

YUHOREPORT

AXELL CORPORATION

| | |
|-------------------|-----------------------|
| Fiscal Year Ended | March 31, 2006 |
| 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 | 2002 | 2003 | 2004 | 2005 | 2006 | Change 2006/2002 |
|---|------------|------------|------------|-----------|-----------|---------------------|
| Nonconsolidated | | | | | | |
| Net sales | 1,984 | 3,256 | 5,391 | 7,345 | 7,611 | 384% |
| Ordinary profit | 757 | 1,216 | 2,375 | 3,273 | 3,773 | 498% |
| Net income | 459 | 663 | 1,425 | 2,063 | 2,286 | 498% |
| Equity income assuming application of equity method | - | - | - | - | - | |
| Common stock | 722 | 947 | 953 | 971 | 999 | 138% |
| Shares outstanding | 14,445 | 15,445 | 30,966 | 62,363 | 125,800 | 871% |
| Shareholders' equity | 1,857 | 2,949 | 4,219 | 5,981 | 7,812 | 421% |
| Total assets | 2,289 | 3,496 | 5,426 | 7,255 | 9,077 | 397% |
| Shareholders' equity per share (Yen) | 128,603.12 | 189,835.44 | 135,535.34 | 95,368.52 | 61,746.26 | 48% |
| Dividends per share (Yen) | 8,000.00 | 11,700.00 | 10,000.00 | 8,500.00 | 6,500.00 | |
| Net income per share (Yen) | 31,780.78 | 43,792.23 | 45,380.57 | 32,607.20 | 17,859.16 | 56% |
| Net income per share, fully diluted (Yen) | - | 43,228.45 | 44,296.14 | 31,878.77 | 17,539.78 | |
| Dividend payout ratio (%) | 25.1 | 27.2 | 22.0 | 26.1 | 36.4 | |
| Net cash provided by (used in) operating activities | 525 | 910 | 1,659 | 1,915 | 2,952 | |
| Net cash provided by (used in) investing activities | (53) | (88) | (226) | (41) | (300) | |
| Net cash provided by (used in) financing activities | (47) | 423 | (173) | (279) | (478) | |
| Cash and cash equivalents at end of term | 1,586 | 2,832 | 4,091 | 5,685 | 7,859 | 496% |
| Employees | 13 | 17 | 24 | 34 | 39 | 300% |

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 four 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, the third time at a 2-to-1 ratio with a recording date of May 20, 2004 and the fourth time at a 2-to-1 ratio with a recording date of May 20, 2005. Calculations of earnings per share and diluted earnings per share for the fiscal years ended March 2002, March 2004, March 2005 and March 2006 assumed that the respective splits occurred at the beginning of those years.

Dividends per share for the 2006 fiscal year include a commemorative dividend of 1,000 yen, marking the 10th anniversary of the Company's founding.

Common size statements

| Years ended March 31; Percent | Nonconsolidated | | |
|--|-----------------|-------|-------|
| | 2004 | 2005 | 2006 |
| Balance sheet | | | |
| Assets | 100.0 | 100.0 | 100.0 |
| Current assets | 92.0 | 94.2 | 92.5 |
| Tangible fixed assets | 2.2 | 1.4 | 2.1 |
| Intangible fixed assets | 1.0 | 1.3 | 1.1 |
| Investments and other assets | 4.8 | 3.1 | 4.3 |
| Total fixed assets | 8.0 | 5.8 | 7.5 |
| Liabilities and shareholders' equity | 100.0 | 100.0 | 100.0 |
| Current liabilities | 22.1 | 17.5 | 13.5 |
| Long-term liabilities | 0.1 | 0.1 | 0.4 |
| Total liabilities | 22.2 | 17.6 | 13.9 |
| Common stock | 17.6 | 13.4 | 11.0 |
| Capital reserves | 14.7 | 11.2 | 9.3 |
| Retained earnings | 44.9 | 57.5 | 64.9 |
| Unrealized gains or losses on other securities | 0.6 | 0.3 | 0.9 |
| Total shareholders' equity | 77.8 | 82.4 | 86.1 |
| Statement of income | | | |
| Net sales | 100.0 | 100.0 | 100.0 |
| Cost of sales | 35.5 | 32.2 | 30.5 |
| Gross profit on sales | 64.5 | 67.8 | 69.5 |
| Selling, general and administrative expenses | 20.3 | 23.2 | 19.9 |
| Operating income | 44.2 | 44.6 | 49.6 |
| Nonoperating income | 0.0 | 0.1 | 0.1 |
| Nonoperating expenses | 0.1 | 0.1 | 0.1 |
| Ordinary profit | 44.1 | 44.6 | 49.6 |
| Extraordinary income | - | 0.1 | - |
| Extraordinary losses | 0.1 | 0.1 | 0.4 |
| Income before taxes and other adjustments | 44.0 | 44.6 | 49.2 |
| | 17.5 | 16.5 | 19.2 |
| Net income | 26.5 | 28.1 | 30.0 |

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 has developed three principal lines of application-specific standard products (ASSPs): the AG-1 and AG-2 series, which it sells in the amusement device market; and the AG-9 series, which it sells in the ordinary built-in device market. These products, along with application-specific integrated circuits (ASICs) which others commission the Company to develop, form the core of its business in graphics LSIs. The Company's strategy for expanding market size and creating new markets in this area is twofold: to develop products in which the graphics rendering capability is placed inside the LSI, rather than in the CPU (note), thereby reducing the burden on the CPU; and to develop products that offer extremely fine, high-resolution graphics for the built-in systems markets, which include the amusement device market. The Company has also sought to expand the range of its activities in the amusement device market by developing the AS201 sound LSI, and other non-graphics, non-sound products based on the large-scale integration of peripheral functions in that market.

"CPU" is an abbreviation for "central processing unit."

ASSPs

The Company develops and sells ASSPs that 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 series of graphics LSIs for the amusement device market and the AG-9 series of graphics LSIs for the ordinary built-in device market. The line is complemented by the AS201 sound LSI for the amusement market and by products the Company has developed through large-scale integration of periphery functions in that market. The AG-2 series is currently the Company's major product. In addition to offering a variety of graphics rendering functions such as enlarge, shrink, rotate, translucence, etc., the AG-2 contains the Company's proprietary RM1 compression-decompression technology, which is optimized for motion-image data. The AG-2 offers four times the chip performance power (and approximately 50 times the compression-decompression capability) of the Company's previous

mainstay product, the AG-1. This added performance enables the AG-2 to provide a 100-million-dot per second graphics rendering capability for SVGA graphics display units (note 1). These performance capabilities have been well received, and the AG-2 has maintained a position in the market as one of the most frequently used graphics LSIs in pachinko and pachinko slot LCDs (note 2).

The AG-9 series constitutes the AG901 and the AG902, which are sold for use in a wide variety of graphics rendering applications in IT equipment, factory automation, measuring instruments, medical equipment, in-vehicle systems, POP (advertising) terminals, surveillance and security equipment, and graphics recorders. The AG902 incorporates the Company's proprietary RS1 compression-decompression technology for still images. This graphics LSI enables high-definition graphics rendering in SXGA-size resolution (note 3) through an ordinary built-in system. The versatility of the AG-9 series has gained the support and appreciation of a number of customers. Encouraged by this success, the Company will continue to endeavor to build new markets through research and development of optimization technology.

Outside the field of graphics LSIs, the Company has developed the AS201 sound LSI, which it is selling in the amusement device market, and other LSI products that meet needs in that market. Through the development and sales of these products, the Company is aiming to broaden the range of its business operations.

1. "SVGA" is an abbreviation for "super video graphics array" and denotes 800×600 dot resolution.
2. "LCD" is an abbreviation for "liquid crystal display."
3. "SXGA" is an abbreviation for "super extended graphics array" and denotes 1280×1024 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 comprises graphics LSIs for the amusement device market and for ordinary built-in systems. Although the Company currently has no new development commissions or ongoing development projects, it continues to produce and sell large numbers of customized LSIs for ordinary built-in devices, development work for which was conducted in past years.

(2) Characteristics of the Company

The Company's key characteristic can be summarized by the phrase "a minimally staffed, R&D-oriented fabless semiconductor company." Fabless semiconductor manufacturers are involved in the so-called "upstream" processes of LSI manufacturing, which encompass planning and design. The actual manufacturing of the chips is outsourced. Because the Company sells principally through agents, moreover, its sales activities revolve mainly around product planning and marketing, which allows it to operate with a small number of employees relative to the size of its sales. The Company ascribes its ability to operate in this way to three factors: first, it possesses R&D capabilities that are differentiated from others in terms of LSI design; second, it possesses product planning and marketing capabilities that enable it to translate its LSI design strengths into specific products; and third, in addition to providing customers with manufactured products, it also emphasizes the development and supply of products that support customers' program development environments, including development and evaluation boards and development support software.

(3) Sales methods

The Company's basic sales policy is to employ sales agents (Midoriya Electric Co., Ltd., Internix Incorporated, Okaya Electronics Corp. and Ryosan Company, Limited). 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 relationships between the Company and its sales agents are close ones, which are not limited to selling. They include cooperation in collecting and analyzing information on important customer needs related to the development of new products and the creation of high added value.

(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 with the three companies that manufacture its chips, Fujitsu Limited, Rohm Co., Ltd. and NEC Electronics Corporation. Ensuring the availability of manufacturing capacity is of the highest priority to the Company, and it ascribes these excellent relationships to the effectiveness of the work it continues to do to secure this 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 | Develops application-specific LSI (ASIC) for the amusement device market. |
| 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. |
| | July | Begins selling the AG-1 series graphics LSI, the Company's first LSI for specific applications (ASSP). |
| | September | Begins selling its AS-1 series (sound LSI) of application-specific standard products (ASSPs) in the amusement device market. |
| 2001 | January | Relocates corporate headquarters to Iidabashi, Chiyoda-ku, Tokyo. |
| | May | Enters into sales agency agreement with electronics distributor Okaya Electronics Corp. |
| 2002 | June | Begins selling its AG-2 series (graphics LSI with RM1 graphics compression-decompression technology) of ASSPs in the amusement device market. |
| | December | Registers its shares for over-the-counter trading with the Japan Securities Dealers Association (in December 2004, the market was restructured and renamed the JASDAQ Market Inc.). |
| 2003 | March | Begins selling its AG-9 series (graphics LSI AG901) of ASSPs in the market for ordinary built-in devices. |
| 2004 | August | Begins selling its AG902 graphics LSI with RS1 compression-decompression technology in the market for ordinary built-in devices. |
| | September | Begins selling its AS201 series (sound LSI) of ASSPs in the amusement device market. |
| | October | Completes development of RS2 technology. |
| 2005 | July | Obtains ISO 9001:2000 certification from the Japan Quality Assurance Organization. |
| 2006 | May | Relocates corporate headquarters to Sotokanda, Chiyoda-ku, Tokyo. |

"LSI" is an abbreviation for "large-scale integration."

"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.

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

"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.

The term "graphics LSI," as used in the Company's annual filing with the Financial Services Agency, refers to an LSI with graphics rendering capabilities.

The term "sound LSI," as used in the Company's annual filing with the Financial Services Agency, refers to an LSI with sound-generating capabilities.

"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 a proprietary compression/decompression technology for still images which meets JPEG 2000 standards.

"ISO" is the acronym for International Organization for Standardization. ISO9001:2000 sets standards for quality management systems.

Risk factors**(a) Regarding the Company's dividend 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, the Company posted net income of 17,859.16 yen per share and declared dividends of 6,500.00 yen per share (including a payout of 1,000 yen to commemorate the 10th anniversary of its founding). In determining its annual payouts, the Company considers its stated goal of "achieving a dividend payout ratio of 30 percent within several years." The common dividend paid out for the year under review, in fact, brought the payout ratio to 30.8 percent. Consequently, the Company has revised this target and established the achievement of a dividend payout ratio of 50 percent within the next several years as a new goal. The Company has an unbroken string of six consecutive years of dividend increases since it began paying dividends. But because the Company determines its dividends within the framework of a targeted payout ratio, dividends could fluctuate upward or downward hereafter, depending on the financial results achieved any given year.

(b) Anomalous changes in financial conditions and operating results**1) Nature of the Company's business**

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

2) Market size

The Company's principal market is the amusement device market. The Company uses figures for market size that are arrived at through an analysis of publicly available information, adjusted to take other materials it has been able to obtain into account. 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

Currently, the Company estimates that its market share for graphics LSIs in the amusement device market is about 50 percent. In addition to the Company's graphics LSIs, customers also use chips developed and sold as ASSPs by other

companies and LSIs that they commission other semiconductor manufacturers to manufacture as ASICs. Occasionally, game device makers also use chips 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 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 liability for defect warranties on its products. Consequently, its position has been that it is unnecessary to recognize an allowance for such an eventuality. To deal with potential risks of defect liabilities, however, the Company is expanding its retained earnings by transferring certain amounts from unappropriated profits to special reserves in the shareholders' equity section of the balance sheet. If such a liability should arise and exceed the reserved amount, however, and if the liability could not be covered by retained earnings carried forward, the Company's financial performance would be seriously impacted.

(c) Matters related to the Company's organization

1) Building organizational foundations

Today the Company is run by a nine-person management team, which includes six directors and three external auditors. It is not an organization that depends solely on President and Representative Director Yuzuru Sasaki. To add stability and breadth to the foundations of its management team, moreover, the shareholders approved the addition of two new directors to the Board at the Company's ordinary general meeting of shareholders held on June 18, 2006.

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. If Mr. Sasaki should suddenly leave the Company, therefore, it could have a material impact on the Company's financial performance.

2) Adequacy of the management structure for the Company size

The Company's small size, comprising eight directors and 39 employees, allows it to function properly under its current management structure. As evidenced by last year's addition of five 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 six persons, including temporary staff hired from agencies. The Company attributes its ability to run its sales organization with a small staff to the close collaborative ties it maintains with its sales agents. 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.

(d) 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.

2) Growing R&D expenditures

The Company develops its products in accordance with a medium-and-long-term management plan and a clear product development strategy. Currently, the development of a single LSI requires several tens of millions to several hundreds of millions of yen. If multiple development projects for LSI products come to completion simultaneously hereafter (resulting in high final process-related testing costs), or if there is an increase in R&D expenses as a result of higher level of R&D staffing, the Company's financial performance could be materially affected.

3) Technical trends

Advances in semiconductor technology are enhancing the performance of ASSPs and ASICs (in terms of their level of integration, speed, functionality, and numbers 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 such proprietary areas 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 its 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 fails to achieve research results because of a lack of timely collaboration, or if it is slow to introduce effective technologies from other companies, this could exert a significant impact on its financial performance.

(e) Manufacturing and sales systems

1) Outsourcing

As an R&D-oriented 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 were to arise hereafter—if, for instance, the Company were 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 four companies that function as its sales agents: Midoriya Electric Co., Ltd.; Internix Incorporated; Okaya Electronics Corp; and Ryosan Co., Ltd. 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.

(f) Future directions of the business

1) Efforts in the amusement device market

The Company estimates that it has captured approximately 50 percent of the amusement device market due to the strength of its AG-2 graphics LSI. Development is now underway on a product to succeed the AG-2, the AG301, which the Company expects to bring out in the first half of the fiscal year to March 2007 and for which it expects to begin volume production and sales in the fourth quarter of the same year. It is clear that development and sales trends with respect to this product will have an enormous impact on the Company's financial performance. Work on the AG301 to date has proceeded smoothly, but if unexpected problems should arise to negatively impact development or sales, it could have a material impact on the Company's financial performance.

2) Efforts in the ordinary built-in device market

The Company launched the first of its AG-9 product series, the AG901, in the 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 had focused on developing graphics LSIs for sale in the amusement device market, but it has now begun efforts to create new markets for such equipment as in-vehicle displays, POP terminals, security devices, graphic recorders, IT equipment, factory automation machinery, measuring instruments, and medical equipment. 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.

(g) 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 legislation. 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, moreover, the Company is careful to assure reliability and quality in its product design and other aspects of

operations. In this connection, it attained ISO9001-2000 certification during the year under review. In the event of an occurrence such as that mentioned above, 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) The rarity of 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 response to the development and sale of similar products by other companies. The Company's inability to counteract such actions effectively would expose it to a 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. It cannot rule out the possibility that intellectual property rights related to its businesses will be established in the name of a third party, however, 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.

1. The word "algorithm" refers to calculation methods and steps that enable devices to compress or decompress data efficiently and to produce high-speed, high-performance graphics.

2. The word “architecture,” as used in this report, is an all-inclusive term for LSI structure, configuration, design philosophy, methodology, and so on that are adopted to differentiate a product in terms of its graphics rendering capability, price-performance ratio, etc.

Research and development

The Company is actively engaged in a program of R&D aimed at ensuring the competitiveness of its graphics and sound LSIs. The Company complements these efforts through collaborative research projects conducted with universities and through the use of licensed technologies. The Company is also working to ensure better quality of its LSI designs and enhance the efficiency of the development process by enabling its researchers to work in the most advanced design and development environments available for LSI development (CAD, various measuring instruments, etc.) and by bringing its operations up to ISO9001:2000 standards.

The Company is also actively involved in developing technologies that contribute to the enhancement of the functions and performance of LSIs. It devotes considerable resources to developing tools for use in final product development, moreover, such as development support software and development support and evaluation boards. Specifically, the R&D program focuses on continuously generating higher added value in the graphics LSIs sold in the mainstay amusement device market, supplementing this focus with work on sound LSIs and other products for this market and then with work on graphics LSIs for the ordinary built-in device market.

With respect to product development environments, the aim is to upgrade development software, etc., as necessary to keep pace with the increasingly high added value of the Company’s LSI products. As such, the Company will seek continually to carry out an R&D program aimed at qualitatively improving its total solution packages for customers.

As a result of these efforts, the Company spent 850 million yen on R&D during the year under review.

1) R&D related to graphics technology

Because of their powerful graphics engines, the Company’s LSIs enable rapid, versatile rendering and a rich range of effects. With the aim of enhancing these functions further, the Company is engaged in research on technologies that will provide higher resolutions. In the amusement device market, the need for sufficient power to generate higher resolutions and greater versatility is increasing. The Company is responding by developing next-generation products that will enhance the processing capacity of its graphics engines and improve the compression-decompression capabilities of its LSIs. Finally, work is proceeding on

the design of a new graphics engine to meet the requirements of products that are two generations into the future. The Company has begun this work at the algorithm stage to ensure the production of high added value.

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

The development of proprietary technologies for image compression and decompression and the inclusion of these technologies in its LSIs are key factors for the Company's ability to differentiate its products in the market. The Company's RM-1 compression-decompression technology for moving images offers compression performance and processing speeds greater than MPEG2 (note 1). RM-1 is the key technology in the AG-2 series of graphics LSIs. The growth of the AG-2 series into the Company's principal product is a testament to the technology's effectiveness. The Company's RS1 compression-decompression technology for still images, on the other hand, offers compression performance and processing speeds greater than those prescribed by JPEG. This technology is included in the AG902, which is being sold in the market for ordinary built-in systems.

The Company has also completed development of its next-generation RS2 compression-decompression technology, which offers performance and speeds at levels set by JPEG2000, which is generally viewed as the industry standard. In the year to March 2007, while proceeding with work aimed at incorporating the RS2 into an LSI, the Company will continue to promote an R&D program aimed at developing greater performance and speeds for its various compression-decompression technologies.

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

In this area, the Company is focused on developing functional improvements in the compression-decompression technology for sound used in the AS201 chip, which is being mass produced and sold in the amusement device market. In addition to R&D on next-generation sound LSIs, the Company is also working on sound compression-decompression technologies that offer higher compression rates and greater processing speeds for eventual incorporation into LSIs.

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 to control the graphics and sound. The Company develops support environments that enable customers to dramatically reduce the workload related to such program development. With the aim of offering its customers total solutions, the Company will continue to develop support environments that shorten the development period for its customers and facilitate the development process itself.

1. "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.
2. "SoC" is an abbreviation for "System-on-Chip." It is a LSI integrated by multiple-chip circuits.

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 formed 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, 2006).

(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. While the financial statements have been prepared using properly recorded accounting records as basic data, moreover, 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. As it did in the previous fiscal year, the Company disposed of a number of products developed in the early stages of its involvement in the amusement device market. This write-off had only a minor impact on the profits for the year under review. Under current conditions, therefore, the Company does not estimate potential losses from the disposal of inventory assets.

2) Impairment losses on fixed assets

In the year under review, the Company recognized impairment losses on facility-related fixed assets as a result of the relocation of its headquarters in May 2006. The Company does not expect to recognize similar impairment losses in succeeding years. Hence, it has not estimated the cost of removing the assets in question.

3) Impairment of investments

The Company holds 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 exchange of technical support. These shares comprise stocks of publicly traded companies whose share prices can fluctuate considerably. If the Company believes that losses in the value of investments which are attributable to poor financial performance of the company in question are not reflected in the book value or determines that situations have arisen in which the book value of its investments cannot be recovered, or if the Company believes that any decline in the investment value of its holdings is more than temporary, it will recognize impairment losses based on prescribed procedures.

(2) Analysis of results for the year to March 31, 2006

The Company experienced no major change in its market share (note) for graphics LSIs in the amusement device market. At the same time, however, the special demand seen in the year to March 2005 did not recur. Consequently, there was a slight shrinkage of the Company's market size and a minor reduction in its sales. Because of increases in unit sales of sound LSIs and graphics LSIs in the ordinary built-in devices market, however, overall net sales increased by 265 million yen.

Compared to the previous year, moreover, there were fewer trial production runs in connection with final-stage R&D testing, which led to a 217 million yen

reduction in R&D expenses. This, in turn, resulted in a 184 million yen decline in SG&A expenses and a higher rate of profit growth than sales growth. As a result of the foregoing, the Company reported its seventh consecutive term of higher revenue and profit.

(3) Factors with a significant impact on financial performance

Please refer to the discussion under the “Risk factors.” 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

As of the end of the year under review, the Company estimates that its share of graphics LSI sales in the amusement device market was approximately 50 percent. It believes that the remainder was held by other semiconductor manufacturers who produced ASICs for individual customers or who converted ASSPs originally designed for consumer game consoles to graphics LSI use. The Company believes that the year to March 2007 will be a period of transition in this market, in which existing graphics chips will be replaced by new LSIs. Based on an analysis of the sales trends for other companies, the Company believes that its market share could fall slightly in the amusement device market. In response to this situation, the Company is planning to begin volume production and sales of its next-generation graphics LSI, the AG301, in the fourth quarter of the fiscal year to March 2007. The Company believes that it can take advantage of gains in market share resulting from this product’s enhanced performance and higher added value to begin expanding its scale of operations again in its 13th fiscal period (the year to March 2008), when full-fledged mass production of this new product is projected to begin.

The Company estimates that its market share for sound LSIs in the amusement device market increased to 15 percent during the year under review. It believes that unit sales will increase steadily hereafter, bringing its market share to approximately 20 percent at the end of the year to March 2007.

In the ordinary built-in devices market, the Company is currently aiming to double unit sales of graphics LSIs. This is an extremely varied market, with many types of equipment requiring graphics rendering devices. The Company is focusing its

sales efforts on a number of specific market segments in which it sees growth possibilities and which afford possibilities for expanding its business.

(5) Sources of capital and liquidity

During the fiscal year under review, net cash provided by operating activities increased by 1,036 million yen to 2,952 million yen. In addition to an increase in net income before taxes and other adjustments to 3,745 million yen, this result reflected a 1,293 million yen decrease in taxes paid and declines in trade payables and trade receivables of 156 million yen and 647 million yen, respectively.

Net cash used in investing activities increased by 258 million yen to 300 million yen, reflecting a 250 million yen expenditure on tangible fixed assets.

Net cash used in financing activities amounted to 478 million yen, an increase of 198 million yen over the previous fiscal year. The main use of cash was for dividend payments, which amounted to 528 million yen.

Cash and cash equivalents as of the end of the term consequently stood at 7,859 million yen, a 2,173 million yen year-on-year increase.

As of the end of the fiscal year, the Company's balance of cash and deposits stood at 4,859 million yen, which amounted to 54 percent of total assets. Its ratio of current assets to total assets was 93 percent. In terms of liquidity, therefore, the Company is well positioned qualitatively and quantitatively to take advantage of opportunities in a nimble and proactive manner and to continue to finance a successful R&D program.

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

The Company is an innovative R&D-oriented semiconductor manufacturer that utilizes cutting-edge LSI design technologies to develop graphics and sound-related products. The Company defines itself and its mission as: (1) a gathering of highly intelligent individuals with a substantial degree of expert knowledge, (2) which is engaged in creating proprietary technologies and new products, (3) as a fabless manufacturer. This basic identity informs its management philosophy and actions. Management believes that the Company's product development capabilities are its core competence and that it must bring this competence to bear on two major tasks: creating higher added value and a greater diversity of products for the amusement device market; and devoting increasing efforts to creating new opportunities in the ordinary built-in device market. To meet the challenges of a larger scope of operations and a growing diversity of markets, moreover, management will endeavor to develop stronger

and more effective internal controls and to organize systems to ensure product quality.

The figures for market share, as used in the Company's annual filing with the Financial Services Agency, are based on publicly available materials produced by independent market research agencies, complemented by the Company's own research and analysis.

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 six directors (including one representative director). This Board's size enables the Company to expedite its management decisions efficiently. 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. The Company has no external directors. Hence, it has no issues to report in terms of human relations-related, capital-based, or other business relationships with outside directors.

(Board of Corporate Auditors)

The Company has adopted a system of corporate auditors. The Board of Corporate Auditors consists of three external auditors with no financial interests in the Company (one of whom is a standing auditor). As a rule, all corporate auditors must attend the regular monthly meetings of the Board of Directors, at which they are free to express their opinions to the directors. In addition, the standing auditor participates in the monthly General Managers' Meeting (for matters concerning budgetary control, etc.). Through such activities, the corporate auditors gain a firm grasp of the progress of operations, based on which they make judgments on the legality and appropriateness of operational and financial audits.

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

2) Internal audits and audits by statutory auditors

The Company has appointed an experienced outsider who is familiar with the industry as a corporate adviser. This person's sole responsibility is to carry out internal audits. This internal auditor has the right to sit in as an observer at Board of Directors meetings as well as at General Managers' Meetings. The standing corporate auditor likewise participates as an observer in General Managers' Meetings. By sharing information gained through attendance in such meetings, both the internal auditor and the statutory auditor endeavor to understand how decisions are reached regarding the direction of the business. Despite their close working relationship, these two persons participate in management-related meetings as independent auditors. Gathering information from various sources, positions them to convey opinions as they believe necessary at the various meetings.

The Board of Corporate Auditors also engages in its duties in close cooperation with the financial auditors. Specifically, before the beginning of each fiscal year, corporate auditors discuss and determine full-year auditing plans with the financial auditors, and both the corporate auditors and financial auditors prepare financial auditing reports at the time of account settlement for the interim period and at the time of book closing for the full year. In addition, the system allows either to call meetings whenever necessary.

As a means of enhancing the efficiency of information gathering by the internal auditor, moreover, the system permits the internal auditor to participate in meetings at which the financial auditors report their findings regarding the Company's financial statements to the Board of Corporate Auditors.

3) Financial auditing

Ernst & Young ShinNihon are the Company's financial auditors. They work closely with the Board of Corporate Auditors, the individual corporate auditors, and the internal auditor in performing their various duties, which include proposing an auditing plan, conducting audits during the year, and preparing a report on their findings regarding the Company's financial statements.

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 number of 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 | Kazunori Watanabe | 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 requiring engagement partners to rotate after a certain period of time.

Number of assistants involved in audits:

CPAs: 6 Junior accountants: 7

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

To minimize damage resulting from various risks to its operations, the Company has been developing a more effective set of rules and regulations related to crisis management and to other areas of operations. Aiming to foster not only strict adherence to the law but also behavior that reflects respect for corporate ethics and social norms, the Company has also formulated compliance regulations based on a code of behavior, etc. The Company spares no effort in inculcating compliance through seminars and other activities which are held for all employees. It has also established regulations related to whistle blowing and has formally set up an apparatus for accepting internal complaints. Through this system, protection is afforded to the whistle blower while enabling the Company to carry out investigations.

When necessary, the Company also consults with its legal counsel regarding not only the operations of this risk management system but also matters related to management and daily operations. In these and other ways, it has established a system that assures the legality of its actions.

(4) 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

Corporate 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 |
| 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 |
| Kazunori Matsuura | Director | Apr-98 | Nippon Steel Corp. | 25-Jan-70 | 3,840 |
| Akihiro Saito | Director | Jan-02 | Nippon Steel Corp. | 4-Aug-66 | 80 |
| 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 | - |
| | | | | | 29,714 |

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

Employees

| | Total or average |
|--|-------------------------|
| Number | 39 |
| Average age | 36.1 |
| Average years of service | 2.8 |
| Average annual salary (Thousands of yen) | 10,726 |

The average annual salary includes bonuses.

The five 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 | 2004 | 2005 | 2006 |
|--|-------|---------|---------|
| Net cash provided by (used in) operating activities | | | |
| Net income before taxes and other adjustments | 2,370 | 3,275 | 3,745 |
| Depreciation | 59 | 76 | 89 |
| Amortization of long-term prepaid expenses | 0 | 5 | 11 |
| Amortization of deferred assets | 6 | 7 | 5 |
| Impairment losses | - | - | 21 |
| Interest and dividend income | (0) | (1) | (2) |
| Interest income from securities | - | (0) | (0) |
| Gain on cancellation of an insurance policy | - | (1) | - |
| Loss on disposal of tangible fixed assets | 4 | 0 | 4 |
| Loss on sale of tangible fixed assets | - | - | 1 |
| Gain on sale of investment securities | - | (6) | - |
| Loss on sale of investment securities | 0 | - | - |
| Decrease (increase) in trade receivables | (369) | (395) | 647 |
| Decrease (increase) in inventories | (33) | 75 | 2 |
| Decrease (increase) in other current assets | (28) | 19 | 3 |
| Increase (decrease) in trade payables | 138 | (8) | (156) |
| Increase (decrease) in other current liabilities | 56 | 122 | (64) |
| Increase (decrease) in consumption tax payable | 48 | 5 | (30) |
| Directors' and corporate auditors' bonuses | (17) | (23) | (34) |
| | 2,235 | 3,152 | 4,243 |
| Interest and dividend income | 0 | 1 | 2 |
| Income tax and others | (576) | (1,238) | (1,293) |
| | 1,659 | 1,915 | 2,952 |
| 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 | (81) | (36) | (172) |
| Payments for acquisition of intangible fixed assets | (83) | (32) | (41) |
| Payments for investment securities | (66) | - | - |
| Proceeds from sales of investment securities | 0 | 23 | - |
| Payments of guarantees and deposits | (0) | (33) | (36) |
| Proceeds from repayments of guarantees and deposits | 4 | 0 | 0 |
| Proceeds from cancellation of an insurance policy | - | 63 | - |
| Others | (0) | (26) | (49) |
| | (226) | (41) | (300) |

| Years ended March 31; Millions of yen | 2004 | 2005 | 2006 |
|--|-------|-------|-------|
| Net cash provided by (used in) financing activities | | | |
| Proceeds from issuing of securities | 12 | 35 | 55 |
| Expenditures for issuing of securities | (6) | (7) | (5) |
| Dividends | (179) | (307) | (528) |
| | (173) | (279) | (478) |
| Increase in cash and cash equivalents | 1,259 | 1,594 | 2,173 |
| Cash and cash equivalents at beginning of term | 2,832 | 4,091 | 5,685 |
| Cash and cash equivalents at end of term | 4,091 | 5,685 | 7,859 |

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

| Years ended March 31; Millions of yen | 2004 | 2005 | 2006 |
|---------------------------------------|-------|-------|-------|
| Cash and deposit account | 4,091 | 2,185 | 4,859 |
| Marketable securities account | - | 3,499 | 2,999 |
| Cash and cash equivalents at year-end | 4,091 | 5,685 | 7,859 |

Capital expenditures

In a reflection of its expanding range of business, the Company spent 113 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. Because of construction related to the Company's relocation of its corporate headquarters, the Company recognized 21 million yen in impairment losses as a result of the earlier-than-expected removal and sale of certain business-related assets.

There were no disposals or sales of major facilities during the fiscal year.

Dividend policy

The Company recognizes that returning profits to shareholders is an important issue for management. Its basic policy with respect to cash dividends is to determine the amount of the payout through a comprehensive analysis of the future direction of the business, while considering at the same time its needs for a stronger balance sheet and for a larger pool of retained earnings for use in operations expansion. To date, the Company had used its stated goal of achieving a dividend payout ratio of 30 percent as an index for determining dividends. With its declaration of a cash payout of 6,500 yen per share for the year under review (including a 1,000 yen commemorative dividend marking the 10th anniversary of the Company's founding), the Company has reached its goal of 30 percent on a common dividend basis. Consequently, it has established achievement of a payout ratio of 50 percent over the next several years as its new goal for dividends. It will thus actively increase its payouts at levels appropriate to profit growth, again while considering financial conditions, operating performance, and future business directions.

With the coming into force of the Corporation Law on May 1, 2006, limits on the number of times dividends may be paid have been eliminated. The Company plans no special change in this regard, however.

Operations

Nonconsolidated statement of income

| Years ended March 31; Millions of yen | 2004 | 2005 | 2006 |
|--|-------------|-------------|-------------|
| Net sales | 5,391 | 7,345 | 7,611 |
| Cost of sales | | | |
| Finished goods inventory, beginning of term | 55 | 91 | 14 |
| Finished goods purchased during term | 1,951 | 2,289 | 2,317 |
| | 2,007 | 2,380 | 2,332 |
| Finished goods inventory, end of term | 91 | 14 | 12 |
| | 1,916 | 2,365 | 2,320 |
| Gross profit on sales | 3,474 | 4,979 | 5,290 |
| Selling, general and administrative expenses | 1,093 | 1,701 | 1,516 |
| Operating income | 2,381 | 3,278 | 3,774 |
| Nonoperating income | | | |
| Interest income | 0 | 0 | 0 |
| Interest income from securities | - | 0 | 0 |
| Dividend income | 0 | 1 | 2 |
| Income from published manuscripts | 0 | - | - |
| Dividends from life insurance policies | 0 | - | 0 |
| Gain on cancellation of an insurance policy | - | 1 | - |
| Miscellaneous income | 0 | 0 | 0 |
| | 0 | 3 | 3 |
| Nonoperating expenses | | | |
| New share issuance expenses | 6 | 7 | 5 |
| Miscellaneous losses | 0 | 0 | 0 |
| | 6 | 7 | 5 |
| Ordinary profit | 2,375 | 3,273 | 3,773 |
| Extraordinary income | | | |
| Gain on sale of investment securities | - | 6 | - |
| | - | 6 | - |
| Extraordinary losses | | | |
| Loss on removal of fixed assets | 4 | 0 | 4 |
| Loss on sale of fixed assets | - | - | 1 |
| Loss on disposal of inventories | - | 4 | 0 |
| Impairment losses | - | - | 21 |
| | 4 | 4 | 28 |
| Income before taxes and other adjustments | 2,370 | 3,275 | 3,745 |
| Corporate, inhabitant and enterprise taxes | 982 | 1,197 | 1,499 |
| Deferred taxes | (37) | 15 | (40) |
| | 945 | 1,212 | 1,459 |
| Net income | 1,425 | 2,063 | 2,286 |
| Retained earnings carried forward from previous term | 511 | 605 | 603 |
| Unappropriated profit, end of term | 1,937 | 2,668 | 2,889 |

Appropriation of retained earnings

| Millions of yen | June 17, 2004 | June 18, 2005 | June 18, 2006 |
|---|---------------|---------------|---------------|
| Unappropriated profit, end of term | 1,937 | 2,668 | 2,889 |
| Appropriation of retained earnings | | | |
| Dividends | 309 | 530 | 817 |
| Directors' and corporate auditors' bonuses | 23 | 34 | 45 |
| [of which, corporate auditors' portion] | [2] | [1] | [2] |
| Voluntary reserves | | | |
| Special reserves | 1,000 | 1,500 | 1,300 |
| | 1,332 | 2,064 | 2,162 |
| Retained earnings carried forward to following term | 605 | 603 | 727 |

Results of operations

Fiscal year ended March 31, 2006

Economic and other factors affecting operations

- 1) Despite early uncertainties, a gradual overall recovery in the Japanese economy
 - Potentially destabilizing factors during the first half of fiscal year: geopolitical uncertainty and high oil prices
 - Change in complexion in the second half of fiscal year, as the overall economy shows signs of a gradual recovery
 - a) Increases in private capital spending and an improved employment picture, which reflect strong corporate earnings
 - b) Sustained, relatively high levels of consumer spending
- 2) Healthy recovery in the electronics industry
 - Fairly rapid inventory adjustment in the IT sector of the digital electronics industry
 - Buoyant recovery in business conditions, reflecting growing demand for digital appliances and other users of semiconductor products
 - On the other hand, some lag in the amusement device market
 - a) Slight market contraction in the first quarter causing a slowdown in sales of products containing the Company's chips
 - b) Return to normal trends in the second quarter, resulting in three quarters of solid growth

Strategic responses by the Company

- 1) In the amusement device market, continuing to provide “total solutions”: i.e., selling not only of graphics and sound LSIs but also tools that support customers’ development environments
- 2) In the ordinary built-in device market, expanding the number of customers through vigorous sales of graphics LSIs

Financial analysis (year-on-year percentage change)

- 1) 3.6% increase in net sales (See segment breakdown for analysis by product.)
- 2) 15.3% increase in ordinary profit

Segment breakdown

- 1) ASSPs: Sales of ASSPs increased by 7.3% to 7,586 million yen.
 - Company resources concentrated into development and sale of ASSPs
 - Sales of ASSPs driven largely by the AG-2 series of graphics LSIs, which are sold to the amusement device market
 - Unit sales of graphic chips to this market declined slightly compared to the previous year, but overall sales of ASSPs were higher because of:
 - a) Higher unit prices, reflecting a shift from the AG-1 series (which constituted about 10% of total sales at the end of the fiscal year to March 2005) to the AG-2 series;
 - b) Significant volumes of sales of the AS201 sound LSI in the second half of the fiscal year; and
 - c) Steady expansion of sales of AG-9 graphics LSIs at a pace on target with original expectations.
- 2) ASICs: Sales of ASICs decreased by 90.9% to 25 million yen.
 - The Company commits resources to the development of ASICs only when projects can be justified on certain grounds, including their advanced technological nature.
 - There were no new commissions accepted for the development of ASICs during the year; there were no ongoing development projects.

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 faces an increasing lack of clarity with respect to the future.

Strategic responses by the Company

- 1) Focuses on sales of graphics 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 LSIs 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 LSIs.)

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.

Issues requiring action

The Company views the following as significant issues requiring action:

1) Developing next-generation graphics LSIs for sale in the amusement device market

- For the amusement device market, development of a next-generation graphics LSI to replace the current mainstay AG-2 series is a significant issue. The next-generation chip, the AG301, is in the final stages of development.
- The Company believes that the AG301 has achieved two goals required for success hereafter: an ability to offer sufficient graphics rendering capabilities to meet the challenges of high resolution in increasingly large panel LCDs; and an ability to provide higher performance in compression-decompression technology to handle the large expected increase in data-processing requirements.
- The Company had previously identified these significant issues, and it has met them with its development of the AG301. The schedule for development, production and sales of the AG301 is as follows:
 - a) Development to be completed by the first half of the year to March 2007; and

b) Volume production and sales to begin by the fourth quarter of the year to March 2007.

- The Company believes that the development and marketing of the AG301 will generate an enormous impact on its financial performance, and it will consequently invest considerable energies into enhancing the product and software development environments and into sales activities.

2) Developing products for sale in the ordinary built-in devices market

- In the market for ordinary built-in devices, the Company's AG-9 series of graphics LSIs offers the advantage over PC-based systems of operability without drawing heavily on the CPU. The series comprises the AG901 and AG902, which were developed for inclusion in such devices as IT equipment, factory automation systems, measuring instruments, medical equipment, in-vehicle systems, POP (advertising) terminals, surveillance and security equipment, and graphics recorders.
- The following products are current examples of mass-produced items in which the AG-9 chip is the key device: control display units for chip mounters (note); monitors on special purpose vehicles which are used for visual confirmation of rear-end safety; medical equipment; and information display terminals for use in amusement parlors.
- The issue in this segment is to increase the number of products that adopt AG-9 technology as a key device. During the year, the Company completed development of the AX-POP2 concept model, which it is using in its sales promotion activities. The Company views the AX-POP2 as a potentially large-volume product in the end-user market. It will continue utilizing the model as a sales promotion tool hereafter as it focuses on the goal of increasing the number of products that incorporate AG-9 series chips.

A chip mounter is a machine that is used to place chips onto printed circuit boards.

3) Developing sound LSIs for sale in the amusement device market

- Mass production of the AS201 sound LSI for the amusement device market began in the second quarter of the year.
- Previously, the Company had devoted a major part of its efforts toward developing and selling graphics LSIs in this market, but it now intends to widen the scope of its activities by adding sound LSIs. Its current goal is to achieve a market share of 20 percent for sound LSIs, and it has begun sales promotion activities aimed at reaching this target by the end of the year to March 2007.

- The Company has also completed development of an LSI product that offers a new mechanism unrelated to either graphics or sound. The aim is to make a comprehensive technical contribution to this market by supplying multiple products with different uses. The Company is also engaged in R&D aimed at integrating graphics and sound capabilities onto a single chip and in other research aimed at incorporating peripheral LSI functions onto graphics LSIs.

4) R&D structure

- The Company recognizes that being fabless requires high-level R&D capabilities. It believes that the key factor behind its strength in R&D has been its ability to build an R&D structure constituting by talented and highly experienced engineers. And it recognizes that it will need to carry out a continual and active hiring program aimed at enhancing this structure.
- The Company's hiring standards require that potential employees possess both high-level technical skills and competence in interpersonal relationships, and that they be decent, honest human beings. Each year, the Company hires only a few employees. But because these new employees are often mid-career hires who can make an immediate contribution or former interns who have transitioned into regular employee status, the Company's R&D structure is gradually being enhanced.
- While building an R&D structure that operates efficiently, partly through joint research projects with universities and cooperating companies, the Company must continue to hire outstanding talent actively hereafter.

5) Outsourcing of LSI manufacturing and strengthening of quality control

- As a fabless manufacturer, the Company is aware of the tremendous importance of establishing and maintaining good relationships with its cooperating manufacturers.
- Maintaining such relationships will enable the Company always to outsource to the best available manufacturer at all times and to ensure the constant availability of the necessary amount of manufacturing capacity.
- The Company is also aware of the importance of strengthening quality control for its products and, in this connection, attained ISO9001:2000 certification during the year. It will endeavor to maintain and improve its quality control systems to assure the reliability of its products.

6) Protection of intellectual property

- The Company acquired a number of patents during the year and continues to take steps to acquire patents for inventions that are now under examination by the government.
- The Company is keenly aware of the importance of intellectual property and is aiming to acquire patents based on strategic judgments about its products and its technologies. During the year, it made its legal counsel regularly available to employees for internal consultation. It will continue to take steps of this kind to ease the administrative burden concerning matters related to intellectual property and to develop an environment that reinforces its strategy with respect to intellectual property.

7) Strengthening internal controls

- The Company's system of internal controls is predicated on its relatively small number of employees. This system includes seminars on compliance conducted by legal counsel, for example, for the purpose of reinforcing the spirit of legal compliance among employees. The Company believes that its current system of internal controls functions reasonably well.
- The Company added five new employees during the year, however, and is gradually increasing the scale of its operations. Given this growth, the Company recognizes that it will have to strengthen its crisis management capabilities and systems of internal control and adopt measures to strengthen itself in each of these areas.

Selling, general and administrative expenses

| Years ended March 31; Millions of yen | 2005 | 2006 |
|---|-------|------|
| Directors' and corporate auditors' salaries | 103 | 103 |
| Salaries, bonuses and allowances | 120 | 162 |
| Depreciation | 21 | 19 |
| Research and development expenses | 1,067 | 850 |

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 | 2005 | 2006 |
|---|-------------|-------------|
| Tools, appliances and fixtures | | |
| Acquisition cost | 3 | 5 |
| Accumulated depreciation | 1 | 2 |
| Net leased property | 1 | 2 |
| Total | | |
| Acquisition cost | 3 | 5 |
| Accumulated depreciation | 1 | 2 |
| Net leased property | 1 | 2 |
| Future minimum lease payments, including interest portion | | |
| Due within one year | 0 | 1 |
| Due after one year | 1 | 2 |
| | 1 | 3 |
| Lease payments | 2 | 1 |
| Pro forma depreciation expenses (assuming declining balance method) | 2 | 1 |
| Pro forma interest expenses | 0 | 0 |

Capital Structure

Nonconsolidated balance sheet: assets

| March 31; Millions of yen | 2004 | 2005 | 2006 |
|-------------------------------------|-------|-------|-------|
| Current assets | | | |
| Cash and deposits | 4,091 | 2,185 | 4,859 |
| Accounts receivable - trade | 631 | 1,026 | 378 |
| Marketable securities | - | 3,499 | 2,999 |
| Finished products | 91 | 14 | 12 |
| Supplies | 0 | 1 | 0 |
| Advances paid | 21 | 0 | 0 |
| Prepaid expenses | 28 | 31 | 33 |
| Deferred tax assets | 75 | 62 | 99 |
| Others | 54 | 11 | 13 |
| | 4,994 | 6,834 | 8,398 |
| Fixed assets | | | |
| Tangible fixed assets | | | |
| Buildings | 35 | 36 | - |
| Accumulated depreciation | 10 | 16 | - |
| | 25 | 19 | - |
| Tools, appliances and fixtures | 162 | 182 | 217 |
| Accumulated depreciation | 66 | 102 | 122 |
| | 95 | 79 | 95 |
| Construction in progress | - | - | 91 |
| | 120 | 99 | 186 |
| Intangible fixed assets | | | |
| Patents | 2 | 53 | 48 |
| Trademarks | 1 | 2 | 3 |
| Software | 46 | 37 | 47 |
| Telephone subscription rights | 0 | 0 | - |
| | 50 | 93 | 99 |
| Investments and other assets | | | |
| Investment securities | 134 | 110 | 201 |
| Long-term loans | - | 0 | 1 |
| Long-term prepaid expenses | 0 | 21 | 38 |
| Rental and guarantee deposits | 63 | 96 | 132 |
| Contributions to insurance savings | 62 | - | 20 |
| | 260 | 228 | 393 |
| Total fixed assets | 431 | 421 | 679 |
| Total assets | 5,426 | 7,255 | 9,077 |

Nonconsolidated balance sheet: liabilities and shareholders' equity

| March 31; Millions of yen | 2004 | 2005 | 2006 |
|--|--------------|--------------|--------------|
| Current liabilities | | | |
| Accounts payable - trade | 255 | 246 | 89 |
| Accounts payable - other | 96 | 180 | 120 |
| Accrued expenses payable | 10 | 13 | 15 |
| Income taxes payable | 739 | 718 | 917 |
| Consumption taxes payable | 79 | 85 | 54 |
| Deposits received | 18 | 23 | 27 |
| | <u>1,200</u> | <u>1,268</u> | <u>1,226</u> |
| Long-term liabilities | | | |
| Deferred tax liabilities | 6 | 5 | 38 |
| | <u>6</u> | <u>5</u> | <u>38</u> |
| Total liabilities | 1,206 | 1,273 | 1,265 |
| Shareholders' equity | | | |
| Common stock | 953 | 971 | 999 |
| Capital reserves | | | |
| Additional paid-in capital | 797 | 815 | 842 |
| | <u>797</u> | <u>815</u> | <u>842</u> |
| Retained earnings | | | |
| Legal income reserve | 1 | 1 | 1 |
| Voluntary reserves | | | |
| Special reserves | 500 | 1,500 | 3,000 |
| Unappropriated profit, end of term | 1,937 | 2,668 | 2,889 |
| | <u>2,438</u> | <u>4,169</u> | <u>5,891</u> |
| Unrealized gains or losses on other securities | 30 | 25 | 79 |
| Total shareholders' equity | <u>4,219</u> | <u>5,981</u> | <u>7,812</u> |
| Total liabilities and shareholders' equity | <u>5,426</u> | <u>7,255</u> | <u>9,077</u> |

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 from 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 its 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 | 231,120 |
| Issued | |
| As of March 31, 2006 | 125,800 |
| As of June 19, 2006 | 125,896 |
| 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 | |
| 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 (note 1) | 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 (note 2) | 431 | 62,363 | 17 | 971 | 17 | 815 | Execution of stock options and stock acquisition rights |
| May 20, 2005 (note 3) | 62,363 | 124,726 | - | 971 | - | 815 | Split 2 for 1 |
| April 1, 2005 - March 31, 2006 (note 2) | 1,074 | 125,800 | 27 | 999 | 27 | 842 | Execution of rights on stock options |
| April 1, 2006 - May 31, 2006 (note 4) | 96 | 125,896 | 2 | 1,001 | 1 | 844 | Execution of warrants |

1. Reflects the exercise of stock options in accordance with Article 280-19 of the Commercial Code, prior to its revision by the "Law Revising Part of the Commercial Code, etc."
2. Reflects the exercise of stock options and stock purchase/subsorption warrants in accordance with Article 280-19 of the Commercial Code, prior to its revision by the "Law Revising Part of the Commercial Code, etc."
3. At the Board of Directors Meeting held on February 15, 2005, the 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.
4. Between April 1, 2006 and May 31, 2006, total outstanding share increased by 96 shares, capital stock by 2 million yen, and additional paid-in capital by 1 million yen as a result of the exercise of stock purchase/subsorption warrants.

Shareholders by type of investor

| Type of investor | Number of shareholders | Number of units owned | % owned |
|--|------------------------|-----------------------|---------|
| National and local government agencies | - | - | - |
| Financial institutions | 13 | 9,136 | 7.26 |
| Securities companies | 14 | 680 | 0.54 |
| Business and other corporations | 48 | 18,328 | 14.57 |
| Nonresidents - businesses and corporations | 46 | 18,066 | 14.36 |
| Nonresidents - individuals | 1 | 1 | 0.00 |
| Individuals and others | 5,039 | 79,589 | 63.27 |
| | 5,161 | 125,800 | 100.0 |
| Shares less than one unit | - | - | - |

Largest shareholders

| Name | Shares owned | Held in trust accounts | % of shares outstanding |
|---|--------------|------------------------|-------------------------|
| Yuzuru Sasaki | 13,084 | | 10.40 |
| Tatsuaki Okumura | 7,552 | | 6.00 |
| Midoriya Electric Co., Ltd. | 7,200 | | 5.72 |
| Sumihiko Ichihara | 6,360 | | 5.05 |
| Takayuki Shibata | 5,900 | | 4.69 |
| Yoshinori Narita | 5,012 | | 3.98 |
| Aval Data Corporation | 4,200 | | 3.33 |
| Kazuyoshi Moriya | 4,080 | | 3.24 |
| Japan Trustee Services Bank (Trust Account) | 4,022 | 4,022 | 3.19 |
| Kazunori Matsuura | 3,840 | | 3.05 |
| | 61,250 | | 48.69 |

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 | Mitsubishi UFJ Trust and Banking Corporation 1-4-5, Marunouchi, Chiyoda-ku, Tokyo |
| Publication of record | <i>Nihon Keizai Shimbun</i> |

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