

YUHOREPORT

AXELL CORPORATION

Fiscal Year Ended	March 31, 2005
Traded	JASDAQ
Stock Code	6730

This report is based on the Company’s Japanese-language annual filing with the Financial Services Agency and supplemented with materials that facilitate comparison with the Company’s peers. The materials from the annual filing with the Financial Services Agency have been edited and reorganized in a format more familiar to the international investment community. All information contained in this report has been obtained from sources believed to be reliable, but the accuracy of the data and the translation, completeness, or timeliness of the information are not warranted by the Company, Pacific Associates, or Asia Securities Printing. None of the above parties shall be responsible for any error or omission or for results obtained from the use of this information.

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Company Profile

Financial highlights

Years ended March 31; Millions of yen	2001	2002	2003	2004	2005	Change 2005/2001
Nonconsolidated						
Net sales	1,107	1,984	3,256	5,391	7,345	664%
Ordinary profit	411	757	1,216	2,375	3,273	796%
Net income	239	459	663	1,425	2,063	863%
Equity income assuming application of equity method	-	-	-	-	-	
Common stock	640	722	947	953	971	152%
Shares outstanding	4,815	14,445	15,445	30,966	62,363	1,295%
Shareholders' equity	1,410	1,857	2,949	4,219	5,981	424%
Total assets	1,723	2,289	3,496	5,426	7,255	421%
Shareholders' equity per share (Yen)	292,933.96	128,603.12	189,835.44	135,535.34	95,368.52	33%
Dividends per share (Yen)	Old shares 5,000.00 New shares (1st issuance) 232.88 New shares (2nd issuance) 54.80	8,000.00	11,700.00	10,000.00	8,500.00	
Net income per share (Yen)	94,692.34	31,780.78	43,792.23	45,380.57	32,607.20	34%
Net income per share, fully diluted (Yen)	-	-	43,228.45	44,296.14	31,878.77	
Dividend payout ratio (%)	5.2	25.1	27.2	22.0	26.1	
Net cash provided by (used in) operating activities	268	525	910	1,659	1,915	
Net cash provided by (used in) investing activities	(220)	(53)	(88)	(226)	(41)	
Net cash provided by (used in) financing activities	1,008	(47)	423	(173)	(279)	
Cash and cash equivalents at end of term	1,162	1,586	2,832	4,091	5,685	489%
Employees	8	13	17	24	34	425%

Dividends per share for the year ended March 2003 included a 2,700 yen payout commemorating the Company's listing on the JASDAQ.

To date the Company has split its stock three times, the first time at a 3-to-1 ratio with a recording date of August 20, 2001, the second time at a 2-to-1 ratio with a recording date of May 20, 2003 and the third time at a 2-to-1 ratio with a recording date of May 20, 2004. Calculations of earnings per share and diluted earnings per share for the fiscal years ended March 2002, March 2004 and March 2005 assumed that the respective splits occurred at the beginning of those years.

Common size statements

Years ended March 31; Percent	Nonconsolidated		
	2003	2004	2005
Balance sheet			
Assets	100.0	100.0	100.0
Current assets	92.0	92.0	94.2
Tangible fixed assets	2.5	2.2	1.4
Intangible fixed assets	0.8	1.0	1.3
Investments and other assets	4.7	4.8	3.1
Total fixed assets	8.0	8.0	5.8
Liabilities and shareholders' equity	100.0	100.0	100.0
Current liabilities	15.6	22.1	17.5
Long-term liabilities	-	0.1	0.1
Total liabilities	15.6	22.2	17.6
Common stock	27.1	17.6	13.4
Capital reserves	22.6	14.7	11.2
Retained earnings	34.7	44.9	57.5
Unrealized gains or losses on other securities	(0.0)	0.6	0.3
Total shareholders' equity	84.4	77.8	82.4
Statement of income			
Net sales	100.0	100.0	100.0
Cost of sales	37.2	35.5	32.2
Gross profit on sales	62.8	64.5	67.8
Selling, general and administrative expenses	24.9	20.3	23.2
Operating income	37.9	44.2	44.6
Nonoperating income	0.1	0.0	0.1
Nonoperating expenses	0.6	0.1	0.1
Ordinary profit	37.4	44.1	44.6
Extraordinary income	-	-	0.1
Extraordinary losses	2.3	0.1	0.1
Income (loss) before taxes and other adjustments	35.1	44.0	44.6
	14.7	17.5	16.5
Net income	20.4	26.5	28.1

Business Overview

Description of business

(1) Outline of business

The Company is an R&D-oriented fabless semiconductor company whose primary business is the development and sale of graphics and sound LSIs. In the area of graphics LSIs, the Company provides products that respond to a wide variety of customer needs by developing and selling both application-specific standard products (ASSPs), such as its AG-1, AG-2 and AG-9 series, and application-specific integrated circuits (ASICs). Particularly in the area of graphics displays, the Company has adopted a development concept in which the graphics rendering capability is located within the LSI itself, rather than in the CPU (note). Using this approach, the Company is developing products that enable extremely fine, high-resolution graphics rendering systems to be built into devices. In the area of sound LSIs for the amusement market, the Company completed development of its AS-2 Series in September 2004, extending its advances in compression/decompression technology for sound generator data.

“CPU” is an abbreviation for “central processing unit.”

ASSPs

The Company develops and sells ASSPs, which offer specified functions and performance for specific devices and are sold to more than one customer. The focus of its research and development in this area is graphics and sound generation. The Company's current range of products includes the AG-1 and AG-2 graphics LSIs, primarily for the amusement market, and the AG901 graphic LSI for IT, FA, measurement and medical equipment-related applications; it also includes the AG902 graphic LSI, which is incorporated into in-vehicle systems, point-of-purchase terminals, surveillance and security equipment, and graphics recorders. The AS201 sound LSI for amusement devices is another major product. The AG-2 graphic LSI is currently the Company's top-selling product. While offering a variety of graphics rendering functions such as enlarge, shrink, rotate, translucence, etc., the AG-2 contains a decompression engine for moving image data, which makes it particularly suitable for use in pachinko and pachinko slot LCDs (note 1). For this reason, the number of customers who are adopting the AG-2 is increasing. With the development of the AG-2, the Company has increased the chip's overall performance capabilities for moving images by a factor of four compared to its earlier mainstay product, the AG-1 (and by approximately 50 times

in terms of compression/decompression capabilities). This added performance enables the AG-2 to provide a 100-million-dot per second graphics rendering capability for SVGA graphics display units (note 2). This product incorporates the new RM1 compression/decompression technology for moving images, which provides exceptionally good picture quality and high compression ratios for moving images. It is being sold as a graphics LSI to the amusement market.

The AG902, which was launched in August 2004, incorporates the Company's proprietary RS1 compression/decompression technology for still images. This new graphic LSI will enable high-definition graphics rendering in SXGA-size resolution (note 3) for ordinary built-in systems. The AG902's functions make it suitable for use in a wide variety of devices, such as in-vehicle systems, point-of-purchase terminals, surveillance and security equipment, and graphics recorders. The Company is selling the AG902 along with the AG901 in its efforts to develop new markets for these technologies.

The Company finished work on its new sound LSI, the AS201, in September 2004, incorporating significant changes in compression/decompression technology. It is currently conducting a marketing program with the aim of beginning mass production and large-volume sales for this new product in the fiscal year ending March 2006.

1. "LCD" is abbreviation for "liquid crystal display."
2. "SVGA" is abbreviation for "super video graphics array" and denotes 800 X 600 dot resolution.
3. "SXGA" is an abbreviation for "super extended graphics array" and denotes 1280 X 1024 dot resolution.

ASICs

The Company develops and sells ASICs, which are customized LSIs offering specified functions and performance for specific devices. Its primary focus is on the graphics segment, where the Company is developing system LSIs that meet customers' needs by integrating its expertise in advanced LSI design with its knowledge of systems development. The Company's current product lineup includes graphics LSIs for liquid crystal displays in pachinko machines, for arcade game machines, and for factory automation equipment.

(2) Characteristics of the Company

The Company's key characteristic is summarized by the phrase "R&D-oriented fabless semiconductor company." In terms of LSI manufacturing processes, this means that the Company involved in so-called "upstream" processes, which range

from planning to design. Outsourcing the actual manufacturing enables the Company to operate without being burdened by the substantial capital investment required to acquire and maintain manufacturing equipment. To be fabless, however, a company must possess an R&D capability which is differentiated from others in terms of LSI design. It is this kind of R&D capability that is the Company's most notable characteristic.

A second characteristic of the Company is its product planning and marketing capabilities, which enable it to translate its strengths in R&D into specific products.

But the Company's services go beyond providing customers with manufactured products. They also include an emphasis on developing and providing products to support customers' program development environments, including development support software and development and evaluation boards. This focus on program development environments is a third characteristic of the Company. The Company is seeking to expand its business through an organic fusion of these characteristics that will enable it to develop original products that stand out from other products in the market.

(3) Sales methods

The Company's basic sales policy is to use sales agents (Midoriya Electric Co., Ltd., Internix Incorporated and Okaya Electronics Corp.). Since the Company is basically an order-made product manufacturer, the sales agents gather all necessary information concerning required quantities and delivery dates and provide the inventory and distribution functions necessary to get the products to the customer. The relationship between the Company and its sales agents is a close one, which is not limited to selling. It includes cooperation in collecting and analyzing information on important customer needs, which is then incorporated into improvements in both new products and existing products.

(4) Manufacturing

As a fabless semiconductor firm, the Company specializes in design operations and outsources all of its manufacturing. The relationships between the Company and those to whom it delegates the manufacturing are consequently critical to the success of its LSI business. The Company maintains excellent relationships in this respect with Fujitsu Limited and Rohm Co., Ltd., both of which take steps to ensure the availability of the necessary manufacturing capacity.

History

Year	Month	Event
1996	February	Capitalized at 99 million yen, AXELL CORPORATION (headquartered in Nakano-ku, Tokyo) is established to develop and sell system LSIs.
	April	Commissioned to develop customized graphics LSI (ASIC) for use in amusement-related applications.
	December	Commissioned to develop customized high-speed graphics LSI (ASIC) for factory-automation systems.
1997	May	Commissioned to develop customized image-processing LSI (ASIC).
1998	January	Enters into sales agency agreement with electronics distributor, Internix Incorporated.
	April	Enters into sales agency agreement with electronics distributor, Midoriya Electric Co., Ltd. Commissioned to develop customized graphics LSI (ASIC) with built-in, high-speed JPEG decoder for use in amusement-related applications.
	July	Begins selling the AG-1 series graphics LSI, the Company's first LSI for a specific application area (ASSP).
	September	Begins selling the AS-1 series sound LSI for a specific application area (ASSP).
1999	November	Begins selling the AX51102 graphics LSI, AG-1 series for a specific application area (ASSP).
2000	April	Begins development of RM1 graphics compression/decompression technology.
	August	Commissioned to develop customized high-resolution graphics LSI (ASIC) for amusement-related applications.
2001	January	Corporate headquarters moved to 4-8-13, Iidabashi, Chiyoda-ku, Tokyo.
	May	Enters into sales agency agreement with electronics distributor Okaya Electronics Corp.
2002	January	Begins selling AS-1 series sound LSI for a specific application area (ASSP).
	June	Begins selling AG-2 series graphics LSI with built-in RM1 compression/decompression technology (ASSP).
	December	Registers shares for over-the-counter trading with the Japan Securities Dealers Association.
2003	March	Begins selling AG-9 series (AG901) graphics LSI for information technology, factory automation, measurement, and medical equipment applications (ASSP).
	June	Begins collaboration with Access Co., Ltd. in the area of advanced image processing for embedded devices. Adopts MiSPO Co., Ltd.'s NORTi as a development environment for the AG901 graphics LSI.
	November	Enters into agreement with Aval Data Corporation for joint development of a systems solutions business.
2004	August	Begins selling the AG-9 series (AG902) graphic LSI, which is designed to be incorporated into in-vehicle systems with built-in RS1 (see note below) technology, point-of-purchase terminals, surveillance and security equipment, and graphic recorders.
	September	Begins selling the AS-2 series (AS201) sound LSI (ASSP).
	October	Completes development of RS2 technology (see note below).
	December	With reorganization of the Nasdaq OTC market into Nasdaq Securities Exchange, Inc., the Company lists shares on Nasdaq Securities Exchange Inc. after canceling its shares registration for over-the-counter trading with the Japan Securities Dealers Association, which had been operating the Nasdaq OTC market through Nasdaq Market, Inc.

"LSI" is an abbreviation for "Large Scale Integrated Circuit."

"ASIC" is an abbreviation for "Application Specific Integrated Circuit." ASICs are designed and manufactured for the applications and uses of specific customers and are sold only to these customers.

"FA" is an abbreviation for "factory automation," a term that encompasses automated systems used in factories and other facilities.

Although the Company began selling its products through Midoriya Electric Co., Ltd. in April 1998, a sales agency agreement with Midoriya Electric was formally entered into in December 2000.

"JPEG" is an abbreviation for the "Joint Photographic Experts Group." The JPEG format refers to compression methods for full-color and gray-scale still images prescribed by the ITU-TS (International Telecommunications Union) and the ISO (International Organization for Standardization). "Decoder" refers to the software and hardware required to return compressed data to its original form.

"ASSP" is an abbreviation for "Application Specific Standard Product." While ASSPs are designed and manufactured for specific applications and uses, they are sold to multiple customers.

"RM1" is an abbreviation for RAPIC Movie Compression Version 1, a proprietary compression/decompression technology developed by the Company for moving pictures. "RAPIC" is also a registered trademark and the name used by the Company to refer to all of its proprietary compression/decompression technology.

"RS1" is an abbreviation for RAPIC Still Image Compression Version 1. It is a name used to refer to the Company's proprietary compression/decompression technology for still images.

"RS2" is an abbreviation for RAPIC Still Image Compression Version 2. It refers to proprietary compression/decompression technology for still images, which meets JPEG 2000 standards.

Risk factors

(1) Singularities of management policy

The Company has recorded net income for the past five years and paid dividends for each of those years. For the year under review, it posted net income of 32,607 yen per share and paid dividends of 8,500 yen per share. In determining dividends, the Company takes into consideration a number of factors; Based on the amount paid out in the previous year, it considers the increase of unappropriated profits from the previous to the latest year, the amount increase necessary to grow retained earnings, and the dividend payout ratio, which it intends to increase to 30% within the next few years. Since it began paying dividends, the Company has increased its amount for five consecutive years. Future decisions on dividends could, however, be affected by financial and management-related demands resulting from economic conditions, R&D activities, a need to increase retained earnings, or other factors.

(2) Anomalous changes in financial conditions and operating results

1) Nature of the Company's business

The Company's business is centered on the manufacture and sales of ASSPs, which have enabled it to recognize a string of record-high sales and ordinary profit continuously since March 2000. However, the ASSPs could fail to meet the needs of the Company's customers or markets due to competition, in which case the Company's financial performance could be severely affected.

2) Market size

The Company needs to estimate market size for amusement-related applications, its principal market, in order to calculate the sales of the current fiscal year and sales forecast of the following fiscal year. Estimates of market size are produced internally; the Company arrives at the figures by analyzing publicly available information, to which it adds other data it obtains from the same market. Were the size of the amusement market to contract unexpectedly, however, it would have a material impact on the Company's financial performance.

3) Competition

The Company currently commands an approximately 50% share of the graphics LSI segment of the amusement market. Besides the Company's ASSPs and ASICs, customers in this market use ASICs provided by other semiconductor companies and LSIs that have been converted to amusement-related uses from their original uses in 3D game consoles. Although the Company will seek to differentiate itself through the development of products that respond to the needs of its customers and its markets, other semiconductor manufacturers could develop products that are superior in performance, or the Company's products might face significant price competition. Any of these developments could seriously impact the Company's financial performance.

4) Liability for defect warranties

To date, the Company has never had to assume any liability for defect warranties on its products. For this reason, it has not been realistic from an accounting standpoint to recognize provisions for this eventuality. To deal with this issue, the Company has enhanced its internal reserves by transferring funds from its unappropriated profits as of term end to the retained earnings account. If such a liability should arise and exceed the reserved amount, however, and if such liability could not be covered by retained earnings carried forward, the Company's financial performance would be seriously impacted.

(3) Matters related to the Company's organization

1) Building organizational foundations

Today the Company is run by an eight-person management team, which includes five directors and three external auditors. It is not an organization that depends solely on President and Representative Director Yuzuru Sasaki. That being said, however, Mr. Sasaki has been Chief Executive Officer of the Company since its founding and has played a vital role in building its organization, drawing on his experience in management and new business start-ups at Aval Data Corporation and Nippon Steel Corporation. Therefore, if Mr. Sasaki should suddenly leave the Company, it could have a material impact on the Company's financial performance.

2) Adequacy of management structure for the Company size

The Company's small size, comprising 8 directors and 34 employees, allows it to function properly under its current management structure. As evidenced by last year's addition of 10 employees, however, the Company is gradually

growing in size. The Company's management systems must respond effectively to this growth. Any failure to deal appropriately with increases in personnel and expansions in the size of the business could constrain future business development and exert a significant impact on the Company's financial performance.

3) Limited sales organization size

As of the end of the fiscal year, the Company's sales group comprised five persons, including temporary staff hired from agencies. This was an increase of two employees over the previous year. The Company's ability to operate with a relatively small number of sales personnel relates primarily to its use of sales agents, with whom it maintains close collaborative ties. As a rule, sales of the Company's products are made through sales agents, whose activities encompass not only sales but also marketing and gathering of information on market needs. It may become necessary to increase the number of personnel involved in sales, however, if business expands in response to a growing market, necessitating a larger product offering. Failure to meet the personnel needs identified in its business plans could exert a significant impact on the Company's financial performance.

(4) Research and development

1) Recruitment of R&D personnel

The Company relies for its design and development work on the abilities and experience of its design engineers. It thus recognizes that ongoing recruitment of talented and experienced professionals is an important issue for management. It expects recruitment to remain an uphill battle, however, given the scarcity of talented engineers in the fields of graphics-related technologies (algorithms and architecture of image-processing, graphics compression/decompression and other technologies) and system LSI design, and the intensifying competition in the industry for such personnel. If the Company should fail to hire adequately, or if currently employed engineers were lost to other companies, therefore, it could have a significant impact on the Company's financial performance.

1. *"Algorithm" refers to methods and procedures required to solve problems.*

2. *"Architecture" refers to design approaches or structures of computers or systems in general.*

2) Growing R&D expenditures

As an R&D-oriented fabless semiconductor company, AXELL CORPORATION is engaged in the development of LSIs based on

medium-to-long-term product strategies. At the present time, the development of a single LSI can cost between several tens of millions of yen and several hundreds of millions of yen. Hence, as the Company expands the range of its operations in the future, the turn-around time for product development and R&D personnel hiring trends could lead to increases in R&D expenditures, which could, in turn, impact its financial performance.

3) Technical trends

Advances in semiconductor technology are enhancing the performance of ASSPs and ASICs (in terms of level of integration, speed, functionality and number of pins). This trend is particularly noticeable in the area of graphics LSIs, where the Company expects embedded peripheral functions (communications, signal processing, codes, sound generation, etc.) to increase in diversity and capabilities. Meeting these challenges will require it to build and maintain excellence in its technical development capabilities and to provide the latest in design environments. It will also be important in terms of its lead in the industry to achieve timely development of new architectures and algorithms.

To remain competitive, the Company is steering R & D into proprietary areas such as the development of graphics rendering and graphics compression/decompression technologies. The Company is also actively pursuing opportunities to engage in collaborative research with universities. This approach has proven effective as a means not only of achieving specific research results but also of recruiting talented research personnel due to the student internships and other arrangements that are a part of such collaboration. The Company also foresees a need to bring in high-caliber graphics-related technologies from the outside, including technologies that supplement internal technologies—and to consider alliances or other arrangements with companies that possess technologies that are potentially beneficial to AXELL CORPORATION's businesses. If the Company falls behind in technological development, on the other hand, or if it is slow to bring in effective technologies from other companies, this could exert a significant impact on its financial performance.

(5) Manufacturing and sales systems

1) Outsourcing

As a fabless semiconductor company, AXELL CORPORATION outsources its manufacturing. The process of outsourcing is therefore crucial to the success of its LSI business. The Company recognizes the importance of establishing the

best possible manufacturing arrangements, which entails building and maintaining good relationships with outside manufacturing concerns. Its current manufacturing relationships are excellent, and it has secured all necessary production capacity. There is no guarantee, however, that if problems should arise hereafter—if, for instance, the Company was unable to secure sufficient production capacity from its outsourcing partners, mechanical problems occurred in its partners' manufacturing equipment, or outsourcing agreements were terminated for some reason—it would be able to find replacements in a timely manner under acceptable conditions. In such event, the Company's financial performance would be seriously affected.

2) The build-to-order system

As a rule, all the Company's proprietary ASSP and ASIC manufacturing is done on a build-to-order basis. This exposes the Company to the impact of changes in sales plans, production plans, and sales performance by its principal final customers, which could result in higher or lower unit sales, delays in the timing of sales, and other issues that affect the Company's financial performance.

3) Sales organization

The Company operates with an eye to efficiency, using a small number of employees. This is reflected in its policy regarding sales, under which it eschews direct sales to customers in favor of arrangements with three companies that function as its sales agents: Midoriya Electric Co., Ltd.; Internix Incorporated; and Okaya Electronics Corp. This collaboration enables the Company to take advantage of these companies' existing information resources and sales networks to engage in both sales and marketing activities. As the Company expands its business hereafter, it will be important to strengthen this already successful sales organization, responding at the same time to future needs for sales agency agreements with other trading companies. Failure by the Company to act expeditiously in this respect could exert a major impact on its financial performance.

(6) Future directions of the business

1) Efforts to create new markets

The Company launched the first of its AG-9 series of products, the AG901 graphic LSI, in the fiscal year ended March 2003. This was followed in August 2004 by the release of the AG902, which features its proprietary compression/decompression technology for still images. Previously, the Company manufactured and sold the AG-1 and AG-2 series of LSIs to the amusement market. Since the year ended March 2004, AXELL CORPORATION has engaged in activity aimed at creating markets for graphics LSIs in a variety of other areas, including IT, FA, measuring instruments, medical equipment, in-vehicle displays, POP terminals, surveillance and security equipment, and graphic recorders. Should these markets turn out to be disappointingly small, notwithstanding the Company's efforts to reorganize them, this could exert a significant impact on its financial performance.

(7) Legal regulations

1) Product quality and reliability

To date, the Company has never been sued for product liability under the Product Liability Law or any other law. There is no guarantee, however, that it will never be sued for such liabilities in the future. Generally speaking, moreover, there is no guarantee that it will never supply its customers with flawed LSIs which cause damage to the final customer. The Company controls use of its products in non-designated machinery and equipment by requiring that users receive prior consent before installing them. Recognizing that losses from product liability constitute a major risk, the Company takes steps to assure sufficient reliability and quality in its product design, and it intends to strengthen these measures in the future. Notwithstanding such efforts, however, the Company may be forced to assume liability as a result of flaws in its products. In such event, the Company would not only be liable for damages, but it would also lose significant amounts of credibility with respect to its products. This would negatively affect its financial performance over both the short and longer term.

2) Registered intellectual property

The Company maintains a policy of filing and registering all intellectual property rights related to its products or technologies. While the Company's products and/or technologies are protected under certain provisions of the Civil

Code, the Unfair Competition Prevention Law, and other statutes, including the Copyright Law, which confers rights without the need for filing or registration, problems could arise if protection under such laws turns out to be insufficient or if the Company is unable to exercise its rights in reaction to the development and sale of similar products by other companies. The Company's inability to counteract such actions effectively would expose it to significant impact on its financial performance.

3) Disputes arising from infringements of intellectual property rights

To date, the Company has never been sued by a third party for infringement of intellectual property rights because of alleged use of such intellectual property in its technologies or products. Based on internal surveys, the Company believes that there is no possibility of such a lawsuit occurring. But it cannot rule out the possibility that intellectual property rights related to its businesses will be established in the name of a third party, or that such intellectual property rights may already exist. In such an event, it could be sued for infringement of a third party's intellectual property rights. Involvement in such a lawsuit would require the Company to expend enormous amounts of time, money and other management resources. If a court ruled against the Company, moreover, it would be forced to discontinue the production and sale of products that include the technology in question and to pay substantial damages. Alternatively, the Company might be required to assume an obligation to pay the holder of the rights consideration for the granting of a license. In either case, the suit would result in a significant impact on the Company's financial performance.

Research and development

The Company's active program of research and development is aimed at solidifying the competitiveness of its graphics and sound LSI products. This effort, complemented by collaboration with universities and by licensed technologies, has enabled the Company to bring a number of products to the stage of commercialization. The Company is also taking steps to improve the quality and efficiency of its design activities by establishing the most advanced design development environment possible for LSI design (involving computer-aided design, various measuring devices, etc.).

In addition to developing various technologies that enhance the functions and performance of LSIs, the Company is actively pursuing development of systems that support the development of application software for its LSIs (development support software, development support and evaluation boards). The Company is currently

engaged in the development of new graphics and sound LSIs to fill the product pipeline in two targeted areas: amusement-related applications; and the broad range of markets for devices requiring graphics rendering capabilities of the type offered by the AG-9 Series.

These efforts resulted in the expenditure of 1,067 million yen for research and development during the fiscal year under review.

1) R&D in the area of graphics rendering technology

Because of the Company's powerful graphics engines, its LSIs offer rapid, versatile rendering and a rich range of effects (rotation, expansion and reduction, translucence processing, movement, and shape change). Development efforts in this area are focused on strengthening these capabilities and enabling the technology to adapt to higher resolution display.

In the area of graphics LSIs for amusement applications, the Company is continuing to work on enhancing the processing capabilities of its graphics engines and on increasing the resolution and multi-functional capabilities of its chips. Work is proceeding on a next-generation graphics engine beginning in the algorithm stage.

2) R&D in the area of graphics compression/decompression technologies

Graphics compression/decompression technologies represent a key element in the Company's ability to differentiate its products in the market. The Company's RM1 compression/decompression technology for moving images offers compression performance and processing speeds greater than MPEG2. The major contribution to sales made during the year under review by the AG-2 graphics LSI for amusement-related applications, which includes RM1, testifies to the technology's effectiveness. The Company's RS1 compression/decompression technology for still images offers compression performance and processing speeds higher than those prescribed by the JPEG. This technology is included in the AG902, which is being targeted for in-vehicle displays, POP terminals, surveillance and security systems, and graphic recorders.

During the year under review, the Company also completed development of its next-generation RS2 compression/decompression technology that offers performance and speed well within the standards set by JPEG 2000, which are becoming the international standard. In the year to March 2006, the Company will engage in work aimed at furthering the capabilities of its compression/decompression technologies for still and moving images.

3) R&D in the area of audio compression/decompression technologies

With the completion of projects concerning a number of sound LSIs during the year, the Company has begun working on the development of compression/decompression technology for sound generator data, which it expects to be incorporated into next-generation products. The goal of this development effort, which is based on one of the Company's elemental technologies in the area of audio playback, is to create an LSI offering multi-channel, high-speed audio compression/decompression capabilities.

4) R&D concerning systems on chips

The Company is involved in the creation of system-on-a-chip solutions for graphics and sound LSIs. The aim of this research is to enable the construction of graphics and sound systems that use virtually no peripheral components. This will be accomplished by integrating such peripheral functions as interfaces, memory modules and computing engines into the LSI.

5) R&D concerning development support environments

Incorporating the Company's graphics and sound LSIs into final products requires customers to develop complex programs that control the graphics and sound. The Company develops support environment that enables customers to dramatically reduce the workload related to such program development. With the aim of offering total solutions to its customers, the Company will continue to develop support environments that shorten the development period for its customers and facilitate the development process itself.

"MPEG" is an abbreviation for "Moving Picture Experts Group." It refers to an international standard set by the ITU-TS and ISO for compressing digital moving pictures and sound. MPEG2 is a compression methodology designed to increase picture quality above the levels established by MPEG.

Technology transfer agreements

Name of licensor	Items covered by agreement	Nature of agreement	Period of agreement
Internix Incorporated	Application-specific standard product LSIs, application-specific integrated circuit LSIs, and their derivatives and related products	Non-exclusive sales agency agreement for sales within Japan	From January 16, 1998 to January 15, 1999, with term extended automatically each year
Midoriya Electric Co., Ltd.	Application-specific standard product LSIs, application-specific integrated circuit LSIs, and their derivatives and related products	Non-exclusive sales agency agreement for sales within Japan	From December 12, 2000 to December 11, 2001, with term extended automatically each year
Okaya Electronics Corp.	Application-specific standard product LSIs, application-specific integrated circuit LSIs, and their derivatives and related products	Non-exclusive sales agency agreement for sales within Japan	From May 1, 2001 to April 30, 2002, with term extended automatically each year
ADM INC.	Application-specific standard product LSIs, application-specific integrated circuit LSIs, and their derivatives and related products	Basic agreement related to product procurement transactions	From February 22, 2001 to February 21, 2002, with term extended automatically each year
Rohm Co., Ltd.	Application-specific standard product LSIs, application-specific integrated circuit LSIs, and their derivatives and related products	Basic agreement related to product procurement transactions	From May 21, 2001 to May 20, 2002, with term extended automatically each year
Fujitsu, Ltd.	LSI development and prototypes, and their derivatives and related products	Basic agreement related to development	From February 7, 2003 to February 6, 2004, with term extended automatically each year

Although the Company entered into an operating alliance with Midoriya Electric Co., Ltd. in April 1998, it did not enter into a sales agency agreement with that company until December 12, 2000.

Analysis of financial condition and results of operations

In the following section, statements regarding the future are based on judgments made as of the end of the fiscal year (March 31, 2005).

(1) Important accounting principles and estimates

The Company's financial statements have been prepared in accordance with accounting standards deemed fair and appropriate in Japan, and they accurately represent the condition of the Company's assets and earnings. In addition, while the financial statements have been prepared using properly recorded accounting records as basic data, the figures may contain valuations based on a management perspective and may therefore differ from other estimates.

1) Inventories

Because of the Company's build-to-order method of operations, its year-end product inventories have been relatively small. During the year under review, the Company disposed of a number of products it had developed in the early stages of its operations for the amusement market. This had a negligible impact on profits during the period. Under current conditions, therefore the Company does not estimate potential losses from the disposal of inventory assets. As it begins to handle more products in the future, however, or as the variety of such products increases, this could require the Company to recognize losses on product inventories, which could in turn affect profitability.

2) Impairment of investments

The Company holds the shares of a number of companies in its "investment securities" account. These shares were purchased for the purpose of maintaining long-term cooperative relationships or of creating opportunities for the exchange of technical support. These shares comprise stocks of publicly traded companies whose share prices can fluctuate considerably. If the Company determines that any decline in the investment value of its holdings is more than temporary, or if losses which are not reflected in book value arise as a result of poor financial performance by the company concerned, or if any other situation arises in which the book value cannot be recovered, the Company could recognize valuation losses on the basis of prescribed procedures.

(2) Analysis of results for the year to March 31, 2005

During the year under review, the Company reported high rates of growth in both sales and profits. This resulted from strong unit growth in sales of its major product, the AG-2 graphics LSI, which is sold for amusement-related applications. AXELL CORPORATION believes that two factors contributed to this high growth: first, the adoption of a product concept in which systems costs are reduced through the design of LSIs whose graphics rendering capabilities do not depend on use of the CPU, and through the design of LSIs that place many peripheral functions onto the chip; and second, the market's appreciation of a level of service known as "total solutions," by which the Company provides customers with more than functional differentiation of the product itself, also offering them services that support their program development environments through the provision of such tools as development support software and evaluation boards.

(3) Factors with a significant impact on financial performance

Please refer to the earlier discussion on the “Risk factors” section. AXELL CORPORATION recognizes that any of the four factors cited in this section, including changes in the nature of the Company’s business, changes in the size of the market for amusement-related applications, changes in the competitive status of its products, and assumption of liability for defect warranties, could have a significant impact on its business.

(4) Current strategic considerations and outlook

The Company believes that its share of the amusement market stood at a little over 50% as of the end of the fiscal year. According to its own analysis, the remainder is held by other semiconductor manufacturers who are producing ASICs for individual customers or who are converting ASSPs originally designed for 3D game consoles to other amusement-related applications. As the transition from the AG1 to the AG2 nears completion, the Company will endeavor to expand its business around the shift in the market to the AG3, its next-generation, high-value-added product. Development of the AG3 is scheduled for completion in the year to March 2006. During the same period, the Company expects to begin commercial production of the AS201 sound LSI, for which sales were initiated during the year ended March 2005. The Company’s goal is to achieve a 20% market share for the AS201 within a few years. AXELL CORPORATION will accordingly adopt a threefold strategy: increasing the number of products used by existing customers, by enhancing the performance features of the Company’s products; growing the customer base; and increasing the total number of units sold through the development of a more varied product line.

As concerns new market development for the AG-9 series, commercial production for customers who made relatively quick decisions to adopt the technology began during the year under review and contributed to net sales. During the year, the Company worked in concert with its sales agents to sell both the AG902 and its forerunner, the AG901, to manufacturers of equipment in a wide range of fields, including in-vehicle systems, point-of-purchase terminals, surveillance and security, graphics recorders, IT, FA, measurement, and medical care. These efforts to create new markets are part of a medium-term management strategy aimed at developing a significant market presence outside the amusement market.

(5) Sources of capital and liquidity

During the year under review, cash flow from operations was 1,915 million yen, a 255 million yen increase from the previous year. Subtracting cash used in investing

and financing activities resulted in cash flow of 1,594 million yen. Even after payments for corporate income taxes, dividends and other external uses, the Company believes that this amount is sufficient to cover the costs of R & D for the AG-3 graphics LSI for the amusement market, which AXELL CORPORATION expects to bring to completion during the year to March 2006.

(6) Management views of the business environment and policies for the future

While management is endeavoring to establish optimal policies for the Company based on an analysis of the current business environment and on the best information that is obtainable, it faces the need to make decisions on many issues that have a bearing on these policies. These include the continuing instability of the international environment, the impact on the domestic economy of these international conditions, widespread uncertainty about economic trends, the maturity of the amusement market, and uncertainty concerning the size of the market for the AG-9 series, for which AXELL CORPORATION is aiming to create new markets. In addition, management believes that it must weigh all future possibilities in concrete terms and exploit these possibilities in the Company's policies. In this regard, management is focused on strengthening three areas in particular: development of the AG-3 graphics LSI for the amusement market, which the Company plans to complete in the year to March 2006; strengthening sales of the AS-201 sound LSI, also for the amusement market; and strengthening marketing efforts for the AG-9 series. Against the background of the Company's larger scale of business and the increasing diversity of the markets that it serves, management will work to establish the quality control capabilities necessary to meet the needs of the increased size of operations that is projected over the medium term.

Corporate governance

(1) Basic philosophy

The Company considers corporate governance to be an important management issue. To increase its enterprise value and enhance trust among its shareholders and other stakeholders, the Company has adopted the basic stance of encouraging rapid and appropriate decision making and of establishing a management structure that is highly efficient and transparent.

(2) Governing bodies and systems of internal controls

1) Governing bodies

(Board of Directors)

The Board of Directors is composed of five directors (including one representative director). This Board size enables the Company to expedite its management decisions efficiently. Although there are no outside directors, the release of one director from all operational duties and his assignment to overseeing the activities of the other directors (including the representative director) has created an oversight capability within the board. (Three of the directors assumed their positions to implement the provisions of the Commercial Code Article 260-3(2) since April 1, 2003.) Based on internal regulations, all directors, including persons directly involved in any issue, may express an opinion on any matter decided by the Board. This results in a system of mutual checks and balances. In addition, the director who has been freed from all operational responsibilities has been placed in charge of internal auditing, an arrangement that provides the Board with an internal auditing mechanism.

The Company has no external directors. Hence, it has no issues to report in terms of human-, capital-based, or other business relationships with outside directors.

(Board of Corporate Auditors)

The Company has adopted a system of statutory auditors. The Board of Statutory Auditors consists of three external auditors with no interests in the Company (one of whom is a standing, or full-time, auditor). The statutory auditors participate in Board of Directors Meetings, at which they express their opinions to the directors. In addition to the Board of Directors Meetings, the standing auditor also participates in monthly management meetings held to deal with matters of budgetary control (“GM Meetings,” with a membership including the president and the general managers of each business group). Through such means, the auditors gain an understanding of the progress of operations, which they use to evaluate the appropriateness of operational and financial audits.

The Company has no issues to report in terms of human-, capital-based, or other business relationships with its outside auditors.

2) Financial auditing

The Company's financial auditor is Ernst & Young ShinNihon. The financial auditor works closely with the statutory auditors. In addition to developing audit plans and reporting audit results, the financial auditor endeavors to exchange necessary information and opinions with the statutory auditors, and to carry out efficient and effective audits.

The following table lists the names of the Certified Public Accountants who carried out the financial audits for the fiscal year, the number of years they have continuously audited the Company and the names of any assistants involved.

Names of CPAs, their affiliated accounting firm, and their years of continuous auditing of the Company

Names of CPAs		Name of accounting firm
Designated partner	Yoshinobu Shimizu	Ernst & Young ShinNihon
Engagement partner	Masafumi Watanabe	

Because neither of the partners noted above has audited the Company for more than seven years, information on their years of continuous auditing of the Company has been omitted from the table.

Ernst & Young ShinNihon has independently adopted a system whereby engagement partners are required to rotate after a certain period of time.

Number of assistants involved in audits:

CPAs: 3 Junior accountants: 3

Professional fees

Remuneration in accordance with Article 2-1 of the Certified Public Accountants Law: 12 million yen

No other remuneration has been paid.

3) Risk management system development

The Company has not yet established a systematic set of independent regulations concerning the issues of compliance and risk management. The Company believes, however, that it is effectively achieving the aims of these regulations by applying those that have already been adopted.

In terms of protecting personal information, the Company is engaged in efforts to strengthen security on a companywide basis. During the latest fiscal year, the

Company adopted and publicly released a basic policy regarding the protection of personal information.

(3) Directors' compensation

1) Compensation paid to directors and corporate auditors

5 directors: 94 million yen (the Company has no external directors.)

3 corporate auditors: 8 million yen (of which 3 are external auditors, 8 million yen)

Maximum compensation (excludes amounts noted in item (2) below)

Directors: 150 million yen per year

Statutory auditors: 20 million yen per year

2) Amount equivalent to employee salary for directors who are also employees

27 million yen

Directors

Name	Title	Date joined company	Previous or current employers/occupations	Date of birth	Shares
Yuzuru Sasaki	President and Representative Director	Feb-96	Aval Data Corp., Nippon Steel Corp.	29-Nov-48	13,084
Tatsuaki Okumura	Director and Chairman	Feb-96	OKK Corp., Aval Data Corp.	28-Aug-38	7,552
Sumihiko Ichihara	Managing Director	Apr-97	Aval Data Corp., Nippon Steel Corp.	24-Sep-55	6,360
Takayuki Shibata	Director	Feb-96	Casio Computer, Nippon Steel Corp.	21-Nov-59	5,900
Nobuhiro Sendai	Director	Aug-00	Toyo Engineering Corp., National Space Development Agency of Japan	26-Sep-52	360
Yoshiki Yoshida	Standing Corporate Auditor	Feb-01	Nikon Corp., Aval Data Corp.	24-Sep-37	90
Masaru Abe	Corporate Auditor	Jun-97	Licensed tax accountant	11-Nov-38	-
Katsumi Satoyoshi	Corporate Auditor	Jun-01	Sumitomo Mitsui Banking Corporation, Licensed tax accountant	6-Nov-35	-
					33,346

Current assignments and previous positions in the Company have been omitted.

Employees

	Total or average
Number	34
Average age	35.7
Average years of service	2.3
Average annual salary (Thousands of yen)	10,545

The average annual salary includes bonuses.

The ten new employees added during the fiscal year were hired to meet the demands of expanded operations.

Union

The Company has no labor union and enjoys amicable labor relations.

Cash Flows

Nonconsolidated statement of cash flows

Years ended March 31; Millions of yen	2003	2004	2005
Net cash provided by (used in) operating activities			
Net income before taxes and other adjustments	1,142	2,370	3,275
Depreciation	32	59	76
Amortization of long-term prepaid expenses	0	0	5
Amortization of deferred assets	18	6	7
Interest and dividend income	(0)	(0)	(1)
Interest income from securities	-	-	(0)
Gain on cancellation of an insurance policy	-	-	(1)
Loss on disposal of tangible fixed assets	0	4	0
Loss on valuation of investment securities	73	-	-
Gain on sale of investment securities	-	-	(6)
Loss on sale of investment securities	-	0	-
Decrease (increase) in trade receivables	97	(369)	(395)
Decrease (increase) in inventories	(54)	(33)	75
Decrease (increase) in other current assets	1	(28)	19
Increase (decrease) in trade payables	(1)	138	(8)
Increase (decrease) in other current liabilities	(26)	56	122
Increase (decrease) in consumption tax payable	0	48	5
Directors' bonuses	(14)	(17)	(23)
	1,272	2,235	3,152
Interest and dividend income	0	0	1
Income tax and others	(362)	(576)	(1,238)
	910	1,659	1,915
Net cash provided by (used in) investing activities			
Payments for marketable securities	-	-	(1,999)
Proceeds from sales of marketable securities	-	-	1,999
Payments for acquisition of tangible fixed assets	(43)	(81)	(36)
Payments for acquisition of intangible fixed assets	(32)	(83)	(32)
Payments for investment securities	-	(66)	-
Proceeds from sales of investment securities	-	0	23
Payments of guarantees and deposits	(12)	(0)	(33)
Proceeds from repayments of guarantees and deposits	-	4	0
Proceeds from cancellation of an insurance policy	-	-	63
Others	0	(0)	(26)
	(88)	(226)	(41)
Net cash provided by (used in) financing activities			
Proceeds from issuing of securities	558	12	35
Expenditures for issuing of securities	(18)	(6)	(7)
Dividends	(115)	(179)	(307)
	423	(173)	(279)
Increase in cash and cash equivalents	1,245	1,259	1,594
Cash and cash equivalents at beginning of term	1,586	2,832	4,091
Cash and cash equivalents at end of term	2,832	4,091	5,685

Relationship between balance of cash and cash equivalents as of term end and balance sheet items

Years ended March 31; Millions of yen	2003	2004	2005
Cash and deposit account	2,832	4,091	2,185
Marketable securities account	-	-	3,499
Cash and cash equivalents at year-end	2,832	4,091	5,685

Capital expenditures

In a reflection of its expanding range of business, the Company spent 39 million yen on capital investments during the fiscal year. These primarily comprised purchases of the following: equipment for development-related uses; equipment and fixtures for design-related uses; equipment and fixtures for management-related uses; and design and development-related software and management-related software. There were no disposals or sales of major facilities during the fiscal year.

Dividend policy

The Company recognizes that providing value to shareholders is an important issue for management. With respect to cash dividends, its basic policy is to use the previous year's net income and dividend as a base and then to determine the payout in consideration of a wide range of factors, including the Company's requirements for future business expansion weighed against its needs for a stronger balance sheet and for increased retained earnings. In the year under review, the Company also established the goal of achieving a 30% dividend payout ratio within the next few years.

In accordance with the foregoing policy, the Company has declared a dividend of 8,500 yen per share for the year ended March 31, 2005, an amount representing a dividend payout ratio of 26.1%.

Operations

Nonconsolidated statement of income

Years ended March 31; Millions of yen	2003	2004	2005
Net sales	3,256	5,391	7,345
Cost of sales			
Finished goods inventory, beginning of term	3	55	91
Finished goods purchased during term	1,262	1,951	2,289
Production costs for the term	0	-	-
	1,267	2,007	2,380
Finished goods inventory, end of term	55	91	14
	1,211	1,916	2,365
Gross profit on sales	2,045	3,474	4,979
Selling, general and administrative expenses	811	1,093	1,701
Operating income	1,233	2,381	3,278
Nonoperating income			
Interest income	0	0	0
Interest income from securities	-	-	0
Dividend income	0	0	1
Subsidy-related income	1	-	-
Income from published manuscripts	-	0	-
Dividends from life insurance policies	-	0	-
Gain on cancellation of an insurance policy	-	-	1
Miscellaneous income	0	0	0
	1	0	3
Nonoperating expenses			
New share issuance expenses	18	6	7
Loss on sale of investment securities	-	0	-
Miscellaneous losses	0	0	0
	18	6	7
Ordinary profit	1,216	2,375	3,273
Extraordinary income			
Gain on sale of investment securities	-	-	6
	-	-	6
Extraordinary losses			
Loss on removal of fixed assets	0	4	0
Valuation loss on investment securities	73	-	-
Loss on disposal of inventories	-	-	4
	74	4	4
Income (loss) before taxes and other adjustments	1,142	2,370	3,275
Corporate, inhabitant and enterprise taxes	487	982	1,197
Deferred taxes	(7)	(37)	15
	479	945	1,212
Net income	663	1,425	2,063
Retained earnings carried forward from previous term	346	511	605
Unappropriated profit, end of term	1,009	1,937	2,668

Appropriation of retained earnings

Millions of yen	June 19, 2003	June 17, 2004	June 18, 2005
Unappropriated profit, end of term	1,009	1,937	2,668
Appropriation of retained earnings			
Dividends	180	309	530
Directors' bonuses	17	23	34
[of which, corporate auditors' portion]	[0]	[2]	[1]
Voluntary reserves			
Special reserves	300	1,000	1,500
	497	1,332	2,064
Retained earnings carried forward to following term	511	605	603

Results of operations

Fiscal year ended March 31, 2005

Economic and other factors affecting operations

1) Leveling off of Japanese economy

- The term begins with the promise of a self-sustaining recovery in the first half, as the export sector benefits from strong growth in the U.S. and Chinese economies.
- But growth rates decelerate in the United States, causing domestic growth to level off.

2) Uncertainty emerges in the electronics industry

- Led by active capital investment in response to a boom in digital electronics sales, the electronics industry initially shows signs of a strong recovery.
- As sales of digital appliance sales soften in the second half, however, the industry faced an increasing lack of clarity with respect to the future.

Strategic responses by the Company

- 1) Focuses on sales of graphic LSIs (ASSPs) to the amusement market, notably the AG-2, which deals with SVGA-size resolution with proprietary compression/decompression technology for moving images.
- 2) Continues to emphasize products aimed at providing total solutions, including software, evaluation boards, and other tools that support customers' development environments.

Financial analysis (year-on-year percentage change)

- 1) 36.2% increase in net sales (See segment breakdown for analysis by product.)
- 2) 37.8% increase in ordinary profit

Segment breakdown

- 1) ASSPs: Sales of ASSPs increased by 34.1% to 7,069 million yen due to:
 - The smooth and rapid transition to the Company's new AG-2 LSI, whose extremely fine, high-resolution graphics rendering capability and RM1 compression/decompression technology are meeting needs in the amusement market;
 - Increasing use of the Company's products in amusement-related devices, whose market continues to grow; and
 - An initial contribution to sales of the AG901 and AG902 graphics LSI for embedding in in-vehicle devices, POP terminals, surveillance and security equipment, graphics recorders, and IT, FA, measuring and medical devices. (The Company continues to maintain that it will take three years to develop the market for devices with embedded graphics LSI.)
- 2) ASICs: Sales of ASICs increased by 133.3% to 275 million yen due to:
 - The recognition of large-volume sales of products developed by the Company in past fiscal years (The Company's primary focus is the development and sale of ASSPs, into which it directs the bulk of its R&D resources. Its policy is to allocate development resources to ASICs only when it is commissioned by a customer to do so and when the advanced technological nature of the project warrants it. There were no new commissions for the development of ASICs during the year, and sales were limited to commercial production of products developed in the past.); and
 - Rapid growth in sales of amusement-related devices incorporating the Company's products.

Fiscal year ended March 31, 2004***Economic and other factors affecting operations***

- 1) Signs of economic recovery in Japan in second half of the year
 - Stemming deflation remaining problematic in the first half, due to economic uncertainties from the Iraq war, SARS, etc.

- Brighter prognosis in the second half due to expanding overseas economies, primarily in the United States and the Asian region.
- 2) Aggressive capital investment by the electronics industry, where trends most directly affect the Company. Industry begins to respond to stronger demand for digital home appliances, multipurpose cell phones, and PCs.

Strategic responses by the Company

Providing “total solutions” through:

- 1) A continuing emphasis on the development of LSIs incorporating proprietary technologies, such as graphics rendering and compression/decompression, with a focus on graphics and sound LSIs for the amusement market; and
- 2) Continuing work on products aimed at supporting customers’ development environments by simplifying and easing their development tasks.

Financial analysis (year-on-year percentage change)

- 1) 65.5% increase in net sales (see segment breakdown for analysis by product)
- 2) 95.2% increase in ordinary profit

Segment breakdown

ASSPs: Two factors contributed significantly to higher sales and profits in this segment. The first was a sharp increase in unit sales of the AX51201 for the amusement market, which incorporates extremely fine, high-resolution graphics rendering technology and the Company’s proprietary RAPIC compression/decompression technology. The second was better-than-expected sales of the existing AX51102 graphics LSI, the Company’s mainstay product through the preceding fiscal year. Sales in this segment consequently increased by 70.0% to 5,272 million yen.

ASICs: The Company’s primary focus is on the development and sales of ASSPs, into which it directs the bulk of its internal design resources. In principle, the Company allocates resources to ASIC development only when there is a pressing reason to do so, such as the advanced technological nature of the undertaking. There were consequently no new commissions for development of ASICs during the year, and sales were limited to commercial production of products developed through the previous fiscal year. As a result, sales in this segment declined by 23.4% to 118 million yen.

Issues requiring action

The Company views the following as significant issues requiring action:

- 1) Adopting measures aimed at creating new markets
 - The Company defines “creating new markets” for the AG901 and the AG902 as the process of developing market segments in which potential users have abandoned efforts to embed graphics rendering systems into their devices for reasons of cost, performance, or reliability; and, at the same time, deploying sales resources to encourage renewed interest in these efforts among these potential customers.
 - The Company continues to invest significant resources into selling the AG901 and the AG902. The AG901, a graphics LSI designed for embedding in IT, FA, measurement and medical devices, was developed in March 2003 and has been sold for about two years; the AG902, designed for use in in-vehicle systems, point-of-purchase terminals, surveillance and security equipment, and graphics recorders, was developed during the latest fiscal year. Both are currently being evaluated by a significant number of potential users.
 - In the market targeted by the Company for these two products, decisions to incorporate these products into key devices can sometimes take years. For the few companies that have made relatively rapid decisions to adopt the new technologies, commercial production has begun in amounts of approximately 10,000 units.
- 2) Strengthening R&D capabilities
 - The Company recognizes that strengthening its R&D capabilities is a significant issue for management that will entail attracting and keeping the most talented and experienced engineers available. Toward this end it will:
 - Continue to make active approaches to potential candidates; and
 - Endeavor to build a more efficient R&D structure by (1) entering into multifaceted alliances, including collaborative research with universities, and (2) actively adopting the technologies of other companies.
 - Work continues from the previous fiscal year on the development of next-generation LSIs for the amusement market that will enhance the graphics rendering capabilities and compression/decompression functions of the Company’s products; development of these next-generation chips is in its final

stage. The Company will also pursue the development of technologies outside the area of graphics and sound LSIs.

- Development of the AG902 and the AS201 sound LSI, which was noted in last year's securities report, was completed during the fiscal year. They both incorporate RS1 compression/decompression technology for still images which enables extremely fine, high-resolution graphics rendering systems to be built into various devices. The Company also completed development of its RS2 compression technology for still images, which was designed to offer higher compression ratios and finer definition.

3) Outsourcing of manufacturing LSI

- As a fabless semiconductor company, the Company is aware of the enormous importance of establishing and maintaining good relationships with cooperating manufacturers. With a number of new graphics LSIs for the amusement market scheduled to be developed in the year to March 2006, it will continue its efforts to select the optimum manufacturer for each of its products.
- To deal with the issue of internal quality control, which was noted in last year's securities report, the Company established the new position of quality control manager in its technology group.

4) Protection of intellectual property

- The Company considers intellectual property rights to be an important issue. It acquired a number of patents during the fiscal year, and it is continuing to take steps to acquire patents for inventions now under examination by the government. It is also taking steps to build a common awareness within its technology group of the need to expedite applications for intellectual property rights for its products and technologies.
- During the fiscal year, the Company entered into an advisory agreement with a law firm to help establish an administrative environment that is conducive to the smooth acquisition of patents.

5) Strengthening internal controls

- In light of its small size, the Company believes that its internal system of controls is sufficient to assure compliance with laws and regulations; the addition of 10 new employees during the fiscal year, however, has brought the numbers to 8 directors and 34 employees.

- Although growth remains gradual, the Company is increasing in size and will begin taking steps to strengthen its crisis management capabilities and internal systems of control to deal with the expanding scale of its business.

Selling, general and administrative expenses

Years ended March 31; Millions of yen	2004	2005
Directors' salaries	79	103
Salaries, bonuses and allowances	97	120
Depreciation	11	21
Research and development expenses	628	1,067

Leases

Under generally accepted accounting principles in Japan, finance leases that do not transfer ownership are accounted for in the same manner as operating leases when “as if capitalized” information is disclosed.

Pro forma information on leased property is as follows:

Millions of yen	2004	2005
Tools, appliances and fixtures		
Acquisition cost	12	3
Accumulated depreciation	7	1
Net leased property	4	1
Total		
Acquisition cost	12	3
Accumulated depreciation	7	1
Net leased property	4	1
Future minimum lease payments, including interest portion		
Due within one year	2	0
Due after one year	2	1
	4	1
Lease payments	3	2
Pro forma depreciation expenses (assuming declining balance method)	2	2
Pro forma interest expenses	0	0

Capital Structure

Nonconsolidated balance sheet: assets

March 31; Millions of yen	2003	2004	2005
Current assets			
Cash and deposits	2,832	4,091	2,185
Accounts receivable - trade	261	631	1,026
Marketable securities	-	-	3,499
Finished products	55	91	14
Supplies	1	0	1
Advances paid	-	21	0
Prepaid expenses	22	28	31
Deferred tax assets	34	75	62
Others	8	54	11
	3,215	4,994	6,834
Fixed assets			
Tangible fixed assets			
Buildings	22	35	36
Accumulated depreciation	8	10	16
	13	25	19
Tools, appliances and fixtures	112	162	182
Accumulated depreciation	40	66	102
	71	95	79
	85	120	99
Intangible fixed assets			
Patents	-	2	53
Trademarks	2	1	2
Software	26	46	37
Telephone subscription rights	0	0	0
	29	50	93
Investments and other assets			
Investment securities	17	134	110
Long-term loans	0	-	0
Long-term prepaid expenses	0	0	21
Deferred tax assets	17	-	-
Rental and guarantee deposits	67	63	96
Contributions to insurance savings	61	62	-
	165	260	228
Total fixed assets	280	431	421
Total assets	3,496	5,426	7,255

Nonconsolidated balance sheet: liabilities and shareholders' equity

March 31; Millions of yen	2003	2004	2005
Current liabilities			
Accounts payable - trade	117	255	246
Accounts payable - other	52	96	180
Accrued expenses payable	4	10	13
Income taxes payable	332	739	718
Consumption taxes payable	31	79	85
Deposits received	9	18	23
	546	1,200	1,268
Long-term liabilities			
Deferred tax liabilities	-	6	5
	-	6	5
Total liabilities	546	1,206	1,273
Shareholders' equity			
Common stock	947	953	971
Capital reserves			
Additional paid-in capital	790	797	815
	790	797	815
Retained earnings			
Legal income reserve	1	1	1
Voluntary reserves			
Special reserves	200	500	1,500
Unappropriated profit, end of term	1,009	1,937	2,668
	1,210	2,438	4,169
Unrealized gains or losses on other securities	(0)	30	25
Total shareholders' equity	2,949	4,219	5,981
Total liabilities and shareholders' equity	3,496	5,426	7,255

Accounting Policies

Summary of accounting policies: nonconsolidated

Basis of presentation	Japanese GAAP
Marketable securities and investment securities	Other securities: Quoted securities: the market value method is applied, based on the market value as of the fiscal year-end. The entire positive or negative valuation difference with the purchase price is booked directly as shareholders' equity, and the cost of securities sold is calculated using the moving average method. Unquoted securities: valued at cost using the moving average method
Inventories	Finished goods: valued at cost, computed on a periodic average basis Supplies: valued at cost, computed using the final purchase cost method
Depreciation	Tangible fixed assets: declining-balance method Intangible fixed assets: Patents: straight-line depreciation over 8-year period Trademarks: straight-line depreciation over 10-year period Software for internal use is amortized on a straight-line basis (based on length of useful internal life (3 - 5 years)).
Deferred assets	Expenses for issuance of new equity: recognized in full at time of expenditure
Opinion of independent auditors	Auditors: Ernst & Young ShinNihon Opinion: unqualified

Share-related Information

Shares in issue

Class of shares	Common
Number of shares authorized	115,560
Issued	
As of March 31, 2005	62,363
As of June 20, 2005	125,128
Stock exchange listings	Jasdaq Securities Exchange
Comments	The Company's standard shares, with no limitations as to shareholders' rights

Changes in common stock and number of shares outstanding

Shares Millions of yen Date	Shares outstanding		Common stock		Additional paid-in capital		Remarks
	Increase or decrease	Balance	Increase or decrease	Balance	Increase or decrease	Balance	
March 15, 2001	695	3,015	347	472	347	368	Private placement of shares
March 28, 2001	1,800	4,815	168	640	171	540	Exercise of stock acquisition rights on unsecured bonds with warrants
August 20, 2001	9,630	14,445	82	722	(82)	458	Credited to capital reserves Split 3 for 1
December 18, 2002	1,000	15,445	225	947	332	790	Public offering via the book-building formula
May 20, 2003	15,445	30,890	-	947	-	790	Split 2 for 1
April 1, 2003 - March 31, 2004	76	30,966	6	953	6	797	Execution of rights on stock options
May 20, 2004	30,966	61,932	-	953	-	797	Split 2 for 1
April 1, 2004 - March 31, 2005	431	62,363	17	971	17	815	Execution of stock options and stock acquisition rights

As a result of the execution of stock options and stock acquisition rights during the period from April 1, 2005 to May 31, 2005, total outstanding shares increased by 402 shares, capital by 8 million yen, and capital reserves by 8 million yen.

At the Board of Directors Meeting held on February 15, 2005, directors approved a 2-for-1 stock split. This split affected shareholders and beneficial shareholders listed on the final registers of shareholders and of beneficial shareholders on March 31, 2005. As a result of the split, total outstanding shares increased by 62,363 shares.

Shareholders by type of investor

Type of investor	Number of shareholders	Number of units owned	% owned
National and local government agencies	-	-	-
Financial institutions	10	4,665	7.48
Securities companies	1	6	0.01
Business and other corporations	56	9,359	15.01
Nonresidents - businesses and corporations	29	4,281	6.86
Nonresidents - individuals	3	8	0.01
Individuals and others	5,146	44,044	70.63
	5,245	62,363	100.0
Shares less than one unit	-	-	-

Largest shareholders

Name	Shares owned	Held in trust accounts	% of shares outstanding
Yuzuru Sasaki	6,542		10.49
Tatsuaki Okumura	4,326		6.93
Midoriya Electric Co., Ltd.	3,600		5.77
Sumihiko Ichihara	3,280		5.25
Takayuki Shibata	3,020		4.84
Yoshinori Narita	2,811		4.50
Aval Data Corporation	2,100		3.36
Kazuyoshi Moriya	2,040		3.27
Kazunori Matsuura	1,920		3.07
Japan Trustee Services Bank (Trust Account)	1,890	1,890	3.03
	31,529		50.51

Share information

Fiscal year-end	March 31
Ex-rights date	March 31
Ex-rights date for interim dividend	September 30
Annual general meeting of shareholders	June
Trading unit	-
Types of share certificates	1, 10 and 100 shares
Transfer agent	UFJ Trust Bank Limited, 1-4-3, Marunouchi, Chiyoda-ku, Tokyo
Publication of record	<i>Nihon Keizai Shimbun</i> (Whereas the Company had previously published its balance sheet and statement of income in the <i>Nihon Keizai Shimbun</i> , it is now making these available on its corporate homepage: http://www.axell.co.jp/ .)

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