categories must be adopted by the European Union member states. Until these implementing measures are clarified, it is difficult to predict the effects of the EuP Directive. However, we expect that the energy requirement for standby mode, which would be one of the first implemented measures, will take effect in the latter half of 2009, and that the implemented measures for imaging equipment, which covers most of Canon products, will take effect in 2010. Canon is pushing forward with preparations to comply with the EuP Directive, but achieving compliance will likely increase Canon's costs.

**10. *Kyoto Protocol to the United Nations Framework Convention on Climate Change***

According to Kyoto Protocol to the U.N. Framework Convention on Climate Change which took effect on February 16, 2005, the first commitment period will commence in 2008 with a span of five years. The Japanese Government will revise its Kyoto Protocol Target Attainment plan that was decided by the Cabinet in 2005 to ensure that Japan achieves the numerical target set by the Kyoto Protocol, in which total emissions of carbon dioxide should be reduced by an average of 6% in comparison with those of 1990 during the first commitment period. Revisions will be decided in a Cabinet meeting in the first quarter of 2008.

In conjunction with this revision of the plan in 2008, the Energy Saving Law in Japan (Law concerning the Rational Use of Energy) that was revised in 2006 will be reviewed for further potential revisions. The purpose of such revisions would be to reinforce versatile energy efficiency improvements such as imposing a duty to report on energy consumptions both at the business sites which use energy currently covered and at the level of the enterprises integrating such sites. Franchise chains which were not regulated so far will also be covered to improve energy efficiency in the service sector.

In response to a demand from the Japanese Government, four of the Electrical and Electronic Industrial Associations to which Canon belongs have revised the numerical target of its voluntary planned reductions upward in each of 2006 and 2007, and the new target is to reduce carbon dioxide emissions per production unit in real values by 35% in comparison with emissions rates of 1990.

Canon will need to strengthen its group structure in Japan in order to achieve its voluntary action plan target in line with the target in the voluntary action of the Industrial Associations, while taking revised laws into its consideration. In addition, Canon closely monitors laws and regulations which may be made more restrictive, as well as the direction of future activities of the Japanese Government and of the industrial sector. Canon is evaluating potential unexpected developments and planning countermeasures to address such developments, if necessary, including making use of the Kyoto mechanism, etc.

**11. *Other environmental activities***

Canon aims to reduce environmental burdens in all stages of its product lifecycles, and through various environmental activities. Canon will continue to create products that are considerate to people and the global environment. Above all, CO<sub>2</sub> emissions demand a lot of attention and international discussions of the numerical targets for CO<sub>2</sub> emission reductions for the Post-Kyoto Protocol period beginning in 2013 have been highly contentious. Now that the EU has already committed to a 20% reduction by 2020 and Japan has advocated a reduction of global CO<sub>2</sub> emissions by half by 2050 in its Cool Earth 50 initiative, it is highly probable that an aggressive numerical target will be set at the 15<sup>th</sup> Conference Of the Parties for United Nations Framework Convention on Climate Change in 2009. An interim target may be imposing a 30-40% reduction target for developed countries.

Canon needs to work diligently toward CO<sub>2</sub> emission reductions through energy efficient product design as well as by implementing further energy conservation efforts in factories.

**C. Organizational structure**

Canon Inc. and its subsidiaries and affiliates form a group of which Canon Inc. is the parent company. As of December 31, 2007, Canon had 239 consolidated subsidiaries and 15 affiliated companies accounted for by the equity method.

The following table lists the significant subsidiaries owned by Canon Inc., all of which are consolidated as of December 31, 2007.

<b>Name of company</b>	<b>Head office location</b>	<b>Proportion of ownership interest owned</b>	<b>Proportion of voting power held</b>
Canon Marketing Japan Inc.	Tokyo, Japan	50.1%	51.8%
Canon U.S.A., Inc.	New York, U.S.A.	100.0%	100.0%
Canon Europa N.V.	Amstelveen, The Netherlands	100.0%	100.0%

**Table of Contents****D. Property, plants and equipment**

Canon's manufacturing is conducted primarily at 24 plants in Japan and 17 plants in other countries. Canon owns all of the buildings and the land on which its plants are located, with the exception of certain leases of land and floor space of certain of its subsidiaries. The names and locations of Canon's plants and other facilities, their approximate floor space and the principal activities and products manufactured therein as at December 31, 2007 are as follows:

<b>Name and location</b>	<b>Floor space (including leased space) (Thousands of square feet)</b>	<b>Principal activities and products manufactured</b>
<b>Domestic</b>		
Headquarters, Tokyo	2,471	R&D, corporate administration and other functions
Canon Global Management Institute, Tokyo	172	Training & administration
Kawasaki Office, Kanagawa	259	Development of production engineering
Kosugi Office, Kanagawa	395	Development of software for office imaging products
Fuji-Susono Research Park, Shizuoka	1,037	R&D in electrophotographic technologies
Ayase Office, Kanagawa	393	R&D and manufacturing of semiconductor devices
Optics R&D Center, Tochigi	473	R&D in optical technologies, development and sales of broadcasting equipment
Yako Development Center, Kanagawa	905	Development of inkjet printers, inkjet chemical products
Utsunomiya Plant, Tochigi	855	Manufacturing of lenses for cameras and other applications
Toride Plant, Ibaraki	2,934	R&D in electrophotographic technologies, mass-production trials and support; manufacturing of office imaging products, chemical products; training of manufacturing
Ami Plant, Ibaraki	1,177	Manufacturing of semiconductor production equipment and LCD production equipment; design and manufacturing of factory automation equipment and metal molds
Utsunomiya Optical Products Plant, Tochigi	1,417	R&D, manufacturing, sales and servicing of semiconductor production equipment
Canon Electronics Inc., Saitama and Gunma	1,170	Camera components, magnetic heads, sensors, micrographics, document scanners, LBPs, laser scanner units and portable data terminals



Canon Finetech Inc., Saitama, Ibaraki, and Fukui	988	Copying machines, copying machines peripherals, chemical products and business-use printers
Canon Precision Inc., Aomori	1,090	Motors, toner cartridges and sensors
Optron Inc., Ibaraki	142	Optical crystals (for steppers, cameras, telescopes) and vapor deposition materials

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<b>Name and location</b>	<b>Floor space (including leased space) (Thousands of square feet)</b>	<b>Principal activities and products manufactured</b>
<b>Domestic</b>		
Canon Chemicals Inc., Ibaraki	2,103	Toner cartridges and rubber functional components
Canon Components Inc., Saitama	607	Image sensor units, printed circuit boards, ink cartridges and medical equipment
Oita Canon Inc., Oita	1,344	Digital cameras, cameras and digital video camcorders
Nagahama Canon Inc., Shiga	1,097	LBPs, toner cartridges and A-Si drums
Oita Canon Materials Inc., Oita	2,015	Chemical products for copying machines and printers
Ueno Canon Materials Inc., Mie	638	Chemical products for copying machines and printers
Fukushima Canon Inc., Fukushima	971	Inkjet printers and inkjet cartridges
Canon Semiconductor Equipment Inc., Ibaraki	553	Semiconductor production-related equipment, copying machines and copying machine units
Canon Ecology Industry Inc., Ibaraki	399	Recycling of toner cartridges and business machine repair
Nisca Corporation, Yamanashi	377	Scanner units and optical equipment
Miyazaki Daishin Canon Co., Ltd., Miyazaki	129	Digital cameras
Canon Mold Co., Ltd., Ibaraki	171	Molds
Canon ANELVA Corporation, Kanagawa and Yamanashi	940	Production equipment for electron devices, Flat Panel Display and semiconductor
Canon Machinery Inc., Shiga	294	Production equipment for cartridges and semiconductor
Tokki Corporation, Tokyo and Niigata	187	Vacuum technology-related equipment
SED Inc., Kanagawa	1,106	Flat-screen SED (Surface-conduction Electron-emitter Display) panels

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<b>Name and location</b>	<b>Floor space (including Leased space) (Thousands of square feet)</b>	<b>Principal activities and products manufactured</b>
<b>Overseas</b>		
[Europe]		
Canon Giessen GmbH, Giessen, Germany	362	Copying machines, toner cartridges and semiconductor production equipment
Canon Bretagne S.A.S., Liffre, France	506	Toner cartridges and recycling of toner cartridges
[America]		
Canon Virginia, Inc., Virginia, U.S.	828	Toner and toner cartridges
[Asia]		
Canon Inc., Taiwan, Taiwan	414	Cameras and lenses
Canon Opto (Malaysia) Sdn. Bhd., Selangor, Malaysia	581	Digital cameras, lenses and optical lens parts
Canon Dalian Business Machines, Inc., Dalian, China	1,355	LBPs and toner cartridges
Canon Zhuhai, Inc., Zhuhai, China	661	LBPs and digital cameras
Tianjin Canon Inc., Tianjin, China	148	Copying machines
Canon Hi-Tech Thailand Ltd., Ayutthaya, Thailand	1,309	Inkjet printers
Canon Ayutthaya Thailand Ltd., Ayutthaya, Thailand	182	Circuit boards for inkjet printers
Canon Engineering Thailand Ltd., Ayutthaya, Thailand	129	Metal molds and plastic injection mold parts
Canon Zhougshan Business Machines Co., Ltd., Zhougshan, China	840	LBPs

Canon Vietnam Co., Ltd., Hanoi, Vietnam	2,492	Inkjet printers and LBPs
Canon (Suzhou) Inc., Suzhou, China	771	Copying machines
Canon Finetech (Suzhou) Business Machines Inc. , Suzhou, China	355	Copying machines
Thai Nisca Co.Ltd., Ayutthaya, Thailand	190	Optical equipment and copying machine peripherals
Canon Finetech Nisca (Shenzhen) Inc., Shenzhen, China	217	Copying machines and LBP peripherals

Canon considers its manufacturing and other facilities to be well maintained and believes that its plant capacity is adequate for its current requirements.

**Main facilities under construction for establishment/expansion**

- Canon Precision Inc.: New Production Base (Business Machines Operations)

Location: Hirosaki-shi, Aomori Pref.

\*To be leased to Canon Precision Inc. by the Company

**Item 4A. Unresolved Staff Comments**

Not applicable.

**Table of Contents****Item 5. Operating and Financial Review and Prospects****A. Operating Results**

The following discussion and analysis provides information that management believes to be relevant to understanding Canon's consolidated financial condition and results of operations.

**Overview**

Canon is one of the world's leading manufacturers of copying machines, laser beam printers, inkjet printers, cameras, steppers and aligners. Canon earns revenues primarily from the manufacture and sale of these products domestically and internationally. Canon's basic management policy is to contribute to the prosperity and well-being of the world while endeavoring to become a truly excellent global corporate group targeting continued growth and development.

Canon divides its businesses into three product groups: business machines, cameras, and optical and other products. The business machines product group has three sub-groups: office imaging products, computer peripherals and business information products.

*Economic environment*

Looking back at the global economy in 2007, the U.S. economy proved sluggish in the second half of the year as the fallout from the subprime loan crisis resulted in a decline not only in housing investment, but also in consumer spending. In Europe, the region moved toward moderate recovery as domestic demand expanded in major European countries, boosted by such factors as increased consumer spending owing to continued improvements in the employment environment. Within Asia, the Chinese economy maintained a high growth rate while other economies in the region also enjoyed generally favorable conditions, primarily due to export growth. In Japan, the economy maintained a trend toward recovery, buoyed by an improvement in consumer spending along with increased capital spending fueled by strong corporate earnings.

*Market environment*

As for the markets in which Canon operates, within the camera segment, demand for digital single-lens reflex (SLR) cameras and digital compact cameras continued to realize healthy growth during the year. Within the office imaging products market, demand for network digital multifunction devices (MFDs) remained solid as the office market shifted toward color models in all regions. As for computer peripherals, including printers, demand for laser beam printers continued to grow for both color and monochrome low-end models. Within the inkjet printer market, as the shift in demand from single-function to multifunction machines gained momentum, price competition for multifunction models increased in severity. In the optical equipment segment, while demand for projection aligners, which are used to produce liquid crystal display (LCD) panels, remained at a low level due to restrained investment by LCD manufacturers, demand for steppers, used in the production of semiconductors, remained at approximately the same level as the previous year. The average value of the yen for the year was ¥117.50 to the U.S. dollar and ¥161.41 to the euro, representing a slight year-on-year decrease against the U.S. dollar, and about a 10% decline against the euro.

*Summary of operations*

Amid these conditions, Canon's consolidated net sales in 2007 increased by 7.8% from the year-ago period to ¥4,481.3 billion, resulting from a solid rise in sales of digital cameras, color network MFDs, and laser beam printers, along with the positive effect of favorable currency exchange rates. Income before income taxes and minority interests in 2007 totaled ¥768.4 billion, a year-on-year increase of 6.8%, while net income for the year totaled ¥488.3 billion, both marking all-time highs.

*Key performance indicators*

Following are the key performance indicators (KPIs) that Canon uses in managing its business. The changes from year to year in these KPIs are set forth in the table shown below.

**KEY PERFORMANCE INDICATORS**

	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Net sales (Millions of yen)	¥4,481,346	¥4,156,759	¥3,754,191	¥3,467,853	¥3,198,072
Gross profit to net sales ratio	50.1%	49.6%	48.5%	49.4%	50.3%

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R&D expense to net sales ratio	8.2%	7.4%	7.6%	7.9%	8.1%
Operating profit to net sales ratio	16.9%	17.0%	15.5%	15.7%	14.2%
Inventory turnover within days	44 days	45 days	47 days	49 days	49 days
Debt to total assets ratio	0.6%	0.7%	0.8%	1.1%	3.1%
Stockholders' equity to total assets ratio	64.8%	66.0%	64.4%	61.6%	58.6%

Note: Inventory turnover within days; Inventory divided by net sales for the previous six months, multiplied by 182.5.

-Revenues-

As Canon seeks to become a truly excellent global company, one indicator upon which Canon's management places strong emphasis is revenue. Following are some of the KPIs relating to revenue that management considers to be important.

Net sales is one such KPI. Canon derives net sales primarily from the sale of products and, to a much lesser extent, provision of services relating to its products. Sales vary based on such factors as product demand, the number and size of transactions within the reporting period, product reputation for new products and changes in sales prices. Other factors involved are market share and market environment. In addition, management considers an evaluation of net sales by product group important to assessing Canon's performance in sales in various product groups in light of market trends.

Gross profit ratio (ratio of gross profit to net sales) is another KPI for Canon. Through its reforms in product development, Canon has been striving to shorten product development lead times in order to launch new, competitively priced products at a faster pace. In addition, Canon has achieved cost reductions through efficiency enhancements in its production. Canon believes that these achievements have contributed to improving Canon's gross profit ratio, and Canon intends to continue to pursue further shortening of product development lead times and reductions in production costs.

Operating profit ratio (ratio of operating profit to net sales) and research and development ( R&D ) expense to net sales ratio are considered by Canon to be KPIs. Canon is focusing on two areas for improvement. On the one hand, Canon strives to control and reduce its selling, general and administrative expenses. On the other hand, Canon's R&D policy is designed to maintain a high level of spending in core technology in order to sustain Canon's leading position in its current fields of business, and to explore possibilities in other markets. Canon believes such investments will be the basis for future success in its business and operations.

**Table of Contents****-Cash Flow Management-**

Canon also places significant emphasis on cash flow management. The following are the KPIs relating to cash flow management that management believes to be important.

Inventory turnover within days is a KPI because it is a measure of supply-chain management efficiency. Inventories have inherent risks of becoming obsolete, deteriorating or otherwise decreasing in value significantly, which may adversely affect Canon's operating results. To mitigate these risks, management believes that it is important to continue reducing inventories and shortening production lead times in order to achieve early recovery of related product expenses by strengthening supply-chain management.

Canon's management seeks to meet its liquidity and capital requirements primarily with cash flow from operations. Management also seeks debt-free operations. For a manufacturing company such as Canon, the process for realizing profit on any endeavor can be lengthy, involving as it does R&D, manufacturing, and sales activities. Management, therefore, believes that it is important to have sufficient financial strength so that it does not have to rely on external funding. Canon has continued to reduce its reliance on external funding for capital investments in favor of generating the necessary funds from its own operations.

Stockholders' equity to total assets ratio (ratio of total stockholders' equity to total assets) is another KPI for Canon. Canon believes that stockholders' equity to total asset ratio measures its long-term viability. Canon believes that a high or increasing stockholders' equity ratio usually indicates that Canon has a good, or improving ability to fund debt obligations and other unexpected expenses, which means in the long-term that Canon is better able to maintain a high level of stable investments for its future operations and development. As Canon puts a strong emphasis on its research and development activities, management believes that it is important to maintain a stable financial base and, accordingly, a high level of stockholders' equity to total assets ratio.

**Critical accounting policies and estimates**

The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles and based on the selection and application of significant accounting policies which require management to make significant estimates and assumptions. Canon believes that the following are the more critical judgment areas in the application of its accounting policies that currently affect its financial condition and results of operations.

**Revenue recognition**

Canon generates revenue principally through the sale of consumer products, equipment, supplies, and related services under separate contractual arrangements. Canon recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred and title and risk of loss have been transferred to the customer or services have been rendered, the sales price is fixed or determinable, and collectibility is probable.

Revenue from sales of consumer products including office imaging products, computer peripherals, business information products and cameras is recognized upon shipment or delivery, depending upon when title and risk of loss transfer to the customer.

Revenue from sales of optical equipment, such as steppers and aligners that are sold with customer acceptance provisions related to their functionality, is recognized when the equipment is installed at the customer site and the specific criteria of the equipment functionality are successfully tested and demonstrated by Canon. Service revenue is derived primarily from separately priced product maintenance contracts on equipment sold to customers and is measured at the stated amount of the contract and recognized as services are provided.

Canon also offers separately priced product maintenance contracts for most office imaging products, for which the customer typically pays a stated base service fee plus a variable amount based on usage. Revenue from these service maintenance contracts is measured at the stated amount of the contract and recognized as services are provided and variable amounts are earned.

Revenue from the sale of equipment under sales-type leases is recognized at the inception of the lease. Income on sales-type leases and direct-financing leases is recognized over the life of each respective lease using the interest method. Leases not qualifying as sales-type leases or direct-financing leases are accounted for as operating leases and related revenue is recognized ratably over the lease term. When equipment leases are bundled with product maintenance contracts, revenue is first allocated considering the relative fair value of the lease and non-lease deliverables based upon the estimated relative fair values of each element. Lease deliverables generally include

equipment, financing and executory costs, while non-lease deliverables generally consist of product maintenance contracts and supplies.

For all other arrangements with multiple elements, Canon allocates revenue to each element based on its relative fair value if such element meets the criteria for treatment as a separate unit of accounting as prescribed in the Emerging Issues Task Force ( EITF ) Issue No.00-21, Revenue Arrangements with Multiple Deliverables. Otherwise, revenue is deferred until the undelivered elements are fulfilled and accounted for as a single unit of accounting.

Canon records estimated reductions to sales at the time of sale for sales incentive programs including product discounts, customer promotions and volume-based rebates. Estimated reductions in sales are based upon historical trends and other known factors at the time of sale. In addition, Canon provides price protection to certain resellers of its products, and records reductions to sales for the estimated impact of price protection obligations when announced.

Estimated product warranty costs are recorded at the time revenue is recognized and are included in selling, general and administrative expenses. Estimates for accrued product warranty costs are based on historical experience, and are affected by ongoing product failure rates, specific product class failures outside of the baseline experience, material usage and service delivery costs incurred in correcting a product failure.

#### Allowance for doubtful receivables

Allowance for doubtful receivables is determined using a combination of factors to ensure that Canon's trade and financing receivables are not overstated due to uncollectibility. Canon maintains an allowance for doubtful receivables for all customers based on a variety of factors, including the length of time receivables are past due, trends in overall weighted average risk rating of the total portfolio, macroeconomic conditions, significant one-time events and historical experience. Also, Canon records specific reserves for individual accounts when Canon becomes aware of a customer's inability to meet its financial obligations to Canon, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances related to customers change, estimates of the recoverability of receivables would be further adjusted.

#### Valuation of inventories

Inventories are stated at the lower of cost or market value. Cost is determined principally by the average method for domestic inventories and the first-in, first-out method for overseas inventories. Market value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make a sale. Canon routinely reviews its inventories for their salability and for indications of obsolescence to determine if inventories should be written-down to market value. Judgments and estimates must be made and used in connection with establishing such allowances in any accounting period. In estimating the market value of its inventories, Canon considers the age of the inventories and the likelihood of spoilage or changes in market demand for its inventories.



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### **Property, plant and equipment and accounting change**

Property, plant and equipment are stated at cost. Depreciation is calculated principally by the declining-balance method, except for certain assets which are depreciated by the straight-line method over the estimated useful lives of the assets.

Effective April 1, 2007, the Company and its domestic subsidiaries elected to change the declining-balance method of depreciating machinery and equipment from the fixed-percentage-on-declining base application to the 250% declining-balance application. Estimated residual values were also reduced in conjunction with this change. The Company and its domestic subsidiaries believe that the 250% declining-balance application is preferable because it provides a better matching of the allocation of cost of machinery and equipment with associated revenues in light of increasingly short product life cycles.

### **Environmental liabilities**

Canon is subject to liability for the investigation and clean-up of environmental contamination at each of the properties that Canon owns or operates, as well as at certain properties Canon formerly owned or operated. Canon employs extensive internal environmental protection programs that focus on preventive measures. Canon conducts environmental assessments for a number of its locations and operating facilities. If Canon was to be held responsible for damages in any future litigation or proceedings, such costs may not be covered by insurance and may be material. The liabilities for environmental remediation and other environmental costs are accrued when it is considered probable and costs can be reasonably estimated.

### **Income taxes**

As more fully disclosed in the Notes to Consolidated Financial Statements, Canon adopted FASB Interpretation No.48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No.109, on January 1, 2007. Canon considers many factors when evaluating and estimating income tax uncertainties. These factors include an evaluation of the technical merits of the tax positions as well as the amounts and probabilities of the outcomes that could be realized upon settlement. The actual resolutions of those uncertainties will inevitably differ from those estimates, and such differences may be material to the financial statements.

### **Valuation of deferred tax assets**

Canon currently has significant deferred tax assets, which are subject to periodic recoverability assessments. Realization of Canon's deferred tax assets is principally dependent upon its achievement of projected future taxable income. Canon's judgments regarding future profitability may change due to future market conditions, its ability to continue to successfully execute its operating restructuring activities and other factors. Any changes in these factors may require possible recognition of significant valuation allowances to reduce the net carrying value of these deferred tax asset balances. When Canon determines that certain deferred tax assets may not be recoverable, the amounts which may not be realized are charged to income tax expense and will adversely affect net income.

### **Employee retirement and severance benefit plans**

Canon has significant employee retirement and severance benefit obligations that are recognized based on actuarial valuations. Inherent in these valuations are key assumptions, including discount rates and expected return on plan assets. Management must consider current market conditions, including changes in interest rates, in selecting these assumptions. Other assumptions include assumed rate of increase in compensation levels, mortality rate, and withdrawal rate. Changes in these assumptions inherent in the valuation are reasonably likely to occur from period to period. Actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect future pension expenses. While management believes that the assumptions used are appropriate, the differences may affect employee retirement and severance benefit costs in the future.

In preparing its financial statements for fiscal 2007, Canon estimated a weighted-average discount rate of 2.5% for Japanese plans and 4.5% for foreign plans and a weighted-average expected long-term rate of return on plan assets of 3.9% for Japanese plans and 6.0% for foreign plans. In estimating the discount rate, Canon uses available information about rates of return on high-quality fixed-income governmental and corporate bonds currently available and expected to be available during the period to the maturity of the pension benefits. Canon establishes the expected long-term rate of return on plan assets based on management's expectations of the long-term return of the various plan asset categories in which it invests. Management develops expectations with respect to each plan asset category based on

actual historical returns and its current expectations for future returns.

Decreases in discount rates lead to increases in actuarial pension benefit obligations which, in turn, could lead to an increase in service cost and amortization cost through amortization of actuarial gain or loss, a decrease in interest cost, and vice versa. A decrease of 50 basis points in the discount rate increases the projected benefit obligation by approximately 9%. The net effect of changes in the discount rate, as well as the net effect of other changes in actuarial assumptions and experience, are deferred until subsequent periods, as permitted by the Statement of Financial Accounting Standards ( SFAS ) No. 87, Employers Accounting for Pensions.

Decreases in expected return on plan assets may increase net periodic benefit cost by decreasing expected return amounts, while differences between expected value and actual fair value of those assets could affect pension expense in the following years, and vice versa. For fiscal 2008, if a change of 50 basis points in the expected long-term rate of return on plan assets is to occur, that may cause a change of approximately ¥3,022 million in net periodic benefit cost. Canon multiplies management s expected long-term rate of return on plan assets by the value of its plan assets, to arrive at the expected return on plan assets that is included in pension income (expense). Canon defers recognition of the difference between this expected return on plan assets and the actual return on plan assets. The net deferral affects the value of plan assets in future fiscal years and, ultimately, future pension income (expense).

On December 31, 2006, Canon adopted the recognition and disclosure provisions of SFAS 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) ( SFAS 158 ). SFAS 158 required Canon to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plans in the December 31, 2006 consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income (loss), net of tax.

Effective January 1, 2007, Canon and certain of its domestic subsidiaries have amended their funded defined benefit pension plans, and the projected benefit obligation has decreased by ¥101,620 million, primarily due to the modification of the pattern of future benefit payments. This decrease is amortized as a reduction of net periodic benefit cost over the employee s average remaining service period. The amount is approximately ¥5,834 million per year. In conjunction therewith, Canon and certain of its domestic subsidiaries have implemented an unfunded retirement and severance plan and a defined contribution pension plan for certain future pension benefits attributable to employee s future services.

**Table of Contents****Consolidated result of operations****Fiscal 2007 compared with fiscal 2006**

Summarized results of operations for fiscal 2007 and fiscal 2006 are as follows:

	<b>2007</b>	<b>Change</b>	<b>2006</b>
	<b>(Millions of yen, except per share amounts and percentage data)</b>		
Net sales	¥4,481,346	+ 7.8%	¥4,156,759
Operating profit	756,673	+ 7.0	707,033
Income before income taxes and minority interests	768,388	+ 6.8	719,143
Net income	488,332	+ 7.2	455,325
Net income per share:			
Basic	377.59	+10.4	341.95
Diluted	377.53	+10.4	341.84

Note: See notes to Item 3A Selected Financial Data .

**Sales**

Canon's consolidated net sales in fiscal 2007 totaled ¥4,481,346 million. This represents a 7.8% increase from the previous fiscal year, reflecting solid rises in sales of digital cameras and color network digital MFDs, and laser beam printers, along with the positive effects of the depreciation of the yen.

Overseas operations are significant to Canon's operating results and generated approximately 77% of total net sales in fiscal 2007. Such sales are denominated in the applicable local currency and are subject to fluctuations in the value of the yen in relation to such other currencies. Despite efforts to reduce the impact of currency fluctuations on operating results, including localizing some manufacturing and procuring parts and materials from overseas suppliers, Canon believes such fluctuations have had and will continue to have a significant effect on results of operations.

The average value of the yen in fiscal 2007 was ¥117.50 to the U.S. dollar, and ¥161.41 to the euro, representing a slight decrease against the U.S. dollar, and about 10% decline against the euro, compared with the previous year. The effects of foreign exchange rate fluctuations favorably impacted net sales by approximately ¥125,500 million. This favorable impact was comprised of approximately ¥9,600 million for U.S. dollar denominated sales, ¥104,700 million for euro denominated sales and ¥11,200 million for other foreign currency denominated sales.

**Cost of sales**

Cost of sales principally reflects the cost of raw materials, parts and labor used by Canon in the manufacture of its products. A portion of the raw materials used by Canon is imported or includes imported materials. Such raw materials are subject to fluctuations in world market prices and exchange rates that may affect Canon's cost of sales. Other components of cost of sales include depreciation expenses from plants, maintenance expenses, light and fuel expenses and rent expenses. The ratio of cost of sales to net sales for fiscal 2007, 2006 and 2005 was 49.9%, 50.4% and 51.5%, respectively.

**Gross profit**

Canon's gross profit in fiscal 2007 increased by 9.1% to ¥2,246,981 million from fiscal 2006. The gross profit ratio improved 0.5 points year on year to reach 50.1%. The improved gross profit ratio was mainly the result of such factors as the launch of new products and the in-house manufacturing of key components and key devices, in addition to cost-reduction efforts realized through ongoing production-reform and procurement-reform activities, which absorbed the negative effects of escalating raw materials cost and severe price competition in the consumer product market.

**Operating expenses**

The major components of operating expenses are payroll, R&D, advertising expenses and other marketing expenses. Although the growth in selling, general and administrative expenses which increased 7.4% year on year remained less than revenue growth, R&D expenditures grew by 19.4% from the year-ago period to ¥368,261 million due to active R&D investment, resulting in an increase in the operating expense to net sales ratio of 0.6 points year on year to 33.2%.

*Operating profit*

Operating profit in fiscal 2007 increased by 7.0% to ¥756,673 million from fiscal 2006. Operating profit in fiscal 2007 was 16.9% of net sales.

The company and its domestic subsidiaries implemented a change in the accounting method used to calculate depreciation of fixed assets at the start of the second quarter of the year, which resulted in an increase of depreciation expense by ¥63,773 million compared with the previously used method.

*Other income (deductions)*

Other income (deductions) for fiscal 2007 stayed at almost the same level as the previous year. Although interest and dividend income increased by ¥5,666 million, the foreign currency exchange loss offset it by ¥6,139 million.

*Income before income taxes and minority interests*

Income before income taxes and minority interests in fiscal 2007 was ¥768,388 million, a 6.8% increase from fiscal 2006, and constituted 17.1% of net sales.

*Income taxes*

Provision for income taxes in fiscal 2007 increased by ¥16,025 million from fiscal 2006, primarily as a result of the increase in income before income taxes and minority interests. The effective tax rate during fiscal 2007 declined by 0.1% compared with fiscal 2006.

*Net income*

As a result of the factors offerings above, net income in fiscal 2007 increased by 7.2% to ¥488,332 million, which represents a 10.9% return on net sales.

Product information

Canon divides its businesses into three product groups: business machines, cameras and optical and other products.

**The business machines product group** includes office imaging products, computer peripherals and business information products.

Office imaging products include mainly office network digital MFDs, color network digital MFDs, office copying machines, personal-use copying machines and full-color copying machines.

Computer peripherals include mainly laser beam printers, inkjet multifunction peripherals, single function inkjet printers and image scanners.

Business information products include mainly computer information systems, document scanners and personal information products.

**The cameras product group** includes mainly digital single lens reflex ( SLR ) cameras, digital compact cameras, interchangeable lenses and digital video camcorders.

**The optical and other products product group** includes mainly semiconductor production equipment, mirror projection mask aligners for LCD panels, broadcasting equipment, medical equipment, large format printers and related components.

**Table of Contents****Sales by product**

Canon's sales by product group are summarized as follows:

	<b>2007</b>	<b>Change</b>	<b>2006</b>
	<b>(Millions of yen, except percentage data)</b>		
Business machines:			
Office imaging products	¥ 1,290,788	+ 8.8%	¥ 1,185,925
Computer peripherals	1,537,511	+ 9.9	1,398,408
Business information products	107,243	+ 0.5	106,754
 Total business machines	 2,935,542	 + 9.1	 2,691,087
 Cameras	 1,152,663	 +10.6	 1,041,865
Optical and other products	393,141	- 7.2	423,807
 Total	 ¥ 4,481,346	 + 7.8%	 ¥ 4,156,759

Sales of business machines, constituting 65.5% of consolidated net sales, increased 9.1%, to ¥2,935,542 million in fiscal 2007.

Sales of office imaging products increased 8.8% in fiscal 2007, to ¥1,290,788 million. In the business machine segment, as demand for network digital MFDs shifted toward color models in both the domestic Japanese and overseas markets, the competitively priced iR C2880 series and the high-end iR C5185 series continued to enjoy strong sales. Among monochrome network digital MFDs, the iR5055 series and the new energy-saving iR3025 series contributed to expanded sales. Additionally, Canon marked its entry into the commercial print market with the launch of the new imagePRESS C7000VP. Color office imaging products accounted for 35% and 31% and monochrome office imaging products accounted for 45% and 49% of office imaging products sales in fiscal 2007 and 2006, respectively. Sales of facsimiles and information system business accounted for 20% of sales of office imaging products in both fiscal 2007 and 2006.

Sales of computer peripherals increased 9.9% in fiscal 2007 to ¥1,537,511 million. Laser beam printers enjoyed a year-on-year increase of over 20% in unit sales, with strong demand for both color and monochrome low-end models, and consumables also growing favorably, resulting in an increase of 10.5% in sales in value terms. As for inkjet printers, despite a continuing decline in unit sales for single-function models and severe price competition in the market, sales in value terms increased by 9.2% in 2007, boosted by such factors as increased unit sales of multifunction models, including the PIXMA MP600/610, and healthy sales growth for consumables.

Sales of business information products increased 0.5%, to ¥107,243 million in fiscal 2007.

Sales of cameras continued to achieve growth of 10.6% in fiscal 2007, totaling ¥1,152,663 million. The growth was fueled by demand for digital SLR cameras, with particularly strong sales for the compact, lightweight-body EOS DIGITAL REBEL XT<sub>i</sub> and the advanced-amateur-model EOS 30D/40D which, in turn, led to expanded sales of interchangeable lenses for SLR cameras. As for compact digital cameras, Canon strengthened its lineup with the launch of 16 new models—5 stylish ELPH-series models and 11 PowerShot-series models—catering to a diverse range of shooting styles. As a result, unit sales of digital cameras for 2007 increased by approximately 17% from the year-ago period. In the field of digital video camcorders, the launch of consumer-market HDV models equipped with Canon HD CMOS sensors contributed to expanded sales, filling out Canon's digital camcorder lineup along with MiniDV, DVD and hard disk models. Sales of cameras constituted 25.7% of consolidated net sales in fiscal 2007.

Sales of optical and other products decreased 7.2% in fiscal 2007, to ¥393,141 million. In the optical and other products segment, sales of aligners, used to produce LCD panels, decreased amid reduced market demand due to restrained investment by LCD manufacturers, and sales of steppers, used in the production of semiconductors, also declined slightly. Sales of optical and other products constituted 8.8% of consolidated net sales in fiscal 2007.

**Sales by region**

A summary of net sales by region in fiscal 2007 and fiscal 2006 is provided below:

	<b>2007</b>	<b>Change</b>	<b>2006</b>
	<b>(Millions of yen, except percentage data)</b>		
Japan	¥ 947,587	+ 1.6%	¥ 932,290
Americas	1,336,168	+ 4.1	1,283,646
Europe	1,499,286	+14.1	1,314,305
Others	698,305	+11.5	626,518
<b>Total</b>	<b>¥4,481,346</b>	<b>+ 7.8%</b>	<b>¥4,156,759</b>

Note: This summary of net sales by region of destination is determined by the location of the customer.

A geographical analysis indicates that net sales in fiscal 2007 increased in every region.

In Japan, sales of office imaging products increased by 6.8% in fiscal 2007 due to the growth of color network digital MFDs and cameras also achieved sales growth of 7.4% due to strong demand for digital SLR cameras. Sales of optical and other products decreased by 6.8% due to a reduced demand for steppers. As a result, net sales in this region increased by 1.6% in fiscal 2007 from fiscal 2006.

In the Americas, net sales increased by 3.1% on a local currency basis in fiscal 2007, mainly due to increased sales of digital cameras and color network digital MFDs. Sales of digital cameras experienced continued strong demand and benefited from the effect of newly-launched products such as the EOS 40D, advanced-amateur-model, and the EOS DIGITAL REBEL XTi. On a yen basis, net sales in the Americas increased by 4.1% in fiscal 2007.

In Europe, net sales increased by 5.3% on a local currency basis in fiscal 2007, mainly due to increased sales of laser beam printers, color network digital MFDs and digital cameras. On a yen basis, after accounting for the depreciation of the yen against the euro, net sales in Europe grew 14.1% in fiscal 2007.

Sales in other areas increased by 11.5% on a yen basis in fiscal 2007, reflecting overall sales growth, particularly in digital cameras and laser beam printers.

#### ***Operating profit by product***

Operating profit for business machines in fiscal 2007 increased by ¥51,032 million to ¥650,261 million. This increase resulted primarily from sales growth and cost reduction efforts.

Operating profit for cameras in fiscal 2007 increased by ¥38,688 million to ¥307,426 million. The suppression of price declines through the launch of new products and continued cost reduction efforts realized through ongoing production reform and procurement boosted the operating profit of this segment.

Operating profit for optical and other products in fiscal 2007 decreased by ¥20,395 million to ¥21,080 million mainly due to a decline in the sales volume of aligners and steppers.

**Table of Contents****Fiscal 2006 compared with fiscal 2005**

Summarized results of operations for fiscal 2006 and fiscal 2005 are as follows:

	<b>2006</b>	<b>Change</b>	<b>2005</b>
	<b>(Millions of yen, except per share amounts and percentage data)</b>		
Net sales	¥4,156,759	+10.7%	¥3,754,191
Operating profit	707,033	+21.3	583,043
Income before income taxes and minority interests	719,143	+17.5	612,004
Net income	455,325	+18.5	384,096
Net income per share:			
Basic	341.95	+18.5	288.63
Diluted	341.84	+18.5	288.36

Note: See notes to Item 3A Selected Financial Data .

*Sales*

Canon's consolidated net sales in fiscal 2006 totaled ¥4,156,759 million. This represents a 10.7% increase from the previous fiscal year, reflecting solid rises in sales of digital cameras and color network digital MFDs, and laser beam printers, along with the positive effects of the depreciation of the yen.

Overseas operations are significant to Canon's operating results and generated approximately 75% of total net sales in fiscal 2006. Such sales are denominated in the applicable local currency and are subject to fluctuations in the value of the yen in relation to such other currencies. Despite efforts to reduce the impact of currency fluctuations on operating results, including localizing some manufacturing and procuring parts and materials from overseas suppliers, Canon believes such fluctuations have had and will continue to have a significant effect on results of operations.

The average value of the yen in fiscal 2006 was ¥116.43 to the U.S. dollar, and ¥146.51 to the euro, representing depreciation of about 5% against the U.S. dollar, and 7% against the euro, compared with the previous year. The effects of foreign exchange rate fluctuations favorably impacted net sales by approximately ¥138,700 million. This favorable impact was comprised of approximately ¥67,800 million for U.S. dollar denominated sales, ¥65,900 million for euro-denominated sales and ¥5,000 million for other foreign currency-denominated sales.

*Cost of sales*

Cost of sales principally reflects the cost of raw materials, parts and labor used by Canon in the manufacture of its products. A portion of the raw materials used by Canon is imported or includes imported materials. Such raw materials are subject to fluctuations in world market prices and exchange rates that may affect Canon's cost of sales. Other components of cost of sales include depreciation expenses from plants, maintenance expenses, light and fuel expenses and rent expenses. The ratio of cost of sales to net sales for fiscal 2006, 2005 and 2004 was 50.4%, 51.5% and 50.6%, respectively.

*Gross profit*

Canon's gross profit in fiscal 2006 increased by 13.3% to ¥2,060,480 million from fiscal 2005. The gross profit ratio improved 1.1 points year on year to reach 49.6%. The improved gross profit ratio was mainly the result of such factors as the introduction of automated production lines, and the in-house manufacturing of key components and key devices, in addition to cost-reduction efforts realized through ongoing production-reform and procurement-reform activities, which absorbed the negative effects of severe price competition in the consumer product market.

*Operating expenses*

The major components of operating expenses are payroll, R&D, advertising expenses and other marketing expenses. Although R&D expenditures grew 7.6% in fiscal 2006 from the previous year to ¥308,307 million, the operating expenses to net sales ratio improved 0.4 points. This was achieved by limiting growth in selling, general and administrative expenses, with the exception of a temporary increase in expenses related to the relocation of operation bases, below the growth rate for net sales. In general, Canon maintains a high level of R&D expenditure to strengthen its R&D capabilities. R&D expenditures grew in fiscal 2006 from the previous year, resulting from increased R&D

activities.

*Operating profit*

Operating profit in fiscal 2006 increased by 21.3% to ¥707,033 million from fiscal 2005. Operating profit in fiscal 2006 was 17.0% of net sales, compared with 15.5% in fiscal 2005.

*Other income (deductions)*

Other income (deductions) for fiscal 2006 declined ¥16,851 million, attributable to an increase of currency exchange losses and a decrease in gains on sales of securities, although interest income grew in line with the rise in the interest rate.

*Income before income taxes and minority interests*

Income before income taxes and minority interests in fiscal 2006 was ¥719,143 million, a 17.5% increase from fiscal 2005, and constituted 17.3% of net sales.

*Income taxes*

Provision for income taxes increased by ¥35,448 million from fiscal 2005, primarily as a result of the increase in income before income taxes and minority interests. The effective tax rate during fiscal 2006 declined by 0.3% compared with fiscal 2005.

*Net income*

As a result of the factors offering above, net income in fiscal 2006 increased by 18.5% to ¥455,325 million, which exceeds the growth rate of income before income taxes and minority interests. This represents an 11.0% return on net sales.



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*Product information*

Canon divides its businesses into three product groups: business machines, cameras and optical and other products.

**The business machines product group** includes office imaging products, computer peripherals and business information products.

Office imaging products include office network digital MFDs, color network digital MFDs, office copying machines, personal-use copying machines and full-color copying machines.

Computer peripherals include laser beam printers, single function inkjet printers, inkjet multifunction peripherals and image scanners.

Business information products include micrographic equipment, personal computers and calculators.

**The cameras product group** includes single lens reflex (&