

YUHOREPORT

# AXELL CORPORATION

Fiscal Year Ended	<b>March 31, 2007</b>
Traded	<b>JASDAQ</b>
Stock Code	<b>6730</b>

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 PRONEXUS. None of the above parties shall be responsible for any error or omission or for results obtained from the use of this information.

## Table of Contents

<b>COMPANY PROFILE</b> .....	<b>3</b>
Financial highlights.....	3
Common size statements.....	4
<b>BUSINESS OVERVIEW</b> .....	<b>5</b>
Description of business.....	5
History.....	9
Risk factors.....	10
Research and development.....	16
Technology transfer agreements.....	18
Analysis of financial condition and results of operations.....	18
Corporate governance.....	22
Directors.....	30
Employees.....	30
Union.....	30
<b>CASH FLOWS</b> .....	<b>31</b>
Nonconsolidated statement of cash flows.....	31
Capital expenditures.....	32
Dividend policy.....	33
<b>OPERATIONS</b> .....	<b>34</b>
Nonconsolidated statement of income.....	34
Nonconsolidated statement of changes in net assets.....	35
Appropriation of retained earnings.....	35
Results of operations.....	36
Issues requiring action.....	39
Leases.....	41
<b>CAPITAL STRUCTURE</b> .....	<b>42</b>
Nonconsolidated balance sheet: assets.....	42
Nonconsolidated balance sheet: liabilities and shareholders’ equity.....	43
<b>ACCOUNTING POLICIES</b> .....	<b>45</b>
<b>SHARE-RELATED INFORMATION</b> .....	<b>46</b>

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## Company Profile

*Financial highlights*

Years ended March 31; Millions of yen	2003	2004	2005	2006	2007	Change 2007/2003
<b>Nonconsolidated</b>						
Net sales	3,256	5,391	7,345	7,611	7,911	243%
Ordinary profit	1,216	2,375	3,273	3,773	3,936	324%
Net income	663	1,425	2,063	2,286	2,390	360%
Equity income assuming application of equity method	-	-	-	-	-	
Common stock	947	953	971	999	1,018	107%
Shares outstanding	15,445	30,966	62,363	125,800	126,700	820%
Shareholders' equity	2,949	4,219	5,981	7,812	8,947	303%
Total assets	3,496	5,426	7,255	9,077	10,165	291%
Shareholders' equity per share (Yen)	189,835.44	135,535.34	95,368.52	61,746.26	70,620.67	37%
Dividends per share (Yen)	11,700.00	10,000.00	8,500.00	6,500.00	7,600.00	
Net income per share (Yen)	43,792.23	45,380.57	32,607.20	17,859.16	18,921.50	43%
Net income per share, fully diluted (Yen)	43,228.45	44,296.14	31,878.77	17,539.78	18,719.02	
Dividend payout ratio (%)	27.2	22.0	26.1	36.4	40.2	
Net cash provided by (used in) operating activities	910	1,659	1,915	2,952	1,531	
Net cash provided by (used in) investing activities	(88)	(226)	(41)	(300)	(117)	
Net cash provided by (used in) financing activities	423	(173)	(279)	(478)	(1,233)	
Cash and cash equivalents at end of term	2,832	4,091	5,685	7,859	8,040	284%
Employees	17	24	34	39	50	294%

*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 2-to-1 ratio with a recording date of May 20, 2003, the second time at a 2-to-1 ratio with a recording date of May 20, 2004, the third 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 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		
	2005	2006	2007
<b>Balance sheet</b>			
<b>Assets</b>	100.0	100.0	100.0
Current assets	94.2	92.5	93.5
Tangible fixed assets	1.4	2.1	1.9
Intangible fixed assets	1.3	1.1	1.1
Investments and other assets	3.1	4.3	3.5
Total fixed assets	5.8	7.5	6.5
<b>Liabilities and net assets</b>	100.0	100.0	100.0
Current liabilities	17.5	13.5	11.5
Long-term liabilities	0.1	0.4	0.5
Total liabilities	17.6	13.9	12.0
Shareholders' equity			
Common stock	13.4	11.0	-
Capital surplus	11.2	9.3	-
Retained earnings	57.5	64.9	-
Unrealized gains or losses on other securities	0.3	0.9	-
Total shareholders' equity	82.4	86.1	-
Net assets			
Common stock	-	-	10.0
Capital surplus	-	-	8.5
Retained earnings	-	-	68.5
Total shareholders' equity	-	-	87.0
Unrealized gains or losses on other securities	-	-	1.0
Total valuation/translation gains (losses)	-	-	1.0
Total net assets	-	-	88.0
<b>Statement of income</b>			
<b>Net sales</b>	100.0	100.0	100.0
Cost of sales	32.2	30.5	28.8
Gross profit on sales	67.8	69.5	71.2
Selling, general and administrative expenses	23.2	19.9	21.6
Operating income	44.6	49.6	49.6
Nonoperating income	0.1	0.1	0.2
Nonoperating expenses	0.1	0.1	0.0
Ordinary profit	44.6	49.6	49.8
Extraordinary income	0.1	-	-
Extraordinary losses	0.1	0.4	-
Income (loss) before taxes and other adjustments	44.6	49.2	49.8
	16.5	19.2	19.6
Net income	28.1	30.0	30.2

## Business Overview

### *Description of business*

#### (1) Outline of business

The Company is an R&D-oriented fabless (Note 1) semiconductor manufacturer whose primary business is the development and sale of ASSPs for graphics-rendering and sound-generation. The Company also accepts commissions for the development of ASIC products, although only in very limited and special circumstances, such as when it can utilize its technological capabilities to meet advanced technological challenges.

The ASSPs that constitute the core of the Company's business today are semiconductors used to generate graphics in the amusement device market. The Company's products have captured an approximately 50% share of this market (Note 2). Graphics displays in amusement devices have demanded higher and higher degrees of resolution (Note 3): from the QVGA (Note 4) standard at the time the Company first entered the market to the SVGA (Note 5) standard that FOLLOWED to the higher-than-XGA (Note 6) resolution required today. The Company is expanding the scale of its business by developing products that offer higher performance and higher added value in response to these changing market needs.

The Company is also planning to expand the scale of its business by diversifying the products it supplies to this market. In this connection, it is developing and selling sound-generating LSIs, semiconductors to control LEDs (Note 7), and other peripheral products.

The Company is also pursuing programs to commercialize graphics-rendering LSIs for the built-in device market and developing and selling ASSPs that enable manufacturers to offer high-resolution, high-definition graphics generation through these devices, which are characterized by various constraints. Currently, while taking steps toward gradual development of a market for graphics-rendering products in this area, the Company is using information on market needs that it has obtained during the year under review to select its target markets and to begin development of graphics-rendering chips that provide optimal solutions for these markets (devices). In this way, the Company is seeking to expand its business scale through diversification of its target markets (devices).

1. "Fabless" denotes a form of operations in which a company develops a semiconductor product based on proprietary ideas and technologies and then commissions the manufacturing of the product to other companies with the requisite manufacturing facilities.

2. *The term “percent share of the market,” which is used in the Company’s annual filing with the Financial Services Agency, is arrived at on the basis of publicly available material; the Company adjusts this data by taking into consideration other information which it obtains directly from the market.*
3. *“Degree of resolution” is a unit denoting the number of points that make up a single image and refers to the number of pixels in a given image area. Degree of resolution is a measurement of the fineness and smoothness of picture quality; the higher this value, the closer the picture comes to a natural image.*
4. *QVGA is an abbreviation for “quarter video graphics array.” The degree of resolution under the QVGA standard is 320 x 240 pixels.*
5. *SVGA is an abbreviation for “super video graphics array.” The degree of resolution under the SVGA standard is 800 x 600 pixels.*
6. *XGA is an abbreviation for “eXtended graphics array.” The degree of resolution under the XGA standard is 1024 x 768 pixels.*
7. *LED is an abbreviation for “light emitting diode.” It refers to a semiconductor device that emits light when a dielectric field is created around it.*

### **ASSPs**

During the fiscal year under review, the Company’s mainstay ASSP products were the AG-2 series and AS201, which are sold to the amusement device market, and the AG-9 series which is sold to the built-in device market. In addition, the Company has begun selling the AG301, full-scale mass production and volume sales of which it plans to commence in the year ended March 2008.

The AG-2 series, which the Company considers the nucleus of its business, features a number of characteristics, including a 100-million dot per second graphics-rendering capability for an SVGA-sized display unit, a wide array of graphics-rendering functions, and a proprietary compression-decompression technology (the “RM1”: see Note 1) for moving images. The Company plans to transition from the AG-2 to the AG301 beginning in the current fiscal year. In addition to providing the degree of resolution required by XGA standard displays, the AG301 includes a newly developed proprietary technology for compression-decompression of moving pictures (the “RM2”: see Note 2). On an integrated performance basis, the AG301 will offer approximately four times the chip performance of the AG-2.

The AS201 sound generator LSI, besides including a new sound compression-decompression technology, features a distinct method of reproducing acoustic source data. The Company is also developing LED-control semiconductors and other peripheral products for the amusement device market, which will present amusement device manufacturers with opportunities to develop new mechanisms for their amusement devices.

The Company has also developed and begun selling two products in its AG-9 series, the AG901 and AG902. These products seek to provide high-resolution graphics-rendering systems for SXGA (Note 3) standard displays in built-in devices; they incorporate a wide range of functions developed to enable their application in a multiplicity of devices. The AG902, in particular, includes a proprietary compression-decompression technology for still images (the RS1: see Note 4) which enables devices to save and reproduce image data downloaded from external sources and which can be adapted to devices that must send and receive image data from remote locations.

1. *RM1 is an abbreviation for "RAPIC Movie Compression Version 1," a proprietary compression-decompression technology developed by the Company for moving images. RAPIC is a registered trademark and the name used by the Company to refer to all its proprietary compression-decompression technology.*
2. *RM2 is an abbreviation for "RAPIC Movie Compression Version 2," a proprietary compression-decompression technology developed by the Company for moving images.*
3. *"SXGA" is an abbreviation for "super extended graphics array" and denotes 1280 × 1024 dot resolution.*
4. *RS1 is an abbreviation for "RAPIC Still Image Compression Version 1," a proprietary compression-decompression technology developed by the Company for still images.*

### **ASICs**

During the fiscal year under review, the Company's ASIC products comprised semiconductors for graphics generation made for sale to manufacturers of built-in devices.

### **(2) Characteristics of the Company**

The Company states in its corporate philosophy that it is a "fabless semiconductor manufacturer" in order to achieve efficiency in operations. In addition to being fabless, the Company has adopted a "horizontal specialization business model."

In the series of processes (from manufacturing to sales) constituting the semiconductor business, the Company is involved primarily in the segment related to sales strategy, which is to say that it is involved in planning related to product development, in R&D focused on product commercialization, and in the selection of markets. In addition to commissioning the manufacturing of its products to major domestic device manufacturers, the Company also adopts a basic policy of selling through distributors, which are trading companies functioning as sales agents.

While adopting this system for sales, the Company, through its sales and technical divisions, also deals directly with the final customer when providing product support and when gathering information about customer needs for the development of next-generation products.

1) Foundries

The Company's relationship with the companies to which it delegates manufacturing is an extremely important factor in its mainstay semiconductor business. It currently delegates these tasks to Fujitsu Limited, Rohm Co., Ltd. and NEC Electronics Corporation. It believes that it has secured the manufacturing capacity it requires for its operations.

2) Sales agents

The Company uses the following trading firms as sales agents: Midoriya Electric Co., Ltd., Internix Incorporated, Okaya Electronics Corp., and Ryosan Co., Ltd. These agents place orders with the Company after finalizing the required quantities and delivery dates with the final customer. They then procure and sell the chips that are delivered by the foundries to these customers. The relationships between the Company and its sales agents is a close one, and both work together to gather and analyze information on customer needs, a process which provides important input for new product development and serves as a means of increasing the value added to the Company's products.

## History

Year	Month	Event
1996	February	AXELL CORPORATION (headquartered in Nakano-ku, Tokyo) is established to develop and sell high-performance semiconductors.
	April	Develops customized semiconductors (hereinafter referred to as "ASICs") for customers in 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 of products to customers in the amusement device market; the AG-1 is a line of semiconductors developed for specified uses (hereinafter referred to as "ASSPs").
1999	September	Begins selling the "AS-1" series of ASSPs to customers 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 the "AG-2" series of ASSPs to customers in the amusement device market.
	December	Registers its shares for over-the-counter trading with the Japan Securities Dealers Association. (In December 2004, this market was restructured and renamed the JASDAQ Securities Exchange.)
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.
2005	July	Obtains ISO 9001:2000 certification from the Japan Quality Assurance Organization.
2006	May	Relocates corporate headquarters to Sotokanda, Chiyoda-ku, Tokyo.
	November	Begins selling the "AG301" series of ASSPs to customers in the amusement device market.

*"Semiconductors," as the term is generally used, refers to large-scale integrated circuits which are formed on silicon wafers (a material used in the manufacture of semiconductor products, silicon has properties that lie between those of conductors and insulators). "Semiconductors" are also referred to as "LSIs," which is an acronym for the English term "Large Scale Integrators."*

*The term "amusement device market," which is used in the Company's annual filing with the Financial Services Agency, refers to the market for pachinko and pachislot machines; this market is also referred to as the "amusement device market."*

*ASICs are semiconductors which are designed and manufactured for the applications and uses of specific customers and which are sold only to these customers. ASIC is an acronym for "application specific integrated circuit."*

*Midoriya Electric Co., Ltd. and the Company entered into a sales agency agreement in December 2000.*

*ASSP is an "application specific standard product." While ASSPs are designed and manufactured for specific applications and uses, they are sold to multiple customers in the general marketplace.*

*The AG-1 series, along with the AG-2 series and the AG301, comprises graphics-rendering products (semiconductors that enable graphics to be shown on LCDs and other display devices) which are supplied to the amusement device market. The AG-1 series enabled the Company to make its initial entry into this market. On an integrated performance basis, the AG-2 series offered four times the chip performance of the AG-1 series (and approximately 50 times the compression-decompression capability); it contributed enormously to increasing the Company's market share and to expanding the scale of its business. The AG301 responded to the wide variety of needs that exist in the amusement device market, including the need for higher resolution; the Company has plans to move into full-scale mass production and volume sales of this product beginning in the year ended March 2008.*

*The AS-1 series and the AS201 are sound-generator LSIs (semiconductors designed to reproduce digital sound data) for the amusement device market. The Company believes that these products will play a key role in its strategy for diversifying its product line for this market.*

*The term "built-in device market," which is used in the Company's annual filing with the Financial Services Agency, refers to "those devices, excluding amusement devices, which belong to the category of built-in devices, as broadly defined." The Company has vigorous ongoing programs for the development of graphics-rendering products and sales to the built-in device market.*

*The AG901 and AG902 are graphics-rendering products sold to the built-in device market. The former offers high-resolution and high-definition capabilities and was developed for inclusion in general built-in device systems. The latter, which contains compression-decompression functions that allow the downloading and saving of external images and the forwarding of such images between remote locations, was designed to expand the range of devices to which this particular graphics-rendering technology can be applied.*

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

## *Risk factors*

The Company believes that the following could significantly impact investors' judgments concerning matters related to the financial performance and financial condition reported in this filing.

Statements concerning the future in the following discussion are based on judgments made by the Company as of the end of the fiscal year under review.

### (a) Regarding the Company's dividend policy

The Company has increased dividends per share on a split-adjusted basis each year from the fiscal year ended March 2001, when it began its payouts, through the fiscal year ended March 2007. Because the Company's policy is to determine its dividend payout on the basis of a set dividend payout ratio, its financial performance in any one year could have an impact on the amount of dividends paid out.

### (b) Anomalous changes in financial condition and operating results

#### 1) Nature of the Company's business

The Company's core business is the development and sale of ASSPs. From the year ended March 2000 to the year ended March 2007, the Company has reported a continuous increase in sales and ordinary profit. If the ASSPs fail to satisfy customer needs or fail to meet the demands of this market due to a lack of competitive features or for other reasons, however, it could significantly impact the Company's financial performance.

#### 2) Market size

The Company's principal market is the amusement device market. The Company has analyzed the size of this market based on publicly available data, which it adjusts with information obtained directly from this market. According to this analysis, between 5 and 5.5 million game devices are manufactured and sold each year. Moreover, the amusement device market in Japan is generally considered to be a mature one. The Company consequently believes that the market will move in a generally stable manner hereafter, at roughly these same quantitative levels. If the size of the market were to begin trending downward unexpectedly for some reason, however, this could have a significant impact on the Company's financial performance.

#### 3) Competition

The Company believes that it currently has an approximately 50% market share for graphics-rendering LSIs in the amusement device market. The Company is seeking to expand the scope of its business by increasing the performance capabilities of the products it supplies and by pursuing further development of proprietary technologies. If other semiconductor manufacturers succeed in entering this market with products that exceed the performance of the Company's products, however, and if the Company is forced to cut prices in order to compete, this could significantly impact its financial performance.

4) Generational change in ASSP products

The Company plans to enlarge its business by enhancing the performance capabilities of its LSIs and by increasing the graphics-rendering functions of its chips. In the fiscal year ending March 2008, the Company expects to begin full-scale mass production of the AG301, which has been designed for the larger and higher-resolution LCD display panels being adopted by the amusement device market. If the sizes and resolutions of LDC displays mounted on amusement devices turn out to be considerably lower than the Company currently expects, however, it could have a significant impact on the Company's financial performance.

5) Liability for defect warranties

To date, the Company has never had to assume liability for a defect warranty on its products. As a practical matter, it consequently faces difficulties from an accounting standpoint in recognizing an allowance for such liabilities on the balance sheet. To deal with this question, the Company has sought to increase 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 were to arise and exceed the amount of the retained earnings, however, and, further, if the excess could not be covered by net income carried forward, it could have a significant impact on the Company's financial performance.

(c) Matters related to the Company's organization

1) Building an organizational foundation

The Company is currently 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. This 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 nine directors and 50 employees, allows it to function properly with its current management structure. As evidenced by last year's addition of eleven 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 expansion of the size of the business could constrain future business development and 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. Talented engineers working on graphics-rendering technologies and semiconductor design are in scarce supply, however, and the competition to hire such people is heating up in the industry. The Company consequently believes that it will be extremely difficult to obtain such engineers. If the Company should fail to meet its hiring needs adequately, or if engineers it currently employs were lost to other companies, therefore, it could have a significant impact on the Company's financial performance.

2) Growing R&D expenditures

As an R&D-oriented fabless semiconductor manufacturer, the Company develops its products on the basis of both a medium-long-term management plan and a product development strategy. It currently costs from several tens of millions of yen to several hundreds of millions of yen to develop a single chip. If multiple projects related to chip development are completed at the same time, or if R&D expenditures increase as a result of higher levels of R&D staffing, this could have a significant impact on the Company's financial performance.

### 3) Technical trends

The performance characteristics of graphics LSIs continue to grow in range and capability. To keep up with this trend, it will be essential for the Company to maintain excellence in its technical development capabilities and for it to provide its researchers with the latest design environments. To remain competitive in this regard, the Company is steering R&D into such proprietary areas as graphics-rendering and compression-decompression technologies. The Company is also actively pursuing collaborative research projects with universities, an approach that has proven effective not only as a means of achieving specific research results but also of recruiting talented research personnel through student internships and other such arrangements associated with this type of collaboration. The Company also foresees a need to consider bringing in high-caliber graphics-related technologies from outside sources, including technologies that supplement its internal technologies, and to consider alliances with companies that offer technologies that can contribute to expanding its business. If the Company's technology development is delayed, however, or if it fails to achieve research results due to a failure to take timely actions, it could significantly impact the Company's financial performance.

#### (e) Manufacturing and sales systems

##### 1) Outsourcing

As an R&D-oriented fabless semiconductor manufacturer, the Company specializes in development and outsources its manufacturing. The process of outsourcing is thus crucial to the success of the Company's principal semiconductor business. The Company recognizes the importance of being able to maintain the best possible manufacturing arrangements at all times, which requires that it build and nurture good relationships with its foundries. At present, the Company's manufacturing relationships are excellent, and it has secured all necessary manufacturing capacity. In the event that it is unable to obtain sufficient manufacturing capacity at a given foundry, however, if a foundry experiences mechanical problems with its production facilities, or if, for some reason, the current outsourcing agreements are terminated, this could have a significant impact on the Company's financial performance.

##### 2) The build-to-order system

Basically, all of the Company's semiconductor products are manufactured on a made-to-order basis. The Company is consequently exposed to the impact of changes in the sales and production plans of its final customers, which can

result in increases or decreases in the unit sales of its products, or in delays in the timing of its sales. If such changes occur, it could have a significant impact on the Company's financial performance.

### 3) Sales organization

The Company operates efficiently with a minimal number of employees. As a rule, it does not engage in direct sales to its customers, choosing instead to carry out sales and marketing activities in collaboration with four companies that function as its sales agents and that provide it with the requisite information and sales networks. These companies are Midoriya Electric Co., Ltd.; Internix Incorporated; Okaya Electronics Corp.; and Ryosan Co., Ltd. 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 built-in device market

The Company developed the AG-9 series for this market, to which it is now selling the series. Although the bulk of sales in this segment is currently in the amusement device market, the Company is taking steps to build a market for graphics LSIs that comprises a variety of devices, such as in-vehicle displays, POP (advertising) terminals, security systems, graphic recorders, IT equipment, factory automation machinery, measuring instruments, and medical equipment. If the size of the new markets the Company seeks to develop turns out be smaller than expected, however, or if the pace of business development in these areas is exceedingly slow, it could have a significant impact on the Company's 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 under any other legislation. There is, however, no guarantee that it will never be sued for such liability in the future. As a general matter, moreover there is no assurance that it can avoid ever supplying defective semiconductor products that are potentially damaging to the final customer. The Company controls the use of its products in non-designated machinery and

equipment by requiring that users receive prior consent before installation. In addition, recognizing that losses from product liability constitute a significant risk, the Company is careful to ensure product reliability and quality in its product design. In the year ended March 2006, it obtained ISO9001: 2000 certification. Despite these efforts, however, product defects could potentially arise. If such defects were to cause accidents for which issues of liability arose for the Company, it could have a significant impact on its financial performance.

2) Regarding the protection and preservation 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 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 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 compensation 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*

As an R&D-oriented semiconductor company, the Company directs the bulk of its R&D activities toward development of graphics-rendering LSIs and other semiconductor products and toward development of compression-decompression technologies for image and sound-generation data. In the fiscal year ended March 2007, the Company spent a total of 934 million yen on R&D expenses.

### 1) R&D to develop graphics rendering LSIs

In addition to products sold to the amusement device market, the Company's core business, the Company also conducts R&D on products for built-in devices. In this area, its efforts are directed toward developing the various functions required for the devices in which its products are incorporated.

### 2) R&D on compression-decompression technologies

Image compression-decompression technologies play a vital role in amusement devices and other built-in devices that display images by utilizing data that is stored in memory (Note 1). With respect to the amusement device market in particular, the Company believes that this technology is the source of its competitiveness in graphics-rendering LSIs. The Company has identified this technology as the critical factor that distinguishes its products from those of its competitors, and it focuses considerable energy on developing these technologies in-house.

### 3) R&D on sound-generation LSIs

Sound-generation chips play an important role in the Company's strategy for diversifying its product line in the amusement device market. In addition to developing sound-generation LSIs, the Company is also investigating compression-decompression technologies for sound generation and working on chip functions that produce a rich range of effects. The Company plans to complete development of a next-generation sound-generation LSI in the year ending March 2008.

### 4) R&D on peripheral LSIs

A further aspect of the Company's program for diversifying its product line for the amusement device market is its development of LED-control semiconductors and its investigation of areas in which it can make technical contributions to other peripheral devices. In the year ending March 2008, the Company plans to begin mass production and volume sales of an LED-control device. It will continue to pursue R&D activities in this area.

5) R&D on converting products for the amusement device market into an SoC (Note 2)

The Company is looking into ways of unifying the mechanisms that control images, sounds, and LEDs onto a single chip. It believes that this technology will contribute to reducing systems-related costs for devices that are manufactured for the amusement device market.

6) R&D on development support environments

Incorporating the Company's graphics and sound LSIs into final products requires amusement device manufacturers to develop complex programs to control graphics and sound. The Company conducts research to develop support environments with the aim of lightening the load and reducing the time required for such program development.

1. *"Memory," also called "memory devices," refers to semiconductor devices that record digital data.*
2. *SoC is an acronym for "System on Chip" and denotes a semiconductor product that integrates multiple-chip circuits.*

## *Technology transfer agreements*

<b>Name of licensor</b>	<b>Items covered by agreement</b>	<b>Nature of agreement</b>	<b>Term of agreement</b>
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.	Development of LSIs and prototypes, and of 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 March 31, 2007.

### (1) Important accounting principles and estimates

The Company's financial statements are prepared in accordance with accounting standards that are deemed fair and appropriate in Japan. These financial statements are prepared, moreover, on the basis of accounting data that have been appropriately recorded. For valuation accounts, the Company uses valuation methods that are recognized as appropriate under generally accepted accounting standards.

### 1) Inventories

Because the Company employs a made-to-order system and outsources the manufacturing of its products to foundries, it has a relatively small product inventory at the end of each term that is subject to valuation. In the year under review, the Company had neither any impairment losses or disposals on product inventory from past fiscal years nor any losses related to estimated disposals of inventory in the future on the books as of the fiscal year-end.

### 2) Impairment of fixed assets

There were no impairment losses on fixed assets during the year under review. The impairment losses on fixed assets occasioned by the move of the Company's headquarters were recognized in the year ended March 2006. The Company did not anticipate any new losses for equipment removal, etc.

### 3) Impairment of investments

The Company holds shares in 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. All of these shares comprise stocks of publicly traded companies whose share prices can fluctuate widely. If a fact or facts not reflected in the current book value of such stocks should emerge and result in a continual decline in the share price of any stock, and if the Company should determine that this decline is not a temporary one, it will recognize an impairment loss on such stocks in accordance with predetermined procedures.

## (2) Analysis of results for the year ended March 31, 2007

The Company experienced no major change in its market share for graphics-rendering LSIs in the amusement device market, holding its share at the roughly the same 50% level as in the previous year. A breakdown of sales shows that unit sales of graphics LSIs declined slightly as a result of trends in the amusement device market. This was offset by higher unit sales of sound LSIs and graphics LSIs for the built-in market. These circumstances resulted in an approximately 300 million yen year-on-year increase in sales to 7,911 million yen.

Because of higher sales and a decline in procurement costs for major products, gross profit increased by 340 million yen to 5,630 million yen, lifting the gross profit margin by 1.7 percentage points. Reflecting this higher gross profit, operating income increased by 148 million yen to 3,923 million. This increase occurred despite higher SG&A expenses, which reflected an increase in the

number of employees. The operating profit margin stood at 49.6%. There is nothing in particular to note with respect to ordinary profit or other profit items below the operating profit level. In the year ended March 31, 2007, the Company reported its eighth consecutive year of higher sales and profits.

(3) Factors with a significant impact on financial performance

Please refer to the discussion under “Risk factors.”

(4) Current strategic considerations and outlook

With respect to sales of graphics LSIs to the amusement device market, the Company continued to expand its business by responding effectively to demands for higher resolution and by developing chip functions that generate a rich range of effects. It believes that this enabled it to maintain market share of approximately 50% in this market. In the year ended March 2008, the Company believes that the market will move in an inconclusive manner as manufacturers react to a revision of the rules related to game machines. In response, the Company will endeavor to expand the size of its business further by commencing full-scale mass production of the AG301, which was developed to meet market need for even higher resolution.

The Company estimates that its market share for sound LSIs in the amusement device market increased to more than 20% in the year under review, meeting its original projections. In the year ended March 2008 and beyond, however, it anticipates a reduction in unit sales of these products in view of current sales and usage trends among customers. Because the Company has identified sound LSIs as an important product in its strategy for diversification in this market, it plans to complete the development of a next-generation chip during the first half of the year ended March 2008. It will also begin mass production of this next-generation product during the year ended March 2008.

Peripheral products, including LED-control chips for the amusement device market, have also been identified as strategic products in the Company’s efforts to diversify its product line to the amusement device market. The Company plans to pursue sales activities aimed at expanding sales of this product to make it a substantial contributor to its overall business.

Graphics LSIs for the built-in device market are the key product in the Company’s strategy for diversifying its markets. During the year under review, sales trends for these products have generally met the Company’s expectations. The Company undertook development of the AG-9 series, which is currently being sold in the

built-in device market, to build a foundation in that market and to gather information about customer needs. In terms of foundation building, the Company achieved sales of over 60,000 units during the year under review, and it aims to build on this achievement to increase unit sales. In terms of gathering information on customer needs, the Company was able to identify substantial market segments within the overall built-in device market and to complete designs of specifications for these segments (devices). Beginning in the year ending March 2008, the Company will develop products that optimally meet the needs of the multiple market segments (devices) it has identified and aims to further expand the scale of its business.

(5) Sources of capital and liquidity

Cash provided by operating activities amounted to 1,531 million yen, a decrease of 1,420 million yen compared to the previous year. The major factors behind this decline were as follows: income before taxes and other adjustments of 3,936 million yen; payments of income tax and others of 1,666 million yen; an increase in trade receivables of 916 million yen; and an increase in trade payables of 143 million yen. The main factors behind the year-on-year decline in cash flow was a change in the trade receivables account, which resulted in a 1,564 million yen decrease in working capital.

Cash used in investing activities amounted to 117 million yen, a 182 million yen decline compared to the previous year. The principal use of cash was a 115 million yen expenditure to acquire fixed assets in conjunction with the relocation of the Company's headquarters.

Cash used in financing activities amounted to 1,233 million yen, a 754 million yen increase compared to the previous year. The principal use of cash was the payment of dividends, which amounted to 1,270 million yen. The year-on-year increase in cash used was attributable to the Company's initiation of an interim dividend, which resulted in a 742 million yen increase in the dividend payout.

As a result, the balance of cash and cash equivalents stood at 8,040 million yen as of the end of the year, an increase of 181 million yen compared to the previous fiscal year.

On the balance sheet, cash and deposits were 4,542 million yen, constituting 45% of total assets, a 9 percentage point decrease from the previous year. Current assets accounted for 94% of total assets, a 1 percentage point increase from the previous year. The balance of cash and deposits at term-end stood at a level which

the Company considers more than adequate to finance dynamic sales activities and a robust and forward-looking program of research and development.

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

The Company is an innovative R&D-oriented semiconductor manufacturer, whose core businesses are graphics-and sound-generating LSIs, which it develops utilizing cutting-edge LSI design technologies. The Company follows a corporate philosophy which it articulates in the following way: (1) AXELL CORPORATION is a gathering of highly intelligent individuals with a substantial degree of expert knowledge, (2) which is engaged in creating proprietary technologies and new products, and (3) which operates as a fabless manufacturer. Management believes that the Company's product development capabilities are its core competence and that it must bring this competence to bear in two areas hereafter: creating higher added value and a greater diversity of products for the amusement device market; and directing its efforts and resources toward reinforcing its presence in the built-in device market.

In addition, as the scope of its operations expands in the amusement device market and the Company conducts business in an increasing variety of markets hereafter, the Company will need to develop internal control systems that are suitable for this enlarged business scale and to strengthen its quality assurance systems.

*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 a basic stance of encouraging rapid, appropriate decision-making and of establishing a management structure that is highly efficient and transparent.

(2) Governing bodies and internal control systems

1) Governing bodies

The Company is governed by a Board of Directors and a Board of Corporate Auditors.

(Board of Directors)

The Board of Directors is composed of six directors (including one representative director).

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.

The Company has stipulated in its Articles of Incorporation that there shall be no more than 10 directors.

(Board of Corporate Auditors)

The Company's Board of Corporate Auditors comprises three external auditors, including one standing auditor.

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 control system

With respect to "putting into place structures necessary to ensure that, in executing their duties, the directors act in accordance with the Articles of Incorporation and that other operations of joint-stock corporations are appropriately carried out," the Company adopted the following resolution at a meeting of its Board of Directors.

(General statement)

There is a need to establish proper corporate governance as a means of enabling companies to meet their social responsibilities. Making corporate governance a reality requires the building and proper application of an internal control system. Based on this recognition, the Company resolved at a meeting of its Board of Directors that it will make a clear statement of its commitment to corporate governance in its corporate philosophy and will adopt the measures prescribed by statute for the purpose of establishing an internal control system. The Company will take steps to ensure that all directors and employees understand the content of this resolution, moreover, and that, under the guidance of those responsible for each operation, the internal control system is appropriately applied and improved. This will enable the Company to create an efficient and legally compliant corporate structure and assure its ability to fulfill its responsibilities to society.

(Corporate philosophy)

1. The Company is an innovative R&D-oriented semiconductor manufacturer, which utilizes cutting-edge LSI design technologies to develop graphics-and sound-generating LSIs; its mission shall be to achieve the following:
  - (1) To become a group of highly intelligent experts possessing advanced levels of professional knowledge;
  - (2) To engage in creating proprietary technologies and new products; and
  - (3) To accomplish the above as a fabless manufacturer.
2. To establish a structure of governance that takes into consideration the interests of all related parties, including shareholders, employees, customers and suppliers
3. To adhere to the law, to the Articles of Incorporation, and to all Company rules; and to disclose information in a timely and appropriate manner
4. While paying sufficient attention to information management, to maintain a free and open corporate climate; and while seeking to expand its scope of operations, to contribute to society in a manner befitting the Company's operations

(Decisions related to improvement of the corporate structure)

- a. System for the preservation and management of information related to the execution of duties by directors

Written documents and other information related to the execution of directors' duties shall be preserved and managed in accordance with rules and related manuals established for the management of such documents and information. When necessary, the Company shall conduct revisions of this system of preservation and management.
- b. Rules and other systems related to managing the danger of losses
  - (i) With respect to avoiding the danger of losses (hereinafter, "risks") and with respect to dealing with risks that have materialized, the Company shall establish and apply rules for risk management and related manuals; and it shall provide employees with training concerning these rules.

- (ii) Directors responsible for the respective operations shall identify potential risks in their areas of jurisdiction, and while keeping abreast of the circumstances in these areas at all times, the directors shall report periodically to the Board of Directors.
  - (iii) When an internal audit is carried out by a person responsible for conducting internal audits, or when problems are identified through such audits, the Company shall deal appropriately and promptly with these problems.
- c. System to ensure that directors execute their duties efficiently
- (i) The Company shall develop and apply rules concerning the duties and authority of directors, and shall develop and apply rules related to directors' decision-making authority and their execution of duties.
  - (ii) A director shall be placed in charge of each organizational unit (group) and shall execute his/her duties in accordance with the prescribed authority, and he/she shall report monthly to the Board of Directors on the status of the executed operations.
  - (iii) Based on rules concerning documents circulated for approval, the directors shall monitor the execution of duties by other groups and shall endeavor to effectuate a system of mutual checks at the execution stage.
  - (iv) The Company shall hold regular meetings (hereinafter, "GM meetings") in which the president, operations directors, and group and team leaders shall participate; through such meetings, the participants shall endeavor to gain a common understanding of the management situation, to learn about activities in other parts of the organization, and to increase the efficiency of each director's own operations.
- d. System to ensure that employees execute their duties in accordance with the law and with the Articles of Incorporation
- (i) The Company shall develop and apply a code of conduct and rules of compliance and shall provide employees with training through periodic compliance seminars taught by outside attorneys.
  - (ii) The Company shall carry out internal audits to confirm that duties are executed in accordance with the law and with the Articles of Incorporation.

- (iii) The Company shall provide opportunities for employees to consult with outside attorneys on legal issues.
  - (iv) The Company shall establish rules that ensure the effectiveness of whistleblowing activities.
  - (v) The Company shall develop a compendium of internal rules (including its Articles of Incorporation) and shall make this compendium readily available for employees to read.
- e. System for directors and employees to report to corporate auditors and system related to other reporting to corporate auditors
- (i) As stipulated under the rules of the Board of Corporate Auditors, directors and employees shall report to the corporate auditors whenever such reports are requested by a corporate auditor.
  - (ii) Following their adoption, all documents circulated for approval shall be passed to the standing corporate auditor by the person who approves the document; through reports on each decision made within the Company, the corporate auditors shall be able to keep abreast of the operations being executed.
- f. System to ensure that other audits by corporate auditors are conducted properly
- (i) The standing corporate auditor shall attend Board of Directors' meetings and GM meetings and shall be enabled to keep current with the progress of operations.
  - (ii) Those who carry out internal audits shall establish regular liaison meetings with the financial auditors as a means of deepening their collaboration and of conducting effective audits.

Matters related to “establishing a system to ensure appropriate operations of the corporate group, which comprises the corporation in question and its parent company and subsidiaries” do not apply; as concerns “matters related to the employees in question, moreover when a corporate auditor requests the assignment of such an employee to assist in his/her duties,” the Board of Directors has not adopted a resolution on this matter because it has been confirmed that, at the present time, there is no need for an employee to be assigned to assist the corporate auditors.

### 3) Internal audits and audits by statutory auditors

The Company has appointed an experienced outsider who is familiar with the industry to serve as a corporate adviser. In addition, during the year under review, the Company has created the position of legal affairs officer (in the year ending March 2008, the name of this position will change to internal control (legal affairs) officer; hereinafter, “internal control (legal affairs) officer”), with responsibility for strengthening the Company’s compliance structure and its system of corporate governance.

Internal audits by the Company shall be carried out by the above-mentioned internal auditor (one person) and by the internal control (legal affairs) officer. These individuals shall examine whether the operations of the Company’s various divisions are carried out in accordance with the various rules, and whether these operations are managed appropriately and effectively. They shall also participate as observers in monthly Board of Directors’ meetings and attend monthly GM meetings in a similar capacity.

As concerns audits by the corporate auditors, all corporate auditors shall, as a rule, attend regularly scheduled Board of Directors’ meetings and shall state their opinions at such meetings; the standing corporate auditor shall also attend GM meetings, moreover, and based on an understanding of the progress of operations, shall determine whether the operational and financial audits are legal and appropriate.

The system enables the Board of Directors, the internal auditor, and the internal control (legal affairs) officer to work in tandem.

The Board of Corporate Auditors shall conduct auditing operations in close collaboration with the financial auditor. Specifically, before the beginning of the fiscal year, both shall discuss auditing plans for the full year, and at the time of the interim closing and at the end of the fiscal year, both shall prepare audit reports concerning the financial audits. The two shall also be allowed to meet at other times, moreover, whenever a need for such a meeting arises.

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.

4) 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 under review, 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: 9      Junior accountants: 2

***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 facing its operations, the Company is currently developing a more effective set of rules and regulations related to crisis management and to other areas of operations.

In addition, the Company has also prepared compliance regulations based on its code of conduct as a means of ensuring that employees execute their duties in

accordance with the law and in accordance with the Articles of Incorporation. The Company spares no effort in inculcating compliance through seminars and other activities held for all employees. It has also established regulations related to whistle blowing and has set up a formal apparatus for accepting internal complaints. Through this system, protection is afforded to whistle blowers 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 regarding 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

7 directors: 99 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 (excluding amounts noted in item (2) below)*

*Directors: 150 million yen per year*

*Corporate auditors: 20 million yen per year*

2) Amount equivalent to employee salaries for directors who are also employees  
 57 million yen

(5) Requirements for resolutions electing directors

The Company has included a provision in its Articles of Incorporation on requirements for the election of directors, which states that shareholders holding one-third or more of the voting rights of all shareholders eligible to vote must be present and that a majority of the shareholders present must approve such resolutions.

(6) Requirements for special resolutions at general meetings of shareholders

With respect to special resolutions made at general meetings of shareholders, as provided for under Article 309-2 of the Corporation Law, the Company has stipulated in its Articles of Incorporation that shareholders holding one-third or more of the voting rights of all shareholders eligible to vote must be present and that two-thirds of the shareholders present must approve such resolutions. The aim of this rule was to promote a smoother transaction of business at General Meetings of Shareholders by reducing the required quorum for special resolutions.

## *Directors*

<b>Name</b>	<b>Title</b>	<b>Date joined company</b>	<b>Previous or current employers/occupations</b>	<b>Date of birth</b>	<b>Shares</b>
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*

	<b>Total or average</b>
Number	50
Average age	36.0
Average years of service	2.8
Average annual salary (Thousands of yen)	10,090

*The average annual salary includes bonuses.*

*The eleven 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	2005	2006	2007
<b>Net cash provided by (used in) operating activities</b>			
Net income before taxes and other adjustments	3,275	3,745	3,936
Depreciation	76	89	115
Amortization of long-term prepaid expenses	5	11	15
Amortization of deferred assets	7	5	0
Impairment losses	-	21	-
Interest and dividend income	(1)	(2)	(3)
Interest income from securities	(0)	(0)	(9)
Gain on cancellation of an insurance policy	(1)	-	-
Loss on disposal of tangible fixed assets	0	4	-
Loss on sale of tangible fixed assets	-	1	-
Gain on sale of investment securities	(6)	-	-
Decrease (increase) in trade receivables	(395)	647	(916)
Decrease (increase) in inventories	75	2	(8)
Decrease (increase) in other current assets	19	3	15
Increase (decrease) in trade payables	(8)	(156)	143
Increase (decrease) in other current liabilities	122	(64)	(46)
Increase (decrease) in consumption tax payable	5	(30)	(10)
Directors' and corporate auditors' bonuses	(23)	(34)	(45)
	3,152	4,243	3,187
Interest and dividend income	1	2	10
Income tax and others	(1,238)	(1,293)	(1,666)
	1,915	2,952	1,531
<b>Net cash provided by (used in) investing activities</b>			
Payments for marketable securities	(1,999)	-	(3,496)
Proceeds from sales of marketable securities	1,999	-	3,496
Payments for acquisition of tangible fixed assets	(36)	(172)	(115)
Payments for acquisition of intangible fixed assets	(32)	(41)	(64)
Proceeds from sales of investment securities	23	-	-
Payments of guarantees and deposits	(33)	(36)	-
Proceeds from repayments of guarantees and deposits	0	0	61
Proceeds from cancellation of an insurance policy	63	-	-
Others	(26)	(49)	0
	(41)	(300)	(117)

A X E L L   C O R P O R A T I O N

Years ended March 31; Millions of yen	2005	2006	2007
<b>Net cash provided by (used in) financing activities</b>			
Proceeds from issuing of securities	35	55	38
Expenditures for issuing of securities	(7)	(5)	(0)
Dividends	(307)	(528)	(1,270)
	(279)	(478)	(1,233)
Increase in cash and cash equivalents	1,594	2,173	181
Cash and cash equivalents at beginning of term	4,091	5,685	7,859
Cash and cash equivalents at end of term	5,685	7,859	8,040

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

Years ended March 31; Millions of yen	2005	2006	2007
Cash and deposit account	2,185	4,859	4,542
Marketable securities account	3,499	2,999	3,498
Cash and cash equivalents at year-end	5,685	7,859	8,040

### *Capital expenditures*

Capital investments during the year under review amounted to 159 million yen. The principal expenditures were for the relocation of the corporate headquarters during the year and for a number of investments, including investments in design and development equipment and in software for design and development.

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. The Company basically believes that dividends should reflect financial performance and arrives at the amount of its payout on the basis of a targeted dividend payout. It adjusts this amount by weighing a comprehensive range of factors, including the amount of retained earnings that is deemed necessary from the standpoint of ongoing business plans and other considerations. Its policy with respect to retained earnings is to use the cash to fund an active and flexible program of obtaining licenses to the technologies of other companies and to finance R&D activities aimed at achieving its medium-to-long term goals.

In accordance with the foregoing, the Company will pay a dividend of 7,600 yen per share for the year under review (comprising an interim dividend of 3,600 yen and a year-end dividend of 4,000 yen per share). This will result in a dividend payout ratio of 40% (compared to 31% for the previous year, based on dividends paid on common stock). The amount paid out for the year under review represents an increase in the year-end dividend of 400 yen per share. This increase came about because net income was higher than originally projected and because the Company chose to use the 40% payout ratio that was originally intended as the target dividend payout ratio.

The Company currently has a target dividend payout ratio of 50%; in its dividend plans for the year ending March 2008, it is assuming a payout of dividends at this rate.

The Company's Articles of Incorporation provide that "by resolution of the Board of Directors, the Company may pay a dividend out of retained earnings to shareholders or registered stock pledges recorded in or registered on the final shareholders' register on September 30 of each year, as provided under Article 454-5 of the Corporation Law." Accordingly, the Company pays out dividends twice annually, once in the form of an interim dividend (which is determined by the Board of Directors, with a date of record of September 30 each year) and the second in the form of a year-end dividend (which is determined by the General Meeting of Shareholders, with date of record of March 31 each year).

Dividends paid out of retained earnings for the year ended March 31, 2007 were as follows:

Date of decision	Dividend payout	Dividend per share
	(Millions of yen)	(Yen)
October 26, 2006 Resolution by Board of Directors	455	3,600
June 17, 2007 Resolution by General Meeting of Shareholders	506	4,000

## Operations

### *Nonconsolidated statement of income*

<b>Years ended March 31; Millions of yen</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>Net sales</b>	7,345	7,611	7,911
<b>Cost of sales</b>			
Finished goods inventory, beginning of term	91	14	12
Finished goods purchased during term	2,289	2,317	2,288
	2,380	2,332	2,300
Finished goods inventory, end of term	14	12	19
	2,365	2,320	2,280
Gross profit on sales	4,979	5,290	5,630
<b>Selling, general and administrative expenses</b>	1,701	1,516	1,707
Operating income	3,278	3,774	3,923
<b>Nonoperating income</b>			
Interest income	0	0	-
Interest income from securities	0	0	9
Dividend income	1	2	3
Dividends from life insurance policies	-	0	-
Gain on cancellation of an insurance policy	1	-	-
Miscellaneous income	0	0	1
	3	3	14
<b>Nonoperating expenses</b>			
New share issuance expenses	7	5	-
Expenses for sale or issuance of shares	-	-	0
Miscellaneous losses	0	0	0
	7	5	0
Ordinary profit	3,273	3,773	3,936
<b>Extraordinary income</b>			
Gain on sale of investment securities	6	-	-
	6	-	-
<b>Extraordinary losses</b>			
Loss on removal of fixed assets	0	4	-
Loss on sale of fixed assets	-	1	-
Loss on disposal of inventories	4	0	-
Impairment losses	-	21	-
	4	28	-
Income before taxes and other adjustments	3,275	3,745	3,936
Corporate, inhabitant and enterprise taxes	1,197	1,499	1,531
Deferred taxes	15	(40)	13
	1,212	1,459	1,545
Net income	2,063	2,286	2,390
Retained earnings carried forward from previous term	605	603	-
Unappropriated profit, end of term	2,668	2,889	-

## Nonconsolidated statement of changes in net assets

Millions of yen; Mar. 31, 2007	Shareholders' equity							
	Capital surplus			Retained earnings				
	Common stock	Additional paid-in capital	Total capital surplus	Legal income reserve	Other retained earnings		Total retained earnings	Total shareholders' equity
					Special earnings reserves	Retained earnings carried forward		
Balance as of Mar. 31, 2006	999	842	842	1	3,000	2,889	5,891	7,733
Changes during the term								
Issuance of new shares	19	19	19					38
Dividends (*)						(817)	(817)	(817)
Dividends						(455)	(455)	(455)
Directors' and corporate auditors' bonuses (*)						(45)	(45)	(45)
Provision for special reserves (*)					1,300	(1,300)	-	-
Net income						2,390	2,390	2,390
Other changes in non-shareholders' equity items during the term (net)								
Total changes during the term	19	19	19	-	1,300	(227)	1,072	1,111
Balance as of Mar. 31, 2007	1,018	861	861	1	4,300	2,662	6,963	8,844

Millions of yen; Mar. 31, 2007	Valuation/translation gains (losses)		Total net assets
	Unrealized gains (losses) on other securities	Total valuation/translation gains (losses)	
Balance as of Mar. 31, 2006	79	79	7,812
Changes during the term			
Issuance of new shares			38
Dividends (*)			(817)
Dividends			(455)
Directors' and corporate auditors' bonuses (*)			(45)
Provision for special reserves (*)			-
Net income			2,390
Other changes in non-shareholders' equity items during the term (net)	23	23	23
Total changes during the term	23	23	1,134
Balance as of Mar. 31, 2007	103	103	8,947

(\*) Earnings appropriated at the Company's Ordinary General Meeting of Shareholders held in June 2006.

## Appropriation of retained earnings

Millions of yen	June 18, 2006
Unappropriated profit, end of term	2,889
Appropriation of retained earnings	
Dividends	817
Directors' and corporate auditors' bonuses	45
[of which, corporate auditors' portion]	[2]
Voluntary reserves	
Special reserves	1,300
	2,162
Retained earnings carried forward to following term	727

## *Results of operations*

### **Fiscal year ended March 31, 2007**

#### *Economic and other factors affecting operations*

- 1) Gradual upward trend in Japanese economy over the full year
  - Optimistic start to the fiscal year: healthy economic growth in Europe and the United States; companies in Japan report solid earnings.
  - In 2<sup>nd</sup> half, the outlook is clouded by deceleration of U.S. economy and by a broad decline in global stock prices.
- 2) Electronics industry remains in relatively good shape, because of a strong domestic market driven by:
  - Vigorous development activities and strong sales of digital appliances such as flat screen TVs
  - Vigorous development and strong sales of high-performance products in the mobile phone industry
  - But an only average year in the amusement device market
    - a) Sales of pachislot machines trend relatively slowly in the aftermath of a revision of regulations related to amusement devices.
    - b) Overall, a healthy trend in sales of pachinko machines

#### *Strategic responses by the Company*

- 1) While focusing on sales of the AG-2 series and the AS201 sound-generating LSI, the Company also begins sales of its new AG301 graphics-generating LSI, which it foresees as becoming its principal product for the fiscal year ended March 2008 and beyond.
- 2) Emphasis on sales of various products to the built-in device market, including its AG-9 series of graphics-generating LSIs

#### *Financial analysis (year-on-year percentage change)*

- 1) 3.9% increase in net sales (See segment breakdown for analysis by product.)
- 2) 4.3% increase in ordinary profit

### ***Segment breakdown***

- 1) ASSPs: Sales of ASSPs increased by 4.0% to 7,891 million yen.
  - Although sales in this segment continued to be driven by the AG-2 series of graphic LSIs, sales of the AG301 also began contributing.
  - Sales of the AS201 series of sound-generating LSIs, for which volume production began in the year ended March 2006, increase in unit terms—accounting for a higher percentage of total sales.
  - Sales of the AG-9 series come in close to projections made at the beginning of the period.
- 2) ASICs: Sales of ASICs, made entirely to the built-in device market, declined by 20.0% to 20 million yen.

### **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 the fiscal year, as the overall economy showed signs of a gradual recovery:
    - a) Increases in private capital spending and an improved employment picture, reflecting 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 equipment employing 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 provision of “total solutions”: i.e., selling not only 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 the following:
    - 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 ended 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.

### *Issues requiring action*

The Company views the following as significant issues requiring action.

- 1) Developing high value-added products for the amusement device market and diversifying the array of its products for that market
  - Selling to the amusement device market is the Company's core business. Development of products with performance capabilities (higher resolution and more advanced functions) that meet current and future requirements in this market is a significant issue.
  - The Company also sells sound-generating LSIs and peripheral semiconductor products such as LED-control chips to this market. Increasing the performance capabilities of such products is an important issue.
  - Today's amusement devices use large quantities of electronic components. Another issue for the Company is expanding the size of its market by developing business in other areas where its technological strengths can be fully exploited.
  - The Company is dealing with each of these issues through R&D on next-generation technologies.
  
- 2) Expanding sales of graphics-rendering LSIs for the built-in device market and engaging in efforts to develop successor products
  - The Company is aiming to make the business of selling graphics-rendering LSIs to the built-in device market a second pillar of its business. It currently sells the AG-9 series in this market, and it has been generating increasing unit sales since it commenced mass production of this product. The market for built-in devices is constituted by a wide variety of devices that are manufactured in small quantities. Accordingly, expanding the range of devices in which the Company's products can be incorporated is a significant issue. In addition, developing products that are optimally suited to carefully selected markets (those selected for their potential scale) is also an important issue.
  - To deal with the foregoing, the Company continues to direct sales resources to this market; and, based on the information obtained through such activities, it is identifying market segments and engaging in R&D on products that will optimally meet the needs in those segments.

### 3) Protecting intellectual property

- The Company is acutely aware of the importance of intellectual property, and it obtains patents when they are deemed necessary in light of “patent strategies” related to its products and/or technologies.
- Current measures being taken to advance the protection of intellectual property include conducting awareness-raising seminars for employees and providing periodic opportunities within the Company for employees to consult with outside attorneys.
- The focus hereafter will be on lightening the administrative load of R&D personnel working on intellectual property-related issues and on establishing an internal environment that fosters more effective intellectual property-related strategies.

### 4) Further strengthening of the internal administrative structure

- Companies are responsible today for establishing highly reliable organizational structures that enable them to provide timely financial reports (including the timely disclosure of other corporate information), and that provide for stringent internal control over all aspects of corporate management. Building an internal control system from this new perspective is a significant issue.
- With respect to internal control, the Company has adopted a system that is appropriate to the size of its business; it believes, further, that even from the perspective of compliance, this system will serve those needs adequately.
- With the aim of strengthening corporate governance in the future, however, the Company will engage in efforts to build a more robust comprehensive internal control structure, which will include a whistleblower function and a crisis management capability.

### *Selling, general and administrative expenses*

<b>Years ended March 31; Millions of yen</b>	<b>2006</b>	<b>2007</b>
Directors' and corporate auditors' salaries	103	108
Salaries, bonuses and allowances	162	211
Depreciation	19	25
Research and development expenses	850	934

## 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	2006	2007
<b>Tools, appliances and fixtures</b>		
Acquisition cost	5	5
Accumulated depreciation	2	1
Net leased property	2	3
<b>Total</b>		
Acquisition cost	5	5
Accumulated depreciation	2	1
Net leased property	2	3
<b>Future minimum lease payments, including interest portion</b>		
Due within one year	1	1
Due after one year	2	2
	3	3
<b>Lease payments, pro forma depreciation expenses and pro forma interest expenses</b>		
Lease payments	1	1
Pro forma depreciation expenses (assuming declining balance method)	1	1
Pro forma interest expenses	0	0
<b>Operating leases - future minimum lease payments</b>		
Due within one year	-	154
Due after one year	-	462
	-	616

## Capital Structure

*Nonconsolidated balance sheet: assets*

March 31; Millions of yen	2005	2006	2007
<b>Current assets</b>			
Cash and deposits	2,185	4,859	4,542
Accounts receivable - trade	1,026	378	1,295
Marketable securities	3,499	2,999	3,498
Finished products	14	12	19
Supplies	1	0	2
Advances paid	0	0	-
Prepaid expenses	31	33	48
Deferred tax assets	62	99	77
Others	11	13	17
	6,834	8,398	9,501
<b>Fixed assets</b>			
<b>Tangible fixed assets</b>			
Buildings	36	-	91
Accumulated depreciation	16	-	16
	19	-	75
Tools, appliances and fixtures	182	217	305
Accumulated depreciation	102	122	182
	79	95	123
Construction in progress	-	91	-
	99	186	199
<b>Intangible fixed assets</b>			
Patents	53	48	43
Trademarks	2	3	3
Software	37	47	61
Telephone subscription rights	0	-	-
	93	99	108
<b>Investments and other assets</b>			
Investment securities	110	201	241
Long-term loans	0	1	-
Long-term prepaid expenses	21	38	22
Rental and guarantee deposits	96	132	70
Contributions to insurance savings	-	20	20
	228	393	356
Total fixed assets	421	679	663
Total assets	7,255	9,077	10,165

*Nonconsolidated balance sheet: liabilities and shareholders' equity*

March 31; Millions of yen	2005	2006	2007
<b>Current liabilities</b>			
Accounts payable - trade	246	89	233
Accounts payable - other	180	120	36
Accrued expenses payable	13	15	23
Income taxes payable	718	917	795
Consumption taxes payable	85	54	44
Deposits received	23	27	37
	1,268	1,226	1,170
<b>Long-term liabilities</b>			
Deferred tax liabilities	5	38	46
	5	38	46
Total liabilities	1,273	1,265	1,217
<b>Shareholders' equity</b>			
Common stock	971	999	-
Capital surplus			
Additional paid-in capital	815	842	-
	815	842	-
Retained earnings			
Legal income reserve	1	1	-
Voluntary reserves			
Special reserves	1,500	3,000	-
Unappropriated profit, end of term	2,668	2,889	-
	4,169	5,891	-
Unrealized gains or losses on other securities	25	79	-
Total shareholders' equity	5,981	7,812	-
Total liabilities and shareholders' equity	7,255	9,077	-

AXELL CORPORATION

March 31; Millions of yen	2005	2006	2007
<b>Net assets</b>			
<b>Shareholders' equity</b>			
Common stock	-	-	1,018
Capital surplus			
Additional paid-in capital	-	-	861
	-	-	861
Retained earnings			
Legal income reserve	-	-	1
Other retained earnings			
Special reserves	-	-	4,300
Retained earnings carried forward	-	-	2,662
	-	-	6,963
Total shareholders' equity	-	-	8,844
<b>Valuation/translation gains (losses)</b>			
Unrealized gains or losses on other securities	-	-	103
	-	-	103
Total net assets	-	-	8,947
<b>Total liabilities and net assets</b>	-	-	10,165

## Accounting Policies

### Summary of accounting policies: nonconsolidated

<b>Basis of presentation</b>	Japanese GAAP
<b>Marketable securities and investment securities</b>	<p>Other securities:</p> <p>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 net assets, and the cost of securities sold is calculated using the moving-average-method.</p> <p>Unquoted securities: valued at cost using the moving average-method</p>
<b>Inventories</b>	<p>Finished goods: valued at cost, computed on a periodic average basis</p> <p>Supplies: valued at cost, computed using the final purchase cost method</p>
<b>Depreciation</b>	<p>Tangible fixed assets: declining-balance method</p> <p>Intangible fixed assets:</p> <p>Patents: straight-line depreciation over 8-year period</p> <p>Trademarks: straight-line depreciation over 10-year period</p> <p>Software for internal use is amortized on a straight-line basis (based on its length of useful internal life of (3 - 5 years)</p>
<b>Deferred assets</b>	Expenses for sale or issuance of shares: recognized in full at time of expenditure
<b>Opinion of independent auditors</b>	<p>Auditors: Ernst &amp; Young ShinNihon</p> <p>Opinion: unqualified</p>

## Share-related Information

### Shares in issue

<b>Class of shares</b>	Common
<b>Number of shares authorized</b>	231,120
<b>Issued</b>	
As of March 31, 2007	126,700
As of June 18, 2007	126,700
<b>Stock exchange listings</b>	Jasdaq Securities Exchange
<b>Comments</b>	The Company's standard shares, with no limitations on 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	
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 - March 31, 2007 (note 2)	900	126,700	19	1,018	19	861	Execution of rights on stock options

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, the 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	12,105	9.56
Securities companies	24	837	0.66
Business and other corporations	52	17,378	13.72
Nonresidents - businesses and corporations	47	16,468	13.00
Nonresidents - individuals	1	1	0.00
Individuals and others	5,254	79,911	63.06
	5,388	126,700	100.0
Shares less than one unit	-	-	-

## Largest shareholders

Name	Shares owned	Held in trust accounts	% of shares outstanding
Yuzuru Sasaki	13,084		10.32
Tatsuaki Okumura	7,552		5.96
Midoriya Electric Co., Ltd.	7,200		5.68
Sumihiko Ichihara	6,360		5.01
Takayuki Shibata	5,900		4.65
Yoshinori Narita	5,012		3.95
Aval Data Corporation	4,200		3.31
Kazuyoshi Moriya	4,080		3.22
Japan Trustee Services Bank (Trust Account)	4,006	4,006	3.16
Kazunori Matsuura	3,840		3.03
	61,234		48.33

## Share information

<b>Business year</b>	April 1 to March 31
<b>Ex-rights date</b>	March 31
<b>Dates of record for dividends</b>	September 30 and March 31
<b>Annual General Meeting of Shareholders</b>	June
<b>Trading unit</b>	-
<b>Types of share certificates</b>	1, 10 and 100 shares
<b>Transfer agent</b>	Mitsubishi UFJ Trust and Banking Corporation 1-4-5, Marunouchi, Chiyoda-ku, Tokyo
<b>Publication of record</b>	<i>The Nihon Keizai Shimbun</i>

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