

CANON INC
Form 20-F
June 10, 2004

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

- () REGISTRATION STATEMENT PURSUANT TO SECTION 12(b)
OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934
OR
(X) ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2003
OR
() TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 0-12131

CANON KABUSHIKI KAISHA

(Name of Registrant in Japanese as specified in its charter)

CANON INC.

(Name of Registrant in English as specified in its charter)

JAPAN

(Jurisdiction of incorporation or organization)

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

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	Name of each exchange on which registered
(1) Common Stock (the shares)	New York Stock Exchange
(2) American Depositary Shares (ADSs), each of which represents one share	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act.

None
(Title of Class)

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

None
(Title of Class)

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* American Depositary Receipts for 50,000,000 American Depositary Shares, each American Depositary Share representing 1 share of common stock of Canon Inc., were registered under the Securities Act of 1933.

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

As of December 31, 2003, 881,338,645 shares of common stock, including 27,717,736 ADSs, were outstanding.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Item 17 Item 18

Table of Contents

TABLE OF CONTENTS

	Page number
<u>CERTAIN DEFINED TERMS, CONVENTIONS AND PRESENTATION OF FINANCIAL INFORMATION</u>	1
<u>FORWARD-LOOKING INFORMATION</u>	1
<u>PART I</u>	
<u>Item 1. Identity of Directors, Senior Management and Advisers</u>	2
<u>Item 2. Offer Statistics and Expected Timetable</u>	2
<u>Item 3. Key Information</u>	2
<u>A. Selected financial data</u>	2
<u>B. Capitalization and indebtedness</u>	3
<u>C. Reasons for the offer and use of proceeds</u>	3
<u>D. Risk factors</u>	3
<u>Item 4. Information on the Company</u>	9
<u>A. History and development of the Company</u>	9
<u>B. Business overview</u>	10
<u>Products</u>	10
<u>Marketing and distribution</u>	12
<u>Service</u>	12
<u>Net sales by product group and geographic area</u>	13
<u>Seasonality</u>	13
<u>Sources of supply</u>	13
<u>Competition</u>	14
<u>Patents and licenses</u>	15
<u>Environmental regulations</u>	15
<u>C. Organizational structure</u>	17
<u>D. Property, plants and equipment</u>	18
<u>Item 5. Operating and Financial Review and Prospects</u>	21
<u>A. Operating results</u>	21
<u>Overview</u>	21
<u>Critical accounting policies and estimates</u>	22
<u>Consolidated result of operations</u>	24
<u>Fiscal 2003 compared with fiscal 2002</u>	24
<u>Fiscal 2002 compared with fiscal 2001</u>	29
<u>Foreign operations and foreign currency transactions</u>	33
<u>Recent developments</u>	33

<u>B. Liquidity and capital resources</u>	34
<u>Liquidity</u>	34
<u>Capital resources</u>	34
<u>C. Research and development, patents and licenses, etc.</u>	35
<u>D. Trend information</u>	36
<u>Trend information</u>	36
<u>Forward looking statements</u>	36
<u>E. Off-balance sheet arrangements</u>	36
<u>F. Contractual obligations</u>	37
<u>Item 6. Directors, Senior Management and Employees</u>	38
<u>A. Directors and senior management</u>	38
<u>B. Compensation</u>	42
<u>C. Board practices</u>	42
<u>D. Employees</u>	43
<u>E. Share ownership</u>	44
<u>Item 7. Major Shareholders and Related Party Transactions</u>	45
<u>A. Major shareholders</u>	45
<u>B. Related party transactions</u>	45
<u>C. Interests of experts and counsel</u>	45

Table of Contents

<u>Item 8. Financial Information</u>	46
<u>A. Consolidated statements and other financial information</u>	46
<u>Consolidated statements</u>	46
<u>Legal proceedings</u>	46
<u>Dividend policy</u>	46
<u>B. Significant changes</u>	46
<u>Item 9. The Offer and Listing</u>	47
<u>A. Offer and listing details</u>	47
<u>Trading in domestic markets</u>	47
<u>Trading in foreign markets</u>	48
<u>B. Plan of distribution</u>	48
<u>C. Markets</u>	48
<u>Item 10. Additional Information</u>	49
<u>A. Share capital</u>	49
<u>B. Memorandum and articles of association</u>	49
<u>C. Material contracts</u>	53
<u>D. Exchange controls</u>	53
<u>E. Taxation</u>	54
<u>F. Dividends and paying agents</u>	56
<u>G. Statement by experts</u>	56
<u>H. Documents on display</u>	56
<u>I. Subsidiary information</u>	56
<u>Item 11. Quantitative and Qualitative Disclosures About Market Risk</u>	56
<u>Market risk exposures</u>	56
<u>Equity price risk</u>	56
<u>Foreign exchange rate and interest rate risk</u>	57
<u>Item 12. Description of Securities Other than Equity Securities</u>	59
<u>PART II</u>	
<u>Item 13. Defaults, Dividend Arrearages and Delinquencies</u>	59
<u>Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds</u>	59
<u>Item 15. Controls and Procedures</u>	60
<u>Item 16A. Audit Committee Financial Expert</u>	60
<u>Item 16B. Code of Ethics</u>	60

<u>Item 16C. Principal Accountant Fees and Services</u>	61
<u>PART III</u>	
<u>Item 17. Financial Statements</u>	62
<u>Report of Independent Registered Public Accounting Firm</u>	63
<u>Consolidated Balance Sheets</u>	64
<u>Consolidated Statements of Income</u>	65
<u>Consolidated Statements of Stockholders' Equity</u>	66
<u>Consolidated Statements of Cash Flows</u>	67
<u>Notes to Consolidated Financial Statements</u>	68
<u>Valuation and Qualifying Accounts</u>	103
<u>Item 18. Financial Statements</u>	104
<u>Item 19. Financial Statements and Exhibits</u>	104
<u>SIGNATURES</u>	105
<u>EXHIBIT INDEX</u>	106
<u>EX-1.1 Articles of Incorporation</u>	
<u>EX-1.2 Regulations of the Board of Directors</u>	
<u>EX-2 Regulations for Handling of Shares</u>	
<u>EX-11.1 Canon Group Code of Conduct</u>	
<u>EX-11.2 Code of Ethics</u>	
<u>EX-12 302 Certification</u>	
<u>EX-13 906 Certification</u>	

Table of Contents

CERTAIN DEFINED TERMS, CONVENTIONS AND PRESENTATION OF FINANCIAL INFORMATION

All information contained in this Annual Report is as of December 31, 2003 unless otherwise specified.

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

On March 31, 2004, the noon buying rate for yen in New York City as reported by the Federal Reserve Bank of New York was
Yen104.18 = U.S.\$1.

The Company's fiscal year end is December 31. In this Annual Report fiscal 2003 refers to the Company's fiscal year ended December 31, 2003, and other fiscal years of the Company are referred to in a corresponding manner.

FORWARD-LOOKING INFORMATION

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

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

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

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

The following selected consolidated financial data has been derived from the consolidated financial statements of Canon as of each of the dates and for each of the periods indicated below. This information should be read in conjunction with and qualified in its entirety by reference to the Consolidated Financial Statements of Canon Inc. and subsidiaries, including the notes thereto, included in this Annual Report, which have been audited by KPMG AZSA & Co., Independent Registered Public Accounting Firm.

Selected financial data*1:	2003	2002	2001	2000	1999
(Millions of yen except average number of shares and per share data)					
Net sales	Yen3,198,072	Yen2,940,128	Yen2,907,573	Yen2,696,420	Yen2,530,896
Operating profit	454,424	346,359	281,839	234,131	168,344
Income before cumulative effect of change in accounting principle	275,730	190,737	163,869	134,088	70,234
Net income	275,730	190,737	167,561	134,088	70,234
Advertising	100,278	71,725	66,837	67,840	67,544
Research and development	259,140	233,669	218,616	194,552	177,922
Depreciation	168,636	158,469	147,286	144,043	155,682
Capital expenditure	210,038	198,702	207,674	170,986	200,386
Long-term debt	59,260	81,349	95,526	142,925	165,277
Common stock	168,892	167,242	165,287	164,796	163,969
Stockholders equity	1,865,545	1,591,950	1,458,476	1,298,914	1,202,003
Total assets	3,182,148	2,942,706	2,844,756	2,832,125	2,587,532
Average number of shares (Thousands)	878,649	876,716	875,960	872,606	870,699
Per share data:					
Income before cumulative effect of change in accounting principle:					

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Basic	Yen	313.81	Yen	217.56	Yen	187.07	Yen	153.66	Yen	80.66
Diluted		310.75		214.80		184.55		151.51		79.50
Net income:										
Basic	Yen	313.81	Yen	217.56	Yen	191.29	Yen	153.66	Yen	80.66
Diluted		310.75		214.80		188.70		151.51		79.50
Cash dividends declared		50.00		30.00		25.00		21.00		17.00
Cash dividends declared (U.S.\$)*2	\$	0.464	\$	0.254	\$	0.196	\$	0.179	\$	0.164

Notes:

1. The above financial data are provided in conformity with accounting principles generally accepted in the United States of America.
2. Annual cash dividends declared (U.S.\$) translated from yen based on a weighted average of the noon buying rates for yen in New York city as reported by the Federal Reserve Bank of New York in effect on the date of each semiannual dividend payment.

Table of Contents

The following table provides the noon buying rates for Japanese yen in New York City as reported by the Federal Reserve Bank of New York expressed in Japanese yen per U.S.\$1 during the periods indicated and the high and low noon buying rates for Japanese yen per U.S.\$1 during the months indicated.

Yen exchange rates per U.S. dollar:	Average	Term end	High	Low
1999	Yen 112.79	Yen 102.16	Yen 101.53	Yen 124.45
2000	108.37	114.35	101.70	114.62
2001	122.18	131.04	114.26	131.47
2002	124.81	118.75	115.71	134.77
2003 Year	115.83	107.13	106.93	121.42
1(st) half		119.87	115.94	121.42
July		120.42	117.24	120.55
August		116.71	116.71	120.47
September		111.43	111.07	117.41
October		110.10	108.18	110.90
November		109.53	107.98	111.20
December		107.13	106.93	109.61
2004 January		105.84	105.52	107.17
February		109.26	105.36	109.59
March		104.18	104.18	112.12
April		110.37	103.70	110.37

B. Capitalization and indebtedness

Not applicable.

C. Reasons for the offer and use of proceeds

Not applicable.

D. Risk Factors

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

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

Risks Related to Canon's Industries

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

Canon has made and will continue to make investments in next-generation technology research and development initiatives. Canon's competitors may achieve research and development breakthroughs in these technologies more

quickly than Canon, or may achieve advances in competing technologies that render products under development by Canon uncompetitive.

In addition to evolution in technologies, Canon has increased the size of its investment in development and manufacturing. If an inconsistency arises between Canon's business strategies and market needs, Canon may not recover a substantial part of its investment, and lose business opportunities, both of which may materially affect Canon's operating results.

Canon's businesses, especially the digital multifunction device and camera businesses in which Canon operates, is highly competitive.

Presently, the analog copying machines and conventional film camera segments of the market are mature, with anticipated declining industry revenues as the market transitions to digital technology. Some of Canon's new digital products replace or compete with its traditional analog products. Changes in the mix of products from analog to digital, and the pace of that change as well as competitive developments could cause actual results to vary from those expected.

The recent trend of rapid digitalization has lowered the entry barriers in the digital camera segment, resulting in the entry of new competitors such as electronics manufacturers and an overall increase in the number of competitors to Canon's business. Although Canon believes that it has successfully kept pace with this trend toward digitalization, it may not be able to compete successfully in the future if it does not continue to invest in R&D activities, implement cost-cutting measures and introduce attractive and high value-added products to the market on a continuous basis.

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

Canon's camera and printer business depends upon seasonal consumer spending.

Sales of Canon's camera and printer products, particularly in the U.S., European and Japanese consumer markets, may be subject to seasonality. As a result, product sales may be impacted by seasonal purchasing patterns with higher sales generally occurring in the second half of the calendar year.

Table of Contents

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

Many of the businesses in which Canon competes are characterized by rapid technological advances in hardware performance, software functionality and product features; the frequent introduction of new products; short product life cycles; and continual improvement in product price characteristics relative to product performance. If Canon does not make an effective transition from existing products and services to new offerings, its revenue may decline. Among the risks associated with the introduction of new products and services are delays in development or manufacturing, variations in costs, delays in customer purchases in anticipation of new introductions, difficulty in predicting customer demand for new offerings and difficulty of effective management of inventory levels in line with anticipated demand.

Canon's revenue and gross margin also may suffer due to the timing of product or service introductions by its competitors. This is especially challenging when a product has a short life cycle or a competitor introduces a new product just before Canon's introduction of a similar product. Furthermore, sales of Canon's new products and services may replace sales of, or result in discounting of, some of its current offerings, sometimes offsetting the benefit of even the introduction of a successful new product or service. Canon must also manage duplicative or overlapping products and operations. Given the competitive nature of Canon's businesses, if any of these risks materialize, future demand for its products and services and consequently, its results of operations, may suffer.

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

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

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

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

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

Canon's steppers and mask aligners are affected by rapid technological change and can quickly become obsolete. Canon believes its future success in the steppers and aligners business depends on its ability to continue to enhance its existing products and develop new products using new and more advanced technologies. In particular, as semiconductor pattern sizes continue to decrease, the demand for more technologically advanced steppers is likely to increase.

Although Canon will continue to offer cost effective products by managing manufacturing costs for its technology, Canon's existing stepper and mask aligner products could become obsolete sooner than anticipated because of faster than anticipated changes in one or more of the technologies related to Canon's products or in the market demand for products based on a particular technology. Any failure by Canon to develop the advanced technologies required by its customers at progressively lower costs and to supply sufficient quantities to a worldwide customer base could adversely affect Canon's net sales and profitability.

Risks Related to Canon's Business

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

Canon depends on Hewlett-Packard for a significant part of its business. For fiscal 2003, approximately 20% of Canon's net sales were to Hewlett-Packard. As a result, its business, results of operations and financial condition may be affected by the policies, business, results of operations and financial condition of Hewlett-Packard. Any decision by Hewlett-Packard management to limit or reduce the scope of its relationship with Canon would adversely affect Canon's results of operations.

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

Canon relies on a limited number of outside vendors which meet Canon's strict criteria for quality, efficiency and environmental friendliness for certain critical components used in its products. Canon's reliance on a limited number of suppliers involves several risks, including a potential inability to obtain an adequate supply of required components, the risk of untimely delivery of these subassemblies and components, and the risk for a substantial increase in price of these components to occur.

Table of Contents

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

A portion of our net sales consists of sales of supplies and the provision of services occurring after the initial equipment placement. As these supplies and services have become more commoditized, the number of competitors in these markets has increased. Our success in maintaining these post-placement sales will depend on our ability to compete successfully with these competitors, some of which may offer lower-priced products or services.

Despite the increase in competitors as described above, Canon currently possesses a high market share in the market for supplies. Accordingly, Canon may be subject to suits, investigations or proceedings under relevant antitrust laws and regulations. Any such suits, investigations or proceedings may lead to substantial costs and have an adverse effect on Canon's operating results or reputation. Moreover, any legal or regulatory proceedings to which Canon is subject could require significant involvement of its senior management and may divert management attention from its business and operations. For more information about current legal proceedings, see Item 8.A. Financial Information Consolidated Statements and Other Financial Information Legal Proceedings.

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

Canon generally experiences seasonal trends in the sale of its consumer-oriented products. The resulting uneven sales pattern makes it difficult to predict near-term demand and places pressure on Canon's inventory management and logistics systems. If predicted demand is substantially greater than actual orders, there will be excess inventory, thereby putting downward pressure on selling prices and reducing Canon's revenue. Alternatively, if orders substantially exceed predicted demand, Canon's ability to fulfill orders may be limited, which could adversely affect net sales and increase the risk of unanticipated variations in its results of operations and financial condition. Many of the factors that create and affect seasonal trends are beyond Canon's control.

The cost of producing new products is initially high, and if such new products are not successful or if Canon fails to achieve cost reductions over time, Canon's gross profits may be adversely affected.

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

- engineering improvements;
- economies of scale;

Initial shipments of Canon's new products adversely affect its profit or cash flow, and if sales of such new products are not successful, Canon may be unable thereafter to improve its gross profit, operating results and cash flow.

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

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

Canon's success depends on the value of its brand name, and if the value of the brand name were to diminish, its revenues, operating results and prospects would be adversely affected.

Canon's success in its markets depends in part on Canon's brand name and its value. In addition, as a manufacturer and distributor of consumer products, Canon's operating results are susceptible to adverse publicity regarding the quality of its products. There can be no assurance that such adverse publicity will not occur or that such claims will not be made in the future. Furthermore, Canon cannot predict the impact of such adverse publicity on its business, financial condition and results of operations.

Canon depends on the attraction and retention of key personnel and highly qualified professionals.

Canon's future operating results depend in significant part upon the continued contributions of its engineers and key employees. In addition, Canon's future operating results depend in part on its ability to attract, train and retain other qualified management, technical, sales and support personnel for Canon's operations. The competition for these people in the high-tech industries in which Canon competes has become increasingly intense in recent years. Moreover, due to the accelerating pace of technological change, it has become increasingly difficult to train new personnel in time to meet product research and development requirements. The loss of key employees or Canon's inability to attract, retain, train and motivate qualified personnel could adversely affect Canon's business, financial condition and results of operations.

Table of Contents

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

Canon's headquarters functions, its information systems and its research and development centers are located in or near Tokyo, Japan, where the possibility of disaster or damage from earthquakes is generally higher than in other parts of the world. In addition, Canon's facilities or offices, including those for research and development, material procurement, manufacturing, logistics, sales, and services are located throughout the world and subject to the possibility of disaster or outage or similar disruption as a result of any of a number of events, including natural disasters, computer viruses and terrorist attacks. Although Canon is working to establish appropriate backup structures for its facilities and information systems, there is no assurance that Canon will be able to completely prevent or mitigate the effect of events or developments such as the aforementioned disasters, leakage of harmful substances, shutdowns of information systems, and leakage, falsifications, and disappearances of internal databases. If such factors adversely affect Canon's operating activities, generate expenses relating to physical or personal damage, or hurt Canon's brand image, its consolidated financial results and condition may be adversely affected.

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

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

- less developed technological infrastructure, which can affect production or other activities or result in lower customer acceptance of Canon's services;
- difficulties in recruiting and retaining personnel;
- potentially adverse tax consequences;
- longer payment cycles;
- unfavorable political or economic factors; and
- unexpected legal or regulatory changes.

Canon's inability to manage successfully the risks inherent in its international activities could adversely affect its business, financial condition and operating results.

In order to produce Canon's products competitively and to reduce costs, Canon has established production facilities in China. Canon is also focusing on strengthening its sales activity in China. However, with China's entry into the WTO, conditions within China are in the process of changing. Under these conditions, unexpected events, including political or legal change, labor shortage or strikes or changes in economic conditions, may occur.

In addition, the spread of an epidemic disease such as severe acute respiratory syndrome (SARS) in China spread in elsewhere in Asia could have a negative effect on Canon's business activity. Canon has previously imposed travel restrictions to and from, certain countries affected by SARS, and similar medical crises in the future may disrupt manufacturing processes and markets for Canon's products. Given the importance of Canon's Asian sales, production facilities and supply relationships, especially in China, Canon's business may be more exposed to this risk than the global economy generally.

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

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

Recent increases in counterfeit Canon products may adversely affect Canon's brand image and its revenues.

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

Table of Contents

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

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

Canon faces the risks that:

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

While Canon is not aware of any actual or potential significant impairment of, or adverse claim to, its rights in such technologies, any interference in Canon's rights to use such technologies could adversely affect its financial condition and operating results.

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

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

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

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

Disputes involving payment of consideration for employee inventions may materially affect Canon's brand image as well as its business.

Canon may face disputes involving payment of consideration given to employee inventions for which the intellectual property rights have been transferred to Canon. This risk is particularly relevant in countries such as Japan and Germany, where patent laws require companies to pay consideration to employees for the assignment of the employee's invention to the company. Canon maintains company rules on and an evaluation system for employee inventions. Canon believes it has been making adequate payments to employees for assignment of inventions based on these rules and a fair and objective assessment of amounts to be paid. Nevertheless, a former employee initiated a suit in November 2003, demanding an increase in the amount paid for an invention, and the suit is currently being adjudicated. The occurrence and outcome of such disputes could affect Canon's business as well as its operations.

Canon's business is subject to environmental laws and regulations.

Canon is subject to certain Japanese and foreign environmental requirements in areas such as energy resource conservation, reduction of hazardous substances, collection and recycling of products, clean air, water protection and waste disposal. Canon believes that it has taken adequate precautions to comply with these regulations in the course of

its ordinary business operations. Furthermore, Canon does not believe that any environmental laws or regulations currently in effect will have a material adverse effect on its operating results or financial condition. However, Canon cannot predict whether any pending or future legislation will be adopted or what effect such legislation would have on it.

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

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

In addition, Canon may face liability for alleged personal injury or property damage due to exposure to chemicals or other hazardous substances at or from its facilities. Canon may also face liability for personal injury, property damage, natural resource damage or for clean-up costs for the alleged migration of contamination or other hazardous substances from its facilities. A significant increase in the number or success of these claims and costs could adversely affect its results of operations or financial condition.

Table of Contents

Economic trends in Canon's major markets may adversely affect its net sales.

Economic downturns and declines in consumption in Canon's major markets, including Japan, the United States and Europe, may affect the levels of both corporate and consumer sales. Purchases of Canon's consumer products, such as cameras and printers, are to a very significant degree discretionary. A decline in the level of consumption caused by the worsening of general economic conditions could adversely affect Canon's results of operations.

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

The cooperation and alliances with, and strategic investments in, third parties undertaken by Canon may not produce successful results.

Canon carries out many activities with other companies in the form of alliances, joint ventures, and strategic investments. These activities are important for Canon's technological development process. However, weak business trends or disappointing performance of partners may adversely affect the success of these activities. In addition, the success of these activities may be adversely affected by the inability of Canon and its partners to successfully define and reach common objectives.

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

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

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

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

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

In connection with certain projects, Canon may receive confidential or sensitive information (such as personal information) from its customers relating to these customers or to other parties. Although Canon makes every effort to keep this information confidential through company procedures designed to prevent accidental release of confidential or sensitive information, such information may be inadvertently disclosed without Canon's knowledge. If this occurs, Canon may be subject to claims for damages from parties affected, suffer harm to its reputation or be subject to

liabilities and/or penalties under applicable statutes.

In addition, inadvertent disclosure of secretive information regarding new technology, as well as market and customer information, would have a material adverse affect upon Canon's business.

Canon depends on efficient logistics services to distribute its products worldwide.

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

Table of Contents

Item 4. Information on the Company

A. History and development of the Company

Canon Inc. is a joint stock corporation (kabushiki kaisha) formed under Japanese Commercial Code. Its principal place of business is at 30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501, Japan. The telephone number is +81-3-3758-2111.

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

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

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

In 1999, Canon and Toshiba Corporation agreed to collaborate on developing and establishing mass-production technologies for SEDs (surface-conduction electron-emitter displays) with potential in large-screen wall-mounted displays.

In 1999, Oita Canon Materials Inc. was established in Oita, Japan as an integrated production site for chemical products for business machines.

In 1999, the Canon Inc. Ayase Office was established in Kanagawa, Japan with the goal of reinforcing the R&D structure for semiconductor-related devices.

In 2000, the Canon Inc. Optics R&D Center, an R&D facility for optical technology, was established in Tochigi, Japan.

In 2000, Canon Inc. changed the listing of its American Depository Receipts (ADRs) to the New York Stock Exchange (NYSE) from the Nasdaq National Markets.

In 2001, Canon Vietnam Co., Ltd. was established in Hanoi, Vietnam as a production site for bubble jet printers.

In 2001, Canon Zhongshan Business Machines Co., Ltd. was established in Zhongshan, China as a production site for laser beam printers. China.

In 2001, Canon (Suzhou) Inc. was established in Suzhou, China as a production site for digital copying machines and digital multifunction devices.

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

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

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

On January 1, 2004, Canon Precision Inc. (Canon Precision), a wholly-owned subsidiary of Canon Inc., merged with Hirosaki Precision, Inc. (Hirosaki Precision), a wholly-owned subsidiary of Canon Precision. Hirosaki Precision was merged into Canon Precision, the surviving company. Canon Precision targets the improved efficiency and specialization of business operations. Since both Canon Precision and Hirosaki Precision were consolidated subsidiaries of Canon Inc., the merger has no impact on Canon's current or future business results.

On January 1, 2004, Canon N.T.C., Inc. (Canon N.T.C.), a wholly-owned subsidiary of Canon Inc., spun off its environmental business operations into a newly established company, named Canon Ecology Industry Inc. Following the separation, Canon N.T.C. focused its energies on its semiconductor equipment-related business and was renamed Canon Semiconductor Equipment Inc. The spin-off was intended to improve efficiency and the specialization of business operations while facilitating the pursuit of independent businesses, consistent with Canon's Excellent Global Corporation Plan.

In fiscal 2003, 2002 and 2001, Canon's capital expenditures were Yen 210,038 million, Yen 198,702 million and Yen 207,674 million, respectively. In 2003, major capital expenditure were for investments in tools and dies, but also included were investments for the relocation of the corporate headquarters office of Canon Sales Co. Inc. and the facilities for production of the semiconductor production equipment in Japan.

For the fiscal 2004, Canon projects that its capital expenditures will amount to approximately Yen 300,000 million. This amount is expected to be spent on such expenditures for the establishment of new production engineering base and new research and development base. Canon anticipates that funds needed to fulfill these capital expenditures will be generated internally through operations.

Table of Contents

B. Business overview

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

Canon sells its products principally under the Canon brand name and through sales subsidiaries. Each of these subsidiaries is responsible for marketing and distribution to retail dealers in an assigned territory. Approximately 73% of consolidated net sales in fiscal 2003 were generated outside Japan; approximately 33% in the Americas, 30% in Europe and 10% in other areas including Asia.

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

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

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

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

Products

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

-Business machines-

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

Office imaging products

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

The office-use market is subject to rapid change, and in fiscal 2003, customer preferences has shifted from copying machines to digital MFDs, as well as from monochrome to color products. To respond to these trends, Canon has been strengthening its lineup of digital MFDs in the imageRUNNER (iR) series, which have versatile functions, such as copying, printing, scanning, faxing and data-sharing functions on the Internet and intranets. Canon is also marketing diverse expansion modules, software and business solutions to increase customer value. For the development of MFDs, Canon makes effective use of wide range of technologies from the fields of optics, mechatronics, electronic photo processing, chemical materials and image processing. Canon's MFDs are differentiated chiefly by the use of leading-edge System On a Chip technology in the imageRUNNER controller, which acts as the "brains" of networked

MFDs. The controller provides easy integration with customers' IT environments together with speedy, high-quality image processing. This boosts office productivity, thereby garnering acclaim from business customers. Canon also introduced new MFD models throughout fiscal 2003, including the Color imageRUNNER C3200 (iR C3200), the first color offerings in the imageRUNNER series, which achieved healthy sales.

Canon has a powerful line of full-color copying machines and color digital MFDs for users ranging from professional graphic designers to business offices. The trend in printing industry is gradually moving away from large-lot printing using expensive machinery to small-lot printing on demand and personalized printing. Canon's high-end MFDs and color digital MFDs can be applied to the print on demand market. In addition, Canon aims to respond to the growing demand for color imaging for business needs with products using its renowned S Toner, featuring spherical particles and a microscopic wax-based structure, and our oil-less fixing engine.

Canon has dominant market share in monochrome copying machines for personal use. Demand for analog products is continuing in Asia, Russia and Eastern Europe. Canon also introduced digital products in the Americas and in Europe in response to the shift in demand toward digital products.

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

Computer peripherals

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

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

Table of Contents

As the inventor of bubble jet printing technology, Canon believes it continues to provide customers with the best performance the technology has to offer. Canon provides high-performance and high value added models both in single-function printers and multi-function printers. In response to heated competition in the inkjet printer segment, Canon launched several new models in fiscal 2003. Particularly noteworthy were the bubble jet printers supporting the PictBridge digital camera-printer communications standard, which were released in the second half of the year. These new models incorporated New MicroFine Droplet Technology, which has boosted image quality and print speed over those offered on previous models. The keys to a successful printer are speed, image quality and paper handling capabilities. Although ranked high among the leaders in all three categories, Canon has targeted each category for improvements. Additionally, the PictBridge system has been marked for enhancement, and future printers will offer even stronger integration with digital cameras.

Canon markets a wide variety of products for a spectrum of user needs, including image scanners in CanoScan LiDE series using Contact Image Sensor, scanners with charge-coupled devices for high resolution that can also scan film in the CanoScan series, and film scanners that handle both 35 mm film and advanced photo system cartridge. Canon has deployed its expertise to develop space-saving, energy-efficient scanners, as well as easy PC connection via universal serial bus interface. However, since peaking in 2000, the scanner market has continued to shrink at a rate of 10% to 20% per year. Under the prevailing highly competitive conditions, it is necessary for Canon to attain a high market share. To achieve that goal, Canon has successfully introduced several new scanner models.

Business information systems

Business information systems primarily consist of micrographic equipment, personal computers, calculators, document scanners and work stations.

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

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

The work stations and personal computers sold by Canon are manufactured by third parties under the manufacturers' own brand names.

-Cameras-

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

Digital cameras have become common tools to input images into PCs. In addition to ensuring the best possible image quality throughout its product lineup, Canon offers digital compact cameras that are easy to use and to carry. In 2003, the compact digital camera market continued to show significant growth. Canon introduced six new PowerShot series and three Digital ELPH series cameras and has finally reached the top position in the industry, in unit sales basis.

Canon's digital single-lens reflex cameras are designed to meet needs from amateurs to professionals. These cameras incorporate innovative technologies such as 45-point area auto-focus, eye-controlled auto-focus, depth-of-field control, Base-stored Image Sensor (BASIS), Complementary Metal Oxide Semiconductor (CMOS) imaging sensors, Digital Imaging Processor (DIGIC), and a fully electronic mount system to transmit data between the lens and the camera chassis. Particularly in the digital single-lens reflex camera segment, popular new product offerings including the EOS 10D and EOS Digital Rebel (EOS 300D Digital) bolstered Canon's dominant position worldwide. Canon's digital single-lens reflex cameras feature the company's proprietary, CMOS imaging sensors to offer advantages like low image noise, and low power consumption. Both the sensor technology, and the cameras themselves, won numerous awards in the respective industries.

Canon also offers a comprehensive line-up of conventional film cameras to satisfy the needs of users everywhere, from models with high-performance zoom lenses to models with large enhanced viewfinders and full water resistance. Hindered by the surging popularity of digital cameras, the continued shrinking of the conventional film camera market has been a recent trend. Canon's introduction of new models in fiscal 2003, however, enabled it to retain its position firmly atop this market worldwide and to record a healthy level of profitability. With a cautious eye on market trends, Canon will continue to develop new products and maintain a firm commitment to the film camera market.

In the camera lens segment, technological developments, including diffractive optical elements, image stabilizer and ultrasonic motor, have helped Canon to maintain a technical lead over other makers. Canon offers over 50 lenses in the EF series. These high-quality, high-performance lenses provide outstanding performance with digital cameras as well as silver-halide cameras, greatly contributing to Canon's sales. Due to market expansion of digital single-lens reflex cameras, sales of middle to high-class lenses have been increasing. The introduction of new lenses offering optimum performance with Canon's digital single-lens reflex cameras is planned for 2004.

Canon also provides full line-up video camcorders from versatile, compact and stylish models to its flagship models for professionals. Canon's video camcorders incorporate the same optical technologies and digital signal processing technology as its world-renowned cameras, and come equipped with optical image stabilizers and its one-chip video integrated circuit signal-processing system large scale integration to ensure high image quality. Canon's video camcorders are favored by many users for its optical image stabilizer, and red-green-blue primary color filters. The adoption of megapixel charge coupled devices, secure digital memory cards and universal serial bus connectivity offers a wealth of possibilities for the creation and management of still images, as well as video. In addition, together with DV Messenger software, Canon video camcorders can be used to communicate via the Internet with real-time sound and images. In the worldwide digital video camcorder market, Canon's eight new products have increased its share in the market. According to GfK Marketing Services Japan Ltd., a market research company, Canon's Optura 300 (MVX 10i) maintained the leading position in terms of units of sales in the Japanese market for the three months from October through December of fiscal 2003. The Optura was rated highly for its advanced DIGIC DV digital imaging processor, which improves both digital movie quality and digital still quality.

Table of Contents

Since Canon introduced the new PictBridge-equipped CP series compact photo printers in fiscal 2003, the market has shown very positive signs of accepting this distinctive new printer category. Canon's CP series of dye-sublimation photo printers allows users to print digital photos without having to use a PC, thereby creating a new photo-processing culture for digital camera users. In fiscal 2004, Canon aims to show strong leadership and presence in this new printer market.

-Optical and other products -

Canon's optical and other products includes semiconductor production equipment, broadcasting lenses, medical equipment and electronic components.

Semiconductor production equipment includes steppers and mask aligners. Steppers are used to expose circuits on silicon substrates. Canon has commercialized a Krypton Fluoride excimer-laser steppers and an Argon Fluoride excimer-laser scanning steppers. At the top of its class, the new Argon Fluoride excimer-laser scanning stepper makes possible top-level throughput rates of over 140 wph (wafers per hour) for 300 mm wafers. Canon announced in Japan in July, 2003 that it had begun accepting purchase orders for its latest 300 mm-compatible lithography tool the Canon FPA-6000ES6 a Krypton Fluoride scanning stepper enabling volume production at the 100 nm process node.

Mask aligners are used to produce liquid crystal displays, or LCDs, and Canon's model for large-sized LCD substrates are sold particularly well in line with increased demand for large flat panels for PC display and LCD televisions. Canon, together with nine other Japanese semiconductor-industry companies, have formed the Extreme Ultraviolet Lithography System Development Association. The consortium aims to develop key technology for next-generation lithography.

Canon is the world leader in television broadcasting lenses, which are used to capture images from sports and news events, concerts and studio broadcasts.

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

Other products sold by Canon include electronic components, such as magnetic heads for audio and video tape recorders and micro-motors for printers and other components, which are sold primarily to equipment manufacturers. Canon has also been developing a cost efficient solar-power system that incorporates amorphous silicon technology which is used in Canon's high-end monochrome copying machines.

Marketing and distribution

Canon sells its products primarily through subsidiaries with responsibility for specific geographic areas. Each subsidiary is responsible for its own market research and for determining its sales channels, advertising and promotional activities.

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

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

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

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

Canon also sells laser beam printers on an OEM basis to Hewlett-Packard Company. Hewlett-Packard Company resells these printers under the HP LaserJet Printers name. During fiscal 2003, such sales constituted approximately 20% of Canon's consolidated net sales, as compared to 21% in the previous fiscal year.

Service

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

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

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

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

Years ended December 31					
(Millions of yen except percentage data)					
	2003	change	2002	change	2001
Bussiness machines:					
Office imaging products	Yen 1,061,099	+3.7%	1,023,131	+4.4%	980,053
Computer peripherals	1,089,312	+3.2	1,055,956	+0.8	1,047,385
Bussiness information products	123,493	-16.1	147,108	-25.0	196,051
	<u>2,273,904</u>	<u>+2.1</u>	<u>2,226,195</u>	<u>+0.1</u>	<u>2,223,489</u>
Cameras	653,540	+34.5	485,778	+27.4	381,367
Optical and other products	270,628	+18.6	228,155	-24.6	302,717
	<u>2,273,904</u>	<u>+2.1</u>	<u>2,226,195</u>	<u>+0.1</u>	<u>2,223,489</u>
Total	Yen 3,198,072	+8.8	2,940,128	+1.1	2,907,573

NET SALES BY GEOGRAPHIC AREA

Years ended December 31					
(Millions of yen except percentage data)					
	2003	change	2002	change	2001
Japan					
Unaffiliated customers	Yen 856,851	+8.6%	789,066	-8.1%	858,580
Intersegment	1,662,172	+12.7	1,475,091	+7.0	1,378,031
Total	2,519,023	+11.3	2,264,157	+1.2	2,236,611
Americas					
Unaffiliated customers	Yen 1,044,998	+3.7%	1,007,572	+2.4%	983,561
Intersegment	8,101	-17.3	9,791	-44.0	17,475
Total	1,053,099	+3.5	1,017,363	+1.6	1,001,036
Europe					
Unaffiliated customers	Yen 968,938	+13.6%	852,931	+5.9%	805,243
Intersegment	3,861	-16.8	4,639	+89.4	2,449
Total	972,799	+13.4	857,570	+6.2	807,692

Others						
Unaffiliated customers	Yen	327,285	+12.6%	290,559	+11.7%	260,189
Intersegment		503,119	+17.9	426,914	+42.6	299,410
Total		<u>830,404</u>	<u>+15.7</u>	<u>717,473</u>	<u>+28.2</u>	<u>559,599</u>
Eliminations						
Unaffiliated customers	Yen		%		%	
Intersegment		(2,177,253)		(1,916,435)		(1,697,365)
Total		<u>(2,177,253)</u>		<u>(1,916,435)</u>		<u>(1,697,365)</u>
Consolidated						
Unaffiliated customers	Yen	3,198,072	+8.8%	2,940,128	+1.1%	2,907,573
Intersegment						
Total		<u>3,198,072</u>	<u>+8.8</u>	<u>2,940,128</u>	<u>+1.1</u>	<u>2,907,573</u>

Note: Net sales geographic area is determined by the location of the Canon entity originating the sale.

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

Seasonality

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

Sources of supply

Canon purchases a variety of parts and raw materials, such as glass, aluminum, plastic, steel and chemicals for use in product manufacturing. All finished and semi-finished products purchased from outside sources are produced in accordance with Canon's designs and specifications. Canon purchases parts and raw materials worldwide for its global production activities. Canon assesses and selects suppliers based on a number of criteria, including environmental friendliness, quality, cost, stability of supply and financial condition. In addition, there has been a recent increase in prices of parts for optical products, due in part to the limited number of suppliers of glass materials and light source lasers. However, Canon has not experienced any difficulty obtaining parts or raw materials and believes that it will be able to continue to obtain the same in sufficient quantities to meet its needs.

Table of Contents

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

Competition

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

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

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

Business machines

The markets for office imaging products, computer peripherals and business information products are highly competitive. Canon's primary competitors in these markets are Xerox Corporation, Hewlett-Packard Company, Lexmark International Group Inc., Ricoh Company, Ltd., and Epson Corporation. Canon believes that it is one of the leading global manufacturers of digital MFDs, laser beam printers, bubble jet printers, image scanners and facsimile machines. In addition to the general elements of competition described above, Canon's ability to compete successfully in these markets also depends significantly on whether it can provide effective, broad-based business solutions to its customers that solve multiple interrelated client needs. In particular, the ability to provide equipment and software that connect effectively to computer networks (ranging in scope from local area networks to the Internet) is often a key to Canon's competitive strength in these markets. In China, whose markets are expected to expand since its joining of the World Trade Organization, the current market leaders are Toshiba Tec Corporation, Sharp Corporation and Konica Minolta Holdings, Inc. However, Canon is striving to become one of the leading players in China. Canon believes that the introduction of new digital technologies and value-added solutions will help steer Canon's business successfully through fast-moving markets such as China.

Cameras

Competition in the camera industry is intense, with many established market participants offering similar products. Canon's primary competitors in digital cameras are Sony Corporation, Fuji Photo Film Co., Ltd., Olympus Optical Co., Ltd., Nikon Corporation, Casio Computer Co., Ltd. and Eastman Kodak Company. Currently, Canon shares the top position with Sony Corporation in unit sales of compact digital cameras, while Canon is the current leader in the digital single-lens reflex camera segment. Canon's primary competitors in conventional film cameras are Nikon

Corporation, Konica Minolta Holdings, Inc., Pentax Corporation, Olympus Optical Co., Ltd., and Fuji Photo Film Co., Ltd. Hindered by the surging popularity of digital cameras, the conventional film camera market continued to shrink in fiscal 2003. The introduction of new models, however, enabled Canon to retain its position firmly atop this market worldwide. Canon's primary competitors in digital video camcorders are Sony Corporation, Victor Company of Japan Ltd. and Matsushita Electric Industrial Co., Ltd. In fiscal 2003, Canon expanded greatly its overall market share in digital video camcorders, especially in the United States. Canon believes that developing cameras with increasingly high resolution and faster image processing are critical to its ability to remain competitive in the fast-growing digital camera market segment.

Steppers and Aligners

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

Canon's primary competitors in the market for steppers and aligners are Nikon Corporation and ASML Holding N.V., or ASML. Nikon Corporation has a reputation for its excellent technology, especially optical lenses, and Intel Corporation, the world's leading semiconductor manufacturer, is one of their major customers. ASML has in recent years improved its competitive position by taking advantage of government subsidies and by focusing on the rapidly growing foundry manufacturer industry. In fiscal 2002, ASML further increased its competitive position by acquiring SVG Lithography Systems Inc. As a result of the acquisition, ASML is now one of the largest semiconductor manufacturing equipment companies in Europe.

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

Table of Contents**Patents and licenses**

Canon holds a large number of patents (including utility model rights), design rights and trademarks in Japan and abroad to protect its research and development and utilizes these intellectual property rights as important strategic management tools. For instance, Canon has obtained and maintains its intellectual property rights such as patents in its products business operations, and forms alliances and technological exchanges with other companies.

According to the Statistical Report issued annually by the United States Patent and Trademark Office, Canon has been consistently ranked as second or third in recent years in terms of the number of patents issued in the United States.

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

Some examples include:

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

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

Some examples include:

Jerome H. Lemelson Patent Incentives, Inc.	(computer systems, image recording, communication devices)
Energy Conversion Devices, Inc.	(solar battery)
Honeywell Inc.	(camera and video products)
Gilbert P. Hyatt U.S. Philips Corporation	(microcomputer)
SI Diamond Technology Inc.	(display technology)

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

Some examples include:

International Business Machines Corporation	(information handling systems)
Hewlett-Packard Company	(Bubble Jet printers)
Xerox Corporation	(business machines)
Matsushita Electric Industrial Co., Ltd.	(video tape recorders and video cameras)
Eastman Kodak Co.	(electro-photography and image processing technology)

Ricoh Company, Ltd.

(electrophotography products, facsimiles, and word processors)

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

Environmental regulations

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

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

These directives were adopted by the European Parliament in December 2002. Member states are required to bring into force the laws necessary to comply with these directives by August 13, 2004. Commencing July 1, 2006, companies must ensure that their electrical and electronic equipment sold in the European Union does not contain lead, cadmium, hexavalent chromium, mercury, polybrominated biphenyls or polybrominated diphenyl ethers if placed on the market after that date. Pursuant to the RoHS Directive, Canon will be required to adapt its products so that they do not contain the prohibited hazardous substances.

The WEEE Directive requires that by August 13, 2005, companies that sell electrical and electronic equipment bearing their trade names in the European Union must arrange and pay for the collection, treatment, recycling, recovery and disposal of their equipment and achieve designated recycling rates by December 31, 2006. Pursuant to the WEEE Directive, Canon will be required to establish collection and recycling systems for waste electrical and electronic equipment and achieve the recycling ratio of waste electrical and electronic equipment by the designated dates. The increased cost associated with the WEEE directive may adversely affect Canon's results of operations.

Table of Contents

2. Superfund of the United States.

Under the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA, and the Resource Conservation and Recovery Act (collectively known as Superfund) and related state laws, certain persons may be liable for the release or threatened release of hazardous substances, including petroleum and its derivatives, into the environment. These persons include the current owner or operator of property where the release or threatened release occurred, any persons who owned or operated the property when the release occurred, and any persons who arranged for the disposal of hazardous substances at the property. Liability under CERCLA is strict, retroactive, and in most cases involving the state government as plaintiff, is joint and several, so that any responsible party may be liable for the entire cost of investigating and remediating the release of hazardous substances. As a practical matter, however, liability at most CERCLA and similar sites is shared among all solvent, potentially responsible parties. The liability of a party is determined by the cost of investigation and remediation, the portion of the hazardous substance(s) the party contributed to the site, and the number of solvent, potentially responsible parties.

Canon has identified a potential remediation site in connection with one of its former manufacturing sites. See Risk Factors Risks Related to Canon s Business Environmental clean-up and remediation costs relating to Canon s properties and associated litigation could decrease Canon s net cash flow, adversely affect its results of operations and impair its financial condition.

3. Soil Pollution Prevention Law of Japan

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

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

4. Law for Promotion of Effective Utilization of Resources of Japan

The Law for Promotion of Effective Utilization of Resources of Japan, or the Resources Law , was enacted in April 2001. The Resources Law requires specified recycling industries, including the copying machine industry, to enact measures designed to promote waste reduction, reuse and recycling of raw materials. These requirements will increase Canon s costs and may have an adverse affect on its results of operations and financial conditions.

5. Law on Promoting Green Purchasing of Japan

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

In response to the law, Canon expects in the future to:

manufacture products that consume less electricity to prevent global warming and to conserve energy,
use recycled parts and recycled materials,

reduce the types of raw materials used in order to conserve resources,

accelerate the date by which the requirements of the law are implemented to promote the elimination of hazardous substances.

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

6. *California Electronic Waste Recycling Act of 2003*

Enacted in September 2003, the California Electronic Waste Recycling Act seeks to create a system for the collection and recycling of electronic products. The Act makes it unlawful to sell, on and after July 1, 2004, a covered electronic device in California to a consumer unless the California Integrated Waste Management Board or the California Environmental Protection Agency's Department of Toxic Substances Control determines that the manufacturer of that device is in compliance with the Act. Electronic devices covered include cathode ray tubes, cathode ray tube devices, flat panel screens, or any other similar video display device with a screen size greater than four inches measured diagonally, if the Department of Toxic Substances Control determines that they are hazardous when discarded or disposed. The Act prohibits the sale of a covered electronic device, after January 1, 2005, that is not labeled, as specified in the Act. Under the Act, retailers selling a covered electronic device in California must collect an electronic waste recycling fee from the consumer on and after July 1, 2004, and to transmit the fee to the California Integrated Waste Management Board. A manufacturer that sells covered electronic devices in California must, by July 1, 2005, and at least once annually thereafter, submit a report to the California Integrated Waste Management Board on the number of covered electronic devices it sold in California during the previous calendar year and other information regarding certain specified materials in those devices. This other information includes estimated amounts of use and reduction in the use from the previous year of six hazardous substances (lead, cadmium, hexavalent chromium, mercury, polybrominated biphenyls or polybrominated diphenyl ethers), as well as estimated amounts of recycled materials contained in covered devices. Manufacturers are also required to make information available to consumers describing where and how to return, recycle and dispose of a covered electronic device. The scope of the covered devices is yet unclear, and Canon will incur costs once the Department of Toxic Substances Control determines which of its products are covered by the Act.

Table of Contents

7. Draft European Union Directive on Batteries and Accumulators and Spent Batteries and Accumulators

On November 21, 2003, the European Commission proposed a draft Directive on Batteries and Accumulators and Spent Batteries and Accumulators to replace a similar existing directive. Whereas the existing directive applies only to batteries with a certain mercury, cadmium and lead content, the new directive applies to all batteries and accumulators placed on the European Community market. When enacted, the new directive will require specified labels on all batteries. In addition, the directive establishes specific targets for collection, treatment and recycling of batteries and accumulators. Canon expects that compliance with the directive will increase its financial costs such as recycling fees and guarantees of products placed on the market.

8. Clean Production Promotion Law of China

The Clean Production Promotion Law of China, effective as of January 1, 2003, provides, among other things, for environmentally conscious design, elimination of hazardous substances, ease of disassembly, material identification, collection and recycling. The Chinese government is expected to publish a list of products to be collected, but it is yet unclear what action Canon needs to take at the present time.

9. Draft Management Methods for the Prevention and Control of Pollution from the Production of Electronic Information Products of China

Modeled on the European Union RoHS Directive described above, the Chinese Ministry of Information Industry and State Environmental Protection Administration are drafting a proposal Management Methods for the Prevention and Control of Pollution from the Production of Electronic Information Products - that regulates the content of electronic information products. This draft law, the latest version of which was issued in August 2003, would prohibit certain substances from being included in electronic products that are manufactured or sold in China. In addition to the six substances prohibited by the EU RoHS Directive, the draft Chinese law would also prohibit other hazardous substances, although it is unclear what substances are covered by this phrase. The proposed law requires producers to label goods that contain harmful materials and designate them as fully-recyclable, partially-recyclable, or non-recyclable. Producers would also be required to assume costs of recovery of discarded equipment. The August 2003 draft does not indicate when the law might become effective, although a previous draft proposed an effective date of January 1, 2006.

New environmental legislation and regulations such as the RoHS Directive in Europe and similar legislation and regulation in other countries will have an impact on Canon's production methods. Lead-free solder, for example, which is to replace traditional toxic lead solder, demands different and more complex manufacturing processes due to its higher melting point. Although the details of the RoHS Directive are yet unclear, Canon has proceeded to develop a green, toxic-free procurement policy with other industry leaders.

In addition, Canon has long been an industry leader in the recycling of laser inkjet cartridges and other consumable items, as well as in the actual materials used for the production and packaging of its products. In 1990, Canon pioneered the collecting and recycling of used toner cartridges, and has to date recycled over 120,000 tons of those cartridges. Today, the toner cartridges Canon collects are 100% recycled in four facilities worldwide.

C. Organizational structure

Canon Inc. and its subsidiaries and affiliates form a group of which Canon Inc. is the parent company. As of December 31, 2003, Canon had 198 consolidated subsidiaries and 19 affiliated companies accounted for by the equity method.

The following table lists the significant subsidiaries owned by Canon Inc., all of which are consolidated, as of December 31, 2003.

Name of company	Head office location	Proportion of ownership interest owned	Proportion of voting power held
Canon Sales Co., Inc.	Tokyo, Japan	50.3%	51.1%
Canon U.S.A., Inc.	New York, U.S.A.	100.0%	100.0%
Canon Europa N.V.	Amstelveen, The Netherlands	100.0%	100.0%

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

Canon's manufacturing is conducted primarily at 18 plants in Japan and 14 plants in other countries. Canon owns all of the buildings and the land on which its plants are located, with the exception of certain leases of land and floor space of certain of its subsidiaries. The names and locations of Canon's plants and other facilities, their approximate floor space and the principal activities and products manufactured therein as at December 31, 2003 are as follows:

Name and location	Floor space (including leased space)	Principal activities and products manufactured
Domestic	(Thousands of square feet)	
Shimomaruko Headquarters, Tokyo (Corporate Headquarters)	2,473	Develop business machines and cameras; prosecute patents; conduct purchasing, quality assurance, research, and planning for production engineering and technology
Kosugi Office, Kanagawa	398	Conduct R&D in software and systems
Fuji-Susono Research Park, Shizuoka	1,014	Conduct R&D in electro-photographic technologies
Canon Research Center, Kanagawa	137	Conduct R&D of basic and advanced technologies for future businesses
Hiratsuka Development Center,	460	Conduct R&D in electronic devices and display
Ayase Office, Kanagawa	315	Conduct R&D in semiconductor devices
Ecology Research & Development Center, Kyoto	92	Conduct R&D in environmental technologies
Optics R&D Center, Tochigi	187	Conduct R&D in optics technologies
Tamagawa Plant, Kanagawa	434	Development of inkjet printers and inkjet chemicals
Utsunomiya Plant, Tochigi	586	Produce camera lenses, video camcorder lenses, broadcasting lenses and other specialized optical lenses
Toride Plant, Ibaraki	2,406	Conduct R&D in electro-photographic technologies, mass-production trials and support, and produce copying machines and laser beam printer consumables
Ami Plant, Ibaraki	1,258	Produce business machines, tools, production equipment and optical products

Utsunomiya Optical Products Operations, Tochigi	1,005	R&D, manufacturing, sales, servicing of steppers; R&D, sales of optical broadcasting equipment; R&D, sales, servicing of medical equipment
Kamisato Office, Saitama	62	Produce medical equipment

18

Table of Contents

Name and location	Floor space (including leased space)	Principal activities and products manufactured
Domestic	(Thousands of square feet)	
Canon Electronics Inc. Plants, Saitama and Gunma	1,070	Produce laser beam printers, laser beam printer units, magnetic components and micrographics
Canon Finetech Inc, Plants, Ibaraki, Tokyo, Yamanashi, and Fukui	1,405	Produce copying machines, copying machine consumables, copying machine parts, copying machine accessories, inkjet color card and label printers
Canon Precision Inc. Plants, Tokyo and Aomori	654	Produce micro-motors, precision parts and laser beam printer consumables
Optron Inc. Plant, Ibaraki	136	Produce optical crystals and vapor deposition materials
Canon Chemicals Inc. Plants, Ibaraki	1,390	Produce copying machine and laser beam printer consumables
Canon Components Inc. Plant, Saitama	357	Produce contact image sensors and inkjet printer consumables
Oita Canon Inc. Plant, Oita	320	Produce 35mm and advanced photo system cameras, digital video camcorders and digital cameras
Nagahama Canon Inc. Plant, Shiga	1,021	Produce laser beam printers, laser beam printer consumables, inkjet printer consumables
Oita Canon Materials Inc. Plant, Oita	1,190	Produce copying machine and laser beam printer consumables
Ueno Canon Materials Inc. Plant, Mie	559	Produce copying machine and laser beam printer consumables
Fukushima Canon Inc. Plant, Fukushima	649	Produce inkjet chemicals
Canon N.T.C., Inc. Plants, Ibaraki and Saitama	1,322	Produce parts for business machines
Nisca Corporation Plant, Yamanashi	676	Produce copying machine parts and accessories

Table of Contents

Name and location	Floor space (including leased space)	Principal activities and products manufactured
Overseas	(Thousands of square feet)	
[Europe]		
Canon Giessen GmbH Plant, Giessen, Germany	359	Produce copying machines and copying machine consumables
Canon Bretagne S.A.S. Plant, Liffre, France	506	Produce copying machines, copying machine consumables and laser beam printers
[America]		
Canon Virginia, Inc. Plants, Virginia, U.S.	1,010	Produce laser beam printers and laser beam printer consumables; refurbish copying machines
[Asia]		
Canon Inc., Taiwan Plant, Taiwan	432	Development and manufacture 35mm single-lens reflex cameras and leaf shutter cameras; manufacture advanced photo system cameras
Canon Opto (Malaysia)Sdn. Bhd. Plant, Selangor, Malaysia	551	Produce leaf shutters, advanced photo system cameras, digital cameras, video camcorder and camera lenses
Canon Dalian Business Machines, Inc. Plant, Dalian China	1,213	Produce laser beam printers and laser beam printer consumables
Cannon Zhuhai, Inc. Plant, Zhuhai, China	669	Produce leaf shutter cameras, laser beam printers, facsimile machines and scanner
Tianjin Canon Co., Ltd. Plant, Tianjin, China	154	Produce copying machines
Guang-Dong United Optical Instrument Co., Ltd. Plant, Guang Dong, China	14	Produce leaf shutter cameras
Canon Hi-Tech (Thailand) Ltd. Plant, Ayutthaya, Thailand	1,043	Produce copying machines, inkjet printers and facsimile machines
Canon Engineering (Thailand) Ltd. Plant, Ayutthaya, Thailand	128	Produce business machines part molds and dies

Canon Zhoughshan Business Machines Co., Ltd. Plant, Zhoughshan, China	470	Produce laser beam printers
Canon Vietnam Co., Ltd. Plant, Hanoi, Vietnam	275	Produce inkjet printers
Canon Suzhou Inc. Plant, Suzhou, China	921	Produce copying machines

Canon considers its manufacturing and other facilities to be well maintained and believes that its plant capacity is adequate for its current requirements. At December 31, 2003, book value Yen 11,358 million of land, buildings and related equipment were subject to mortgages securing Yen 4,955 million of Canon's indebtedness.

Table of Contents

Item 5. Operating and Financial Review and Prospects

A. Operating Results

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

Overview

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

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

Economic environment

Looking back at the global economy in 2003, although economic conditions in the United States remained stagnant during the first half of the year, a recovery quickly took hold from the third quarter, led by healthy consumer spending resulting from tax cuts, and growth in capital investment in the private sector, which was supported by the low-interest rate monetary policy. The economies of Europe remained flat through most of 2003, although an increase in exports accompanying the upturn in the U.S. economy pointed to signs of a recovery in the region in the latter half of the year. Asian economies grew substantially during 2003, particularly in China, as the adverse effects of the Severe Acute Respiratory Syndrome (SARS) epidemic were kept to a minimum. In Japan, while there were no signs of a turnaround in consumer spending or employment and income conditions, a gradual recovery was evident during the second half of the year as exports and capital investment showed steady improvement.

Summary of operations

Canon achieved record highs in both consolidated net sales and net income, and a fourth consecutive year of sales and profit growth, mainly due to a significant increase in sales of digital cameras and color network digital multifunction devices, or MFDs. In fiscal 2003, Canon achieved 8.8% growth in net sales, to Yen 3,198,072 million, marking the first time it has surpassed the Yen 3,000 billion level, and a 44.6% increase in net income, to Yen 275,730 million. Canon's gross profit increased by 14.9%, to Yen 1,608,900 million. This improvement was the result of an increase in sales volume as well as an improved gross profit ratio, made possible through development reforms that shortened lead times for new product launches and cost savings realized through sustained production reforms.

Key performance indicator

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

KEY PERFORMANCE INDICATOR

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net sales (Millions of yen)	Yen 3,198,072	Yen 2,940,128	Yen 2,907,573	Yen 2,696,420
Gross profit to net sales ratio	50.3%	47.6%	44.0%	41.5%
R&D expense to net sales ratio	8.1%	7.9%	7.5%	7.2%
Operating profit to net sales ratio	14.2%	11.8%	9.7%	8.7%
Inventory turnover within days	49 days	51 days	57 days	65 days
Debt to total assets ratio	3.1%	5.0%	10.4%	13.8%

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

-Revenues-

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

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

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

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

Table of Contents

-Cash Flow Management-

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

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

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

Product information

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

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

Office imaging products include office network digital MFDs, color network digital MFDs, office copying machines,

personal-use copying machines and full-color copying machines.

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

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

The camera product group includes single lens reflex (SLR) cameras, compact cameras, digital cameras and digital video camcorders.

The optical and other products product group includes steppers for semiconductor chip production, mirror projection mask aligners used in the production of LCDs, television broadcasting lenses and medical equipment.

Effective January 2003, Canon reclassified certain products that were historically included in business systems, now called business information products. Facsimiles, including certain personal digital MFDs, are now classified as office imaging products. Products based on inkjet technology are now classified as inkjet printers in computer peripherals. In connection with these business alignment adjustments, copying machines were renamed office imaging products and business systems were renamed business information products. Information for previous fiscal years has been reclassified to conform to the current classification.

Critical accounting policies and estimates

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and based on the selection and application of significant accounting policies, which

require management to make significant estimates and assumptions. Canon believes that the following are some of the more critical judgment areas in the application of its accounting policies that currently affect its financial condition and results of operations.

Revenue recognition

Canon recognizes revenue for sales of products when persuasive evidence of an arrangement exists, delivery has occurred and title and risk of loss have been transferred to the customer, the sales price is fixed or determinable, and collectibility is probable. These criteria are met for mass-merchandising products such as printers and cameras at the time when the product is received by the customer based on the free-on-board destination sales terms, and for equipment with acceptance provisions such as steppers and aligners at the time when the equipment is received by the customer and the specific criteria of the equipment functionality is successfully tested and demonstrated by Canon to the customer. Service revenues are derived primarily from maintenance contracts on our equipment sold to customers and are recognized over the term of the contracts. A substantial portion of office imaging products is sold with service maintenance guarantee contracts for which the customer typically pays a base service fee plus a variable amount based on usage.

Allowance for doubtful accounts

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

Valuation of inventories

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

Table of Contents

Environmental liabilities

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

Collectibility of receivables

Canon is required to estimate the collectibility of its trade receivables. A considerable amount of judgment is required in assessing the ultimate realization of these receivables, including the current creditworthiness of each customer, taking into account business conditions, turnover of receivables and financial positions of significant customers. Significant changes in required reserves have been recorded in recent periods and may occur in the future, depending on the financial status of customers under the current environment. In case the financial quality of customers becomes worse, reserves for each customer will increase and will adversely affect net income.

Deferred tax assets

Canon currently has significant deferred tax assets, which are subject to periodic recoverability assessments. Realization of Canon's deferred tax assets is principally dependent upon its achievement of projected future taxable income. Canon's judgments regarding future profitability may change due to future market conditions, its ability to continue to successfully execute its operating restructuring activities and other factors. Any changes, in any of these factors may require possible recognition of significant valuation allowance against these deferred tax asset balances. In the event Canon considers certain deferred tax assets not to be recoverable, unrecoverable amounts will be included in income taxes in the statements of income and may adversely affect net income.

Employee retirement and severance benefit plan

Canon has significant employee retirement and severance benefit obligations which are developed from actuarial valuations. Inherent in these valuations are key assumptions, including discount rates and expected return on plan assets. Management must consider current market conditions, including changes in interest rates, in selecting these assumptions. Other assumptions include assumed rate of increase in compensation levels, mortality rate, and withdrawal rate. Changes in these assumptions inherent in the valuation are reasonably likely to occur from period to period. These changes in assumptions may lead to changes in related employee retirement and severance benefit costs or credits in the future.

Actual net periodic benefit cost may differ from net periodic benefit cost estimated at the beginning of a period due to changes in assumptions regarding the discount rate that would in turn affect service costs, changes in assumptions regarding the expected long-term rate of return on plan assets that would in turn affect interest cost on projected benefit obligations, and changes in assumptions regarding net amortization. The revised discount rate and expected rate of increase in future compensation levels are used to calculate net periodic benefit cost for the following fiscal year, unless more current valuations of plan assets and obligations are available.

In preparing its financial statements for fiscal 2003, Canon estimated a discount rate of 2.7% and an expected long-term rate of return on plan assets of 3.6%. In estimating the discount rate, Canon determines which of its long-term debt securities have the same maturity period as the remaining service period, and matches this period with

the remaining life expectancy of Canon's participants. In addition, in determining the discount rate, Canon takes into account estimations with respect to future changes expected by management in the interest rates of its debt securities. Canon establishes the expected long-term rate of return on plan assets based on management's expectations of the long-term return of the various plan asset categories in which it invests. Management develops expectations with respect to each plan asset category based on actual historical returns and its current expectations for future returns.

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

Increases in expected return on plan assets may decrease net periodic benefit cost by increasing expected return amounts, while differences between expected value and actual fair value of those assets could affect adversely net income in the following years, and vice versa. For fiscal 2004, if a change of 50 basis points in the expected long-term rate of return on plan assets is to occur, that may cause a change of approximately ¥2,360 million in net periodic benefit cost. Canon multiplies management's expected long-term rate of return on plan assets by the value of its plan assets, such value being calculated by taking into account potential changes in the fair value of the plan assets, to arrive at the expected return on plan assets that is included in pension income (expense). Canon defers recognition of the difference between this expected return on plan assets and the actual return on plan assets. The net deferral of unrecognized asset gains (losses) affects the value of plan assets in fiscal years and, ultimately, future pension income (expense).

Canon's domestic benefit plan weighted-average asset allocations (see note 11 to the consolidated financial statements) has changed from fiscal 2002 to fiscal 2003. In particular, cash, as a percentage of total plan assets, increased to 21.8% in fiscal 2003, compared to 6.8% in fiscal 2002. Canon increased the relative proportion of cash and decreased the relative proportion of equity securities and debt securities in anticipation of transferring a substitutional portion of its defined benefit pension plan to the Japanese government in fiscal 2004.

Table of Contents**Consolidated result of operations****Fiscal 2003 compared with fiscal 2002**

Summarized results of operations for fiscal 2003 and fiscal 2002 are as follows:

	2003	Change	2002
	(Millions of yen, except per share amounts and percentage data)		
Net sales	Yen 3,198,072	+ 8.8%	Yen 2,940,128
Operating profit	454,424	+31.2	346,359
Income before income taxes and minority interest	448,170	+35.8	330,017
Net income	275,730	+44.6	190,737
Earnings per share:			
Basic	313,81	+44.2	217.56
Diluted	310,75	+44.7	214.80

Note: See note of Item 3A Selected Financial Data .

Sales

With respect to the markets in which the Canon Group operates, demand for digital cameras and digital video camcorders continued to expand in 2003. While shifting business demand toward multifunctionality and color stimulated strong sales of network digital MFDs, computer peripherals, which consists mainly of printers, struggled amid severe price competition. In the field of optical products, the semiconductor-production equipment market began to show signs of a recovery while increased demand for liquid crystal display (LCD) televisions fueled growth in the market for projection aligners. These increases were a result of enhanced development reforms activities such as 3D computer aided design (3D-CAD). These improvements have significantly shortened product-development lead times and thus made it possible to launch new, competitively priced products at a faster pace. Under these conditions, Canon s consolidated net sales in fiscal 2003 totaled Yen 3,198,072 million. This represents an 8.8% increase from the previous fiscal year, reflecting a significant growth in sales of digital cameras and color network digital MFDs.

Overseas operations are significant to Canon s operating results and generated approximately 73% of total net sales in fiscal 2003. Such sales are denominated in the applicable local currency and are subject to fluctuations in the value of the yen in relation to such other currencies. Despite efforts to reduce the impact of currency fluctuations on operating results, including localizing some manufacturing and procuring parts and materials from overseas suppliers, Canon believes such fluctuations have had and will continue to have a significant effect on results of operations. The average value of the yen in 2003 was Yen 115.61 to the U.S. dollar, and Yen 131.02 to the euro, representing an appreciation of 8% against the U.S. dollar, and a depreciation of 10% against the euro, compared with the previous year. These effects of foreign exchange rate fluctuations unfavorably impacted net sales by approximately Yen 25,100 million. Net sales decreased by approximately Yen 105,800 million in U.S. dollars, increased by Yen 76,400 million in euro, and increased by Yen 4,300 million in other foreign currencies.

Cost of sales

Cost of sales reflects principally the cost of raw materials, parts and labor used by Canon in the manufacture of its products. A portion of the raw materials used by Canon is imported or includes imported materials. Such raw

materials are subject to fluctuations in world market prices and exchange rates that may affect Canon's cost of sales. Other components of cost of sales include depreciation expenses from plants, maintenance expenses, light and fuel expenses and rent expenses. The ratio of cost of sales to net sales for the past three fiscal years was 49.7%, 52.4% and 56.0%, respectively.

Gross profit

Canon's gross profit in fiscal 2003 increased by 14.9% to Yen 1,608,900 million from fiscal 2002 as a result of increased sales and an improved gross profit ratio. Gross profit margins also benefited from cost reductions achieved through continued production reforms activities.

Selling, general and administrative expenses

The major components of selling, general and administrative expenses are payroll, R&D, advertising expenses and other marketing expenses. Selling, general and administrative expenses increased by 9.6% from the previous year and amounted to Yen 1,154,476 million. An increase in R&D expenditures and advertising and other marketing expenses largely accounted for this increase. Canon maintains a high level of R&D expenditure to strengthen its R&D capabilities. R&D expenditures grew 10.9% from the previous year to Yen 259,140 million, resulting from increased R&D activities in the area of business machines and cameras. Advertising and other marketing expenses increased by 39.8% from the previous year to Yen 100,278 million, reflecting management's policy to strengthen Canon's corporate and brand images.

Operating profit

Operating profit in fiscal 2003 significantly increased by 31.2% to Yen 454,424 million from fiscal 2002. Operating profit in fiscal 2003 was 14.2% of net sales, compared with 11.8% in fiscal 2002.

Other income (deductions)

Other income (deductions) improved by Yen 10,088 million, due to the increase in net interest income resulting from the company's strengthened financial condition, as well as the decrease in currency exchange losses and improved earnings of equity affiliates.

Table of Contents*Income before income taxes and minority interests*

Income before income taxes and minority interests in fiscal 2003 was Yen 448,170 million, a 35.8% increase from fiscal 2002, and constituted 14.0% of net sales.

Income taxes

Provision for income taxes increased by Yen 27,950 million from fiscal 2002, primarily as a result of the increase in income before income taxes. The effective tax rate during the term declined by 4.5% compared with fiscal 2002 due to an increased tax credit for R&D expenditures arising from an amendment to Japanese tax regulations.

Net income

Net income in fiscal 2003 increased substantially by 44.6% to Yen 275,730 million, which exceeds the growth rate of income before income taxes. This represents an 8.6% return on net sales.

Sales by product

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

	2003	Change	2002
	(Millions of yen except percentage data)		
Business machines:			
Office imaging products	Yen 1,061,099	+3.7%	Yen 1,023,131
Computer peripherals	1,089,312	+3.2	1,055,956
Business information products	123,493	-16.1	147,108
	<hr/>	<hr/>	<hr/>
Total business machines	2,273,904	+2.1	2,226,195
	<hr/>	<hr/>	<hr/>
Cameras	653,540	+34.5	485,778
Optical and other products.	270,628	+18.6	228,155
	<hr/>	<hr/>	<hr/>
Total	Yen 3,198,072	+8.8%	Yen 2,940,128
	<hr/>	<hr/>	<hr/>

Sales of business machines, constituting 71% of consolidated net sales, increased 2.1%, to Yen 2,273,904 million in fiscal 2003.

Sales of office imaging products increased 3.7%, to Yen 1,061,099 million. Demand for network digital MFDs appears to be shifting from monochrome machines to color models, as well as towards higher-end features. The Color imageRUNNER(iR) C3200/iRC3200N, Canon's first color offerings in the high-end imageRUNNER(iR)-series lineup, was well received in Japan and overseas markets, and contributed significantly to increased sales of office

imaging products. Among monochrome network digital MFDs, the high-end iR5000 series and iR105 models continued to record strong sales during the term. Color office imaging products accounted for 20% and 17% and monochrome office imaging products accounted for 72% and 75% of office imaging products sales in fiscal 2003 and 2002, respectively. Sales of facsimiles remained flat and accounted for the remaining 8% of sales of office imaging products in both fiscal 2003 and 2002.

Sales of computer peripherals increased 3.2%, to Yen 1,089,312 million. While sales of laser beam printers were flat in the previous year due to inventory adjustment by Canon's OEM partner, a recovery in orders fueled robust growth in terms of unit sales during 2003, especially among personal models. Although unit sales of inkjet printers increased due to favorable acceptance of such models as the i560, i860, and MultiPASS MP700/MP730 (high-speed multifunction inkjet systems), severe price competition resulted in a slight decrease in amount of sales. Sales of computer peripherals as a whole mainly increased, due to increased sales of laser beam printers. The adverse effect of severe price competition on sales of computer peripherals was more than offset by a rise in unit sales. As a result, sales of computer peripherals in 2003 increased by 3.2%.

Sales of business information products decreased 16.1%, to Yen 123,493 million, in fiscal 2003, mainly due to management's decision to curtail sales of personal computers on stand-alone basis, because such sales were unprofitable, and to concentrate more on providing comprehensive business solutions.

Sales of cameras continued to achieve significant sales growth of 34.5%, totaling Yen 653,540 million. Amid the continued strong demand for digital cameras worldwide, Canon launched several new compact digital cameras in 2003, including six new PowerShot-series models and three new DIGITAL ELPH-series. These new products, led by the PowerShot S400 DIGITAL ELPH and PowerShot A70, contributed significantly to an increase in sales. Canon's digital single-lens reflex cameras also enjoyed sales growth, supported by the introduction of new product lineups, including the EOS 10D, launched in the first half of 2003, and the EOS Digital Rebel, launched in September 2003. Sales of conventional film cameras continued to decline amid the increasing popularity of digital models. Digital cameras accounted for 61% and 45% and conventional film cameras accounted for 21% and 31% of camera sales in fiscal 2003 and 2002, respectively. Video camcorders accounted for the remaining 18% and 24% of camera sales in fiscal 2003 and 2002, respectively. In the field of digital video camcorders, the eight new products Canon launched in fiscal 2003, including the OPTURA 300, as well as the ZR Series (ZR60, ZR65, ZR70), contributed to increased sales. Sales of cameras constituted 20% of consolidated net sales in fiscal 2003, an increase of 4% from fiscal 2002, primarily due to increased sales of digital cameras.

Sales of optical and other products increased 18.6%, to Yen 270,628 million. Sales of aligners for the production of LCDs displayed notable growth as the PC monitor industry continued its shift from cathode-ray tube (CRT) to LCD computer displays, and the LCD television market continued to expand. Sales of steppers, used for the production of semiconductors, also increased as the semiconductor market began to show signs of a turnaround. Sales of optical and other products constituted 9% of consolidated net sales in fiscal 2003 and increased 18.6% from fiscal 2002, primarily due to increased sales of aligners for LCDs and steppers.

Table of Contents**Sales by region**

A summary of net sales by region in fiscal 2003 and fiscal 2002 is provided below:

	<u>2003</u>	<u>Change</u>	<u>2002</u>
	(Millions of yen, except percentage data)		
Japan	Yen 801,400	+9.4%	Yen 732,551
Americas	1,045,166	+3.5	1,010,166
Europe	969,042	+13.1	857,167
Others	382,464	+12.4	340,244
	<u> </u>	<u> </u>	<u> </u>
Total	Yen 3,198,072	+8.8%	Yen 2,940,128
	<u> </u>	<u> </u>	<u> </u>

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

A geographical analysis indicates that net sales in fiscal 2003 increased in every region.

In Japan, net sales increased by 9.4% in fiscal 2003 despite a decrease in sales of personal computers due to Canon's intentional curtailment of such sales in Japan. The results were mainly attributable to increased sales of office imaging products and digital cameras. Color network digital MFDs, which include the Color imageRUNNER(iR) C3200/iRC3200N, have been well received, contributing to increased sales of office imaging products.

In the Americas, net sales increased by 11.9% on a local currency basis, mainly due to increased sales of digital cameras, network digital MFDs and laser beam printers. Sales of digital cameras experienced continued strong demand and benefited from the effect of newly-launched products. After accounting for the appreciation of the yen against the U.S. dollar, net sales in the Americas increased by 3.5%.

In Europe, net sales increased by 5.4% on a local currency basis, mainly due to increased sales of digital cameras and laser beam printers. After accounting for the depreciation of the yen against the euro, net sales in Europe grew 13.1% in fiscal 2003.

Sales in other areas increased by 12.4% on a yen basis in fiscal 2003, reflecting overall sales growth, particularly in digital cameras and semiconductor equipment.

Operating profit by product

Operating profit for business machines in fiscal 2003 increased Yen 76,080 million to Yen 487,096 million. Operating profit ratio also improved by 2.9% to 21.4%. Sales of business machines in fiscal 2003 totaled Yen 2,273,904 million, an increase of 2.1%. In addition to cost-cutting measures and the introduction of new price-competitive products, which contributed to an improvement in the gross profit ratio, a steady increase in sales volume resulted in an increase in operating profit in fiscal 2003 of 18.5%.

Operating profit for cameras increased Yen 56,028 million to Yen 126,318 million. Significantly improved profitability for camera products resulted from the rapid growth in sales of digital cameras, along with a significant

improvement in the gross profit ratio, made possible through effective cost-saving initiatives in development and production reforms activities. Consequently, operating profit in the camera segment increased by 79.7%.

Optical and other products generated operating losses of Yen 11,414 million in 2003, an improvement from losses of Yen 11,652 million in fiscal 2002, despite increased sales of 18.5% for the segment. These continuing operating losses are primarily the result of severe price competition and a one-time expense for the disposal of inventories relating to obsolete scanning steppers.

Table of Contents

Segment information by product and by geographic area for the years ended December 31, 2003 and 2002 are shown below. This segment information is prepared under Japanese GAAP.

The following table provides segment information by product:

As of / for the year ended December 31, 2003					
	Business machines	Cameras	Optical and other products	Corporate and eliminations	Consolidated
	(Millions of Yen)				
Net sales:					
Unaffiliated customers	Yen 2,273,904	Yen 653,540	Yen 270,628		Yen 3,198,072
Intersegment			141,718	Yen (141,718)	
Total	2,273,904	653,540	412,346	(141,718)	3,198,072
Operating cost and expenses	1,786,808	527,222	423,760	5,858	2,743,648
Operating profit	Yen 487,096	Yen 126,318	Yen (11,414)	Yen (147,576)	Yen 454,424
Assets	Yen 1,260,790	Yen 317,672	Yen 418,208	Yen 1,185,478	Yen 3,182,148
Depreciation and amortization	118,556	17,712	20,526	26,810	183,604
Capital expenditure	105,700	25,894	31,483	46,961	210,038

As of / for the year ended December 31, 2002					
	Business machines	Cameras	Optical and other products	Corporate and eliminations	Consolidated
	(Millions of Yen)				
Net sales:					
Unaffiliated customers	Yen 2,226,195	Yen 485,778	Yen 228,155		Yen 2,940,128
Intersegment			139,608	Yen (139,608)	
Total	2,226,195	485,778	367,763	(139,608)	2,940,128

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Operating cost and expenses	<u>1,815,179</u>	<u>415,488</u>	<u>379,415</u>	<u>(16,313)</u>	<u>2,593,769</u>
Operating profit	Yen <u>411,016</u>	Yen <u>70,290</u>	Yen <u>(11,652)</u>	Yen <u>(123,295)</u>	Yen <u>346,359</u>
Assets	Yen 1,296,829	Yen 263,532	Yen 338,377	Yen 1,043,968	Yen 2,942,706
Depreciation and amortization	106,865	14,118	19,817	24,460	165,260
Capital expenditure	104,877	15,627	23,767	54,431	198,702

Notes:

- (1) General corporate expenses of Yen 147,616 million in fiscal 2003 and Yen 123,193 million in fiscal 2002 are included in Corporate and eliminations.
- (2) Corporate assets of Yen 1,185,506 million in fiscal 2003 and Yen 1,044,036 million in fiscal 2002, which consist mainly of cash and cash equivalents, marketable securities and corporate properties, are included in Corporate and eliminations.

Table of Contents

The following table provides segment information by geographic area:

As of / for the year ended December 31, 2003

	Japan	Americas	Europe	Others	Corporate and eliminations	Consolidated
(Millions of Yen)						
Net sales:						
Unaffiliated customers	Yen 856,851	Yen 1,044,998	Yen 968,938	Yen 327,285		Yen 3,198,072
Intersegment	<u>1,662,172</u>	<u>8,101</u>	<u>3,861</u>	<u>503,119</u>	Yen (2,177,253)	
Total	2,519,023	1,053,099	972,799	830,404	(2,177,253)	3,198,072
Operating cost and expenses	<u>2,025,442</u>	<u>998,492</u>	<u>946,282</u>	<u>806,281</u>	<u>(2,032,849)</u>	<u>2,743,648</u>
Operating profit	<u>Yen 493,581</u>	<u>Yen 54,607</u>	<u>Yen 26,517</u>	<u>Yen 24,123</u>	<u>Yen (144,404)</u>	<u>Yen 454,424</u>
Assets	Yen 1,600,726	Yen 306,140	Yen 546,625	Yen 249,755	Yen 478,902	Yen 3,182,148

As of / for the year ended December 31, 2002

	Japan	Americas	Europe	Others	Corporate and eliminations	Consolidated
(Millions of Yen)						
Net sales:						
Unaffiliated customers	Yen 789,066	Yen 1,007,572	Yen 852,931	Yen 290,559		Yen 2,940,128
Intersegment	<u>1,475,091</u>	<u>9,791</u>	<u>4,639</u>	<u>426,914</u>	Yen (1,916,435)	
Total	2,264,157	1,017,363	857,570	717,473	(1,916,435)	2,940,128
Operating cost and expenses	<u>1,867,817</u>	<u>969,542</u>	<u>836,341</u>	<u>699,420</u>	<u>(1,779,351)</u>	<u>2,593,769</u>
Operating profit	<u>Yen 396,340</u>	<u>Yen 47,821</u>	<u>Yen 21,229</u>	<u>Yen 18,053</u>	<u>Yen (137,084)</u>	<u>Yen 346,359</u>
Assets	Yen 1,485,238	Yen 346,021	Yen 460,521	Yen 202,388	Yen 448,538	Yen 2,942,706

Notes:

(1)

General corporate expenses of Yen 147,616 million in fiscal 2003 and Yen 123,193 million in fiscal 2002 are included in Corporate and eliminations.

- (2) Corporate assets of Yen 1,185,506 million in fiscal 2003 and Yen 1,044,036 million in fiscal 2002, which consist mainly of cash and cash equivalents, marketable securities and corporate properties, are included in Corporate and eliminations.
- (3) Segment information by geographic area is determined by the location of Canon or its relevant subsidiary.

Table of Contents**Fiscal 2002 compared with fiscal 2001**

Canon achieved record highs in fiscal 2002 in both consolidated net sales and net income, and the third consecutive year of sales and profit growth, mainly due to a significant increase in sales of digital cameras and digital video camcorders, and steady growth in the office imaging product group. In fiscal 2002, Canon achieved 1.1% growth in sales, to Yen 2,940,128 million, and a 13.8% increase in net income, to Yen 190,737 million. The improvement in profit margins in fiscal 2002 was largely attributable to cost reductions from product reformation activities and shortened lead times for bringing new products to market.

Summarized results of operations for fiscal 2002 and fiscal 2001 are as follows:

	2002	Change	2001
	(Millions of yen except per share amounts and percentage data)		
Net sales	Yen 2,940,128	+ 1.1%	Yen 2,907,573
Operating profit	346,359	+ 22.9	281,839
Income before income taxes and minority interest	330,017	+ 17.2	281,566
Income before cumulative effect of change in accounting principle	190,737	+ 16.4	163,869
Net income	190,737	+ 13.8	167,561
Earnings per share:			
Income before cumulative effect of change in accounting principle:			
Basic	217.56	+ 16.3	187.07
Diluted	214.80	+ 16.4	184.55
Net income:			
Basic	217.56	+ 13.7	191.29
Diluted	214.80	+ 13.8	188.70

Note: See note of Item 3A Selected Financial Data .

Sales

The global economy reflected the following trends in 2002. The U.S. economy exhibited to signs of an economic upturn at the beginning of the year, led mainly by progress made in the area of inventory adjustment. In the second half of the year, however, the economic recovery in the United States began losing its momentum, owing to deterioration in consumer confidence, which resulted in sluggish consumer spending, and the collapse of several major companies, which led to a decline in business confidence. While European economies recovered moderately overall in 2002, the pace of recovery decelerated in Germany and France during the latter half of the year. In Asia, China's economy continued to grow substantially while the other economies in the region sustained modest growth. The Japanese economy remained stagnant throughout the year with no signs of a recovery amid the harsh backdrop of falling stock prices and growing uncertainty over prospects for a recovery in the global economy, especially in the United States.

With respect to the markets in which the Canon Group operates, flagging global demand for personal computers resulted in reduced demand for printers and other IT-related equipment, while corporate-use digital copying machines,

especially multifunction and color machines, posted favorable results. The digital camera and digital video camcorder markets continued to show strong growth in Japan and overseas, supported by robust demand. In the field of semiconductor-production equipment, price and volume declines in the memory device market due to weak sales of personal computers inhibited a recovery in capital spending by chip manufacturers. The average value of the yen in 2002 was Yen 124.73 to the U.S. dollar, and Yen 118.39 to the euro, a depreciation of 3% and 8%, respectively, compared with the previous year.

Amid these conditions, Canon recorded 1.1% growth in sales, to Yen 2,940,128 million. This growth reflected increased sales of digital cameras and digital video camcorders, and steady growth in the office imaging segment offsetting decline in semiconductor production equipment and other product lines.

Cost of sales

Cost of sales reflects principally the cost of raw materials, parts and labor used by Canon in the manufacture of its products. A portion of the raw materials used by Canon is imported or includes imported materials. Such raw materials are subject to fluctuations in world market prices and exchange rates that may affect Canon's cost of sales. Other components of cost of sales include depreciation expenses from plants, maintenance expenses, light and fuel expenses and rent expenses. The ratio of cost of sales to net sales for the past three fiscal years was 52.4%, 56.0% and 58.5%, respectively.

Selling, general and administrative expenses

Selling, general and administrative expenses increased 5.5% from the previous year and amounted to Yen 1,053,672 million. This increase was primarily attributed to increase in R&D expenditures and advertising and marketing costs. Canon maintains a high level of R&D expenditure to strengthen its R&D capabilities. R&D expenditures increased 6.9% from the previous year to Yen 233,669 million, resulting from increased R&D activities relating to cameras and optical and other products.

Operating profit

Operating profit in fiscal 2002 totaled Yen 346,359 million, an increase of 22.9% from the previous year. Operating profit in fiscal 2002 was 11.8% of net sales, compared with 9.7% in fiscal 2001. In fiscal 2002, the depreciation of the yen increased net sales by approximately Yen 93,300 million and increased cost of sales by approximately Yen 15,300 million. Canon's gross profit ratio during the year improved 3.6% to 47.6%. This improvement in gross profit margins reflects the positive effects of reforms with respect to Canon's research and development (R&D) reformation activities, such as the incorporation of 3D computer aided design (3D-CAD). These improvements have significantly shortened product-development lead times and thus made it possible to launch competitive new products in succession, which has supported favorable pricing. Gross profit margins have also benefited from reductions achieved through continued production reformation activities, and the lower value of the yen.

Table of Contents*Other income (deductions)*

In the area of other income and expenses, the promotion of cash flow management has bolstered Canon's financial strength, evidenced by an improvement in net interest income of Yen 3,551 million in fiscal 2002 compared with fiscal 2001, achieving a positive figure in this category for the first time. Currency exchange losses, however, increased by Yen 8,667 million to Yen 23,468 million, while securities contributed to the Company's retirement benefit trust in fiscal 2001 resulted in a Yen 15,536 million gain. Consequently, non-operating income and expenses in fiscal 2002 worsened by Yen 16,069 million from fiscal 2001.

Income before income taxes and minority interests

Income before income taxes in fiscal 2002 was Yen 330,017 million, a 17.2% increase from fiscal 2001, and constituted 11.2% of net sales.

Net income

Net income in fiscal 2002 totaled Yen 190,737 million, an increase of 13.8% from fiscal 2001. This amount represents a 6.5% return on net sales. Income taxes as a percent of income before income taxes in fiscal 2002 remained at approximately the same level as for fiscal 2001, decreasing by 0.1% to 40.8%.

Sales by product

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

	<u>2002</u>	<u>Change</u>	<u>2001</u>
	(Millions of yen except percentage data)		
Business machines:			
Office imaging products	Yen 1,023,131	+ 4.4%	Yen 980,053
Computer peripherals	1,055,956	+ 0.8	1,047,385
Business information products	147,108	25.0	196,051
	<u>2,226,195</u>	<u>+ 0.1</u>	<u>2,223,489</u>
Cameras	485,778	+ 27.4	381,367
Optical and other products	228,155	24.6	302,717
	<u>713,933</u>	<u>+ 26.0</u>	<u>684,084</u>
Total	Yen 2,940,128	+ 1.1%	Yen 2,907,573
	<u>2,940,128</u>	<u>+ 1.1%</u>	<u>2,907,573</u>

Sales of business machines (office imaging products, computer peripherals and business information products), constituting 75.7% of consolidated net sales, increased 0.1%, to Yen 2,226,195 million in fiscal 2002.

Sales of office imaging products (including digital, color, office and personal models) increased 4.4%, to Yen 1,023,131 million. In the copying machines sub-segment, Canon's imageRUNNER(iR)-series lineup of 16 to 105 copy-per-minute digital networked black-and-white multifunction copying machines showed steady sales growth in fiscal 2002. In particular, the mid-range iR2200/2800/3300 series and the high-end iR5000/6000 series, iR7200 and iR105 model recorded healthy sales during the term. While the color copying machine market showed some growth during the year, reflecting the growing acceptance of color office documents, sales of Canon color copying machines decreased slightly in fiscal 2002 due to a decrease in unit sales of high-end models.

Sales of computer peripherals (mainly laser beam printers, inkjet printers and image scanners) suffered a slight decline of 0.8%, to Yen 1,055,956 million. While unit sales of laser beam printers increased in 2002, total sales slightly decreased due to an overall trend toward sales of lower-end models and to the strategic reduction of inventory balances by Canon's original equipment manufacturing (OEM) partner in the first half of 2002. The introduction of new inkjet printer products, such as the BJ S500/300-series lineup and PIXUS 950i/550i models, contributed to strong sales of inkjet printers in the Japanese and U.S. markets. Although unit sales of inkjet printers decreased in 2002 compared to the prior year, total sales increased due to growth in sales of mid- and high-end models.

Sales of the business information products (including micrographic equipment, personal computers and calculators) decreased 25.0%, to Yen 147,108 million in fiscal 2002. The decrease was mainly due to the declining sales of personal computers in Japan.

Sales of cameras increased 27.4%, to Yen 485,778 million. Demand for digital cameras continued to be strong worldwide, with the successive introductions of new compact PowerShot-series and IXY DIGITAL-series models bolstering Canon's lineup and contributing to a significant increase in sales. Also well received by the market were the EOS D60 and EOS-1Ds digital SLR models, which were also introduced in fiscal 2002. As a result, the unit sales for digital cameras nearly doubled the number for the previous year. In contrast, sales of conventional film cameras continued to slip in fiscal 2002 amid the increasing popularity of digital models and price competition. Sales of digital video camcorders continued to show substantial growth, supported by the introduction of new ZR-series, Elura-series and Optura-series models. Consequently, camera sales overall enjoyed double-digit 27.4% growth in fiscal 2002.

Sales of optical and other products (including steppers for semiconductor chip production, aligners for liquid crystal displays, TV broadcasting lenses, medical equipment) decreased 24.6%, to Yen 228,155 million, mainly due to a decrease in unit sales of steppers for semiconductor chip production. The decrease is attributable to a drop in demand for semiconductor-production equipment, reflecting restrained capital spending by memory device manufacturers. Sales of optical and other products constituted 7.8% of consolidated net sales in fiscal 2002, which decreased 2.6% compared with fiscal 2001.

Table of Contents**Sales by region**

Net sales in fiscal 2002 increased in the Americas, Europe and other areas, but decreased in Japan.

In Japan, net sales decreased by 11.5% in fiscal 2002. Sales of personal computers and semiconductor production equipment declined due to a decrease in the number of units sold. In the Americas, net sales slightly increased by 0.4% on a local currency basis. This increase was mainly attributable to increased sales of digital cameras and digital video camcorders, and was partially offset the negative impact of a decline in laser beam printer sales due to a strategic reduction of inventory balances by Canon's OEM partner. The depreciation of the yen resulted in a 2.9% increase in sales in the Americas related to the translation of U.S. dollar sales to Japanese yen. In Europe, net sales decreased by 1.3% on a local currency basis. Sales growth in digital cameras offset sales declines in semiconductors production equipment and inkjet printers. After accounting for the depreciation of the yen, net sales in Europe increased 6.3% in fiscal 2002. Sales in other areas increased 16.5% in fiscal 2002, reflecting significant overall sales growth, particularly in digital cameras and digital video camcorders.

A summary of net sales by region in fiscal 2002 and fiscal 2001 is provided below:

	<u>2002</u>	<u>Change</u>	<u>2001</u>
	(Millions of yen, except percentage data)		
Japan	Yen 732,551	11.5%	Yen 827,288
Americas	1,010,166	+ 2.9	982,104
Europe	857,167	+ 6.3	806,104
Others	340,244	+16.5	292,077
	<u> </u>	<u> </u>	<u> </u>
Total	Yen 2,940,128	+ 1.1%	Yen 2,907,573
	<u> </u>	<u> </u>	<u> </u>

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

Operating profit by product

Operating profit for business machines in fiscal 2002 increased Yen 76,098 million to Yen 411,016 million. Operating profit ratio also improved by 3.4% to 18.5%. Sales of business machines overall remained at approximately the same level as for fiscal 2001, increasing by 0.1% to Yen 2,226,195 million in fiscal 2002. Cost cutting measures, however, along with healthy sales of price-competitive mid-range and high-end copying machines and bubble jet printers favorably affected operating profit ratio. As a result, operating profit for the business machine segment increased by 22.7%.

Operating profit for cameras increased Yen 34,146 million to Yen 70,290 million. Greatly improved profitability for camera products, realized through the rapid rise in sales of digital cameras and digital video camcorders coupled with effective cost-cutting measures and a decline in the price of electronic components, boosted operating profit in the camera segment by 94.5%.

Optical and other products, which recorded an operating profit of Yen 23,850 million in fiscal 2001, suffered operating losses of Yen 11,652 million in fiscal 2002 mainly due to a 24.6% decrease in sales of semiconductor production equipment, reflecting restrained capital spending by memory device manufacturers.

Table of Contents

Segment information by product and by geographic area for the years ended December 31, 2002 and 2001. This segment information is prepared under Japanese GAAP.

The following table provides segment information by product:

As of/for the year ended December 31, 2002					
	Business machines	Cameras	Optical and other products	Corporate and eliminations	Consolidated
(Millions of yen)					
Net sales:					
Unaffiliated customers	Yen 2,226,195	Yen 485,778	Yen 228,155		Yen 2,940,128
Intersegment			139,608	Yen (139,608)	
Total	2,226,195	485,778	367,763	(139,608)	2,940,128
Operating cost and expenses	1,815,179	415,488	379,415	(16,313)	2,593,769
Operating profit	Yen 411,016	Yen 70,290	Yen (11,652)	Yen (123,295)	Yen 346,359
Assets	Yen 1,296,829	Yen 263,532	Yen 338,377	Yen 1,043,968	Yen 2,942,706
Depreciation and amortization	106,865	14,118	19,817	24,460	165,260
Capital expenditure	104,877	15,627	23,767	54,431	198,702

As of/for the year ended December 31, 2001

	Business machines	Cameras	Optical and other products	Corporate and eliminations	Consolidated
(Millions of yen)					
Net sales:					
Unaffiliated customers	Yen 2,223,489	Yen 381,367	Yen 302,717		Yen 2,907,573

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Intersegment			116,748	Yen (116,748)	
Total	2,223,489	381,367	419,465	(116,748)	2,907,573
Operating cost and expenses	1,888,571	345,223	395,615	(3,675)	2,625,734
Operating profit	Yen 334,918	Yen 36,144	Yen 23,850	Yen (113,073)	Yen 281,839
Assets	Yen 1,280,949	Yen 215,173	Yen 361,799	Yen 986,835	Yen 2,844,756
Depreciation and amortization	105,907	12,745	15,291	18,357	152,300
Capital expenditure	121,333	16,871	36,057	33,413	207,674

Notes:

- (1) General corporate expenses of Yen 123,193 million in fiscal 2002 and Yen 113,128 million in fiscal 2001 are included in Corporate and eliminations.
- (2) Corporate assets of Yen 1,044,036 million in fiscal 2002 and Yen 986,801 million in fiscal 2001, which consist mainly of cash and cash equivalents, marketable securities and corporate properties, are included in Corporate and eliminations.

Table of Contents

The following table provides segment information by geographic area:

As of/for the year ended December 31, 2002

	Japan	Americas	Europe	Others	Corporate and eliminations	Consolidated
(Millions of yen)						
Net sales:						
Unaffiliated customers	Yen 789,066	Yen 1,007,572	Yen 852,931	Yen 290,559		Yen 2,940,128
Intersegment	<u>1,475,091</u>	<u>9,791</u>	<u>4,639</u>	<u>426,914</u>	Yen (1,916,435)	<u> </u>
Total	2,264,157	1,017,363	857,570	717,473	(1,916,435)	2,940,128
Operating cost and expenses	<u>1,867,817</u>	<u>969,542</u>	<u>836,341</u>	<u>699,420</u>	<u>(1,779,351)</u>	<u>2,593,769</u>
Operating profit	<u>Yen 396,340</u>	<u>Yen 47,821</u>	<u>Yen 21,229</u>	<u>Yen 18,053</u>	<u>Yen (137,084)</u>	<u>Yen 346,359</u>
Assets	Yen 1,485,238	Yen 346,021	Yen 460,521	Yen 202,388	Yen 448,538	Yen 2,942,706

As of/for the year ended December 31, 2001

	Japan	Americas	Europe	Others	Corporate and eliminations	Consolidated
(Millions of yen)						
Net sales:						
Unaffiliated customers	Yen 858,580	Yen 983,561	Yen 805,243	Yen 260,189		Yen 2,907,573
Intersegment	<u>1,378,031</u>	<u>17,475</u>	<u>2,449</u>	<u>299,410</u>	Yen (1,697,365)	<u> </u>
Total	2,236,611	1,001,036	807,692	559,599	(1,697,365)	2,907,573
Operating cost and expenses	<u>1,893,448</u>	<u>969,630</u>	<u>806,495</u>	<u>546,291</u>	<u>(1,590,130)</u>	<u>2,625,734</u>

Operating profit	Yen	<u>343,163</u>	Yen	<u>31,406</u>	Yen	<u>1,197</u>	Yen	<u>13,308</u>	Yen	<u>(107,235)</u>	Yen	<u>281,839</u>
Assets	Yen	1,376,939	Yen	346,046	Yen	423,295	Yen	174,553	Yen	523,923	Yen	2,844,756

Notes:

- (1) General corporate expenses of Yen 123,193 million in fiscal 2002 and Yen 113,128 million in fiscal 2001 are included in Corporate and eliminations.
- (2) Corporate assets of Yen 1,044,036 million in fiscal 2002 and Yen 986,801 million in fiscal 2001, which consist mainly of cash and cash equivalents, marketable securities and corporate properties, are included in Corporate and eliminations.
- (3) Segment information by geographic area is determined by the location of Canon or its relevant subsidiary.

Foreign operations and foreign currency transactions

Canon's marketing activities are performed by subsidiaries in various regions in local currencies, while the cost of goods sold is generally in yen. Given Canon's current operating structure, appreciation of the yen has a negative impact on net sales and the gross profit ratio. To reduce the financial risks from changes in foreign exchange rates, Canon utilizes derivative financial instruments, which are comprised principally of forward currency exchange contracts.

The return on foreign operation sales is usually lower than that from domestic operations because foreign operations consist mainly of marketing activities. Return on foreign operation sales is calculated by dividing net income of foreign subsidiaries, after factoring in a consolidation adjustment between foreign subsidiaries, by net sales of foreign subsidiaries. Marketing activities are generally less profitable than production activities, which are mainly conducted by the Company and its domestic subsidiaries. The returns on foreign operation sales in fiscal 2003, 2002 and 2001 were 3.2%, 2.7% and 1.6%, respectively. This compares with returns of 8.6%, 6.5% and 5.8% on total operations for the respective years.

Recent developments

On January 1, 2004, Canon Precision Inc. (Canon Precision), a wholly-owned subsidiary of Canon Inc., merged with Hirosaki Precision, Inc. (Hirosaki Precision), a wholly-owned subsidiary of Canon Precision. Hirosaki Precision was merged into Canon Precision, the surviving company. Canon Precision targets the improved efficiency and specialization of business operations. Since both Canon Precision and Hirosaki Precision were consolidated subsidiaries of Canon Inc., the merger has no impact on Canon's current or future business results.

On January 1, 2004, Canon N.T.C., Inc. (Canon N.T.C.), a wholly-owned subsidiary of Canon Inc., spun off its environmental business operations into a newly established company, named Canon Ecology Industry Inc. Following the separation, Canon N.T.C. focused its energies on its semiconductor equipment-related business and was renamed Canon Semiconductor Equipment Inc. The spin-off was intended to improve efficiency and the specialization of business operations while facilitating the pursuit of independent businesses, consistent with Canon's Excellent Global Corporation Plan.

Table of Contents

B. Liquidity and capital resources

Liquidity

Cash and cash equivalents in fiscal 2003 increased Yen 169,027 million to Yen 690,298 million, compared with Yen 521,271 million in fiscal 2002 and Yen 506,234 million in fiscal 2001. Canon's cash and cash equivalents are primarily denominated in Japanese yen, with the remainder denominated in foreign currencies such as the U.S. dollar.

Net cash provided by operating activities in fiscal 2003 increased by Yen 16,699 million from the previous year, to Yen 465,649 million. Canon's cash inflow is primarily composed of cash received from customers, and its cash outflow is primarily composed of payments by Canon for parts and materials, selling, general and administrative expenses, and income taxes.

For fiscal 2003, cash inflow from cash received from customers increased, due to an increase in net sales. This increase in cash inflow was within the range of the increase in net sales, as there were no significant changes in Canon's collection rates. Cash outflow for payments for parts and materials also increased, as a result of an increase in net sales. However, this increase was less than the increase in net sales, due to reductions in production costs. Production costs declined as a result of both a decline in unit prices of parts and raw materials, as well as Canon's efforts to streamline production processes. Cash outflow for payroll payments increased, due to an increase in the number of employees. Employees in the Asian region increased, due to the expansion of production in this region. Cash outflow for payments for selling, general and administrative expenses increased, due to an increase in advertising and marketing expenses, reflecting management's policy to strengthen Canon's corporate brand image. Cash outflow for payments of income taxes increased, due to an increase in taxable income.

Net cash used in investing activities in fiscal 2003 was Yen 199,948 million, compared with Yen 230,220 million in fiscal 2002 and Yen 192,592 million in fiscal 2001, which consists primarily of capital expenditures. Capital expenditures in fiscal 2003 totaled Yen 210,038 million, mainly to expand production capabilities in Japan and overseas. Of the Yen 24,341 million payment for the purchase of other investments, Yen 12,718 million is attributable to the acquisition of Sumitomo Metal System Solutions Co., Ltd., now Canon System Solutions Inc.

As a result, free cash flow, or cash flow from operating activities minus cash flow from investing activities, totaled Yen 265,701 million for fiscal 2003 as compared to Yen 218,730 million for fiscal 2002.

Net cash used in financing activities totaled Yen 102,039 million in fiscal 2003, mainly resulting from Canon's active efforts to repay short-term loans and long-term debts towards the goal of improving the Company's financial position, including the redemption of Yen 10,000 million in debentures.

Canon seeks to meet its liquidity and capital requirements principally with cash flow from operations and, to a lesser extent, with short-term loans and long-term debt. Consistent with this objective, Canon continued to reduce its reliance on external funding for capital investments in favor of relying upon internally generated cash flows. This approach is supplemented with group-wide treasury and cash management activities undertaken at the parent company level. Canon believes that its working capital is sufficient for its present requirements.

To the extent Canon relies on external funding for its liquidity and capital requirements, it generally has access to various funding sources, including issuance of additional share capital, long-term debt or short-term loans. While Canon has been able to obtain funding from its traditional financing sources and from the capital markets, and believes it will continue to be able to do so in the future, there can be no assurance that adverse economic or other conditions will not affect Canon's liquidity or long-term funding in the future.

Short-term loans (including the current portions of long-term loans) amounted to Yen 39,136 million at December 31, 2003, compared to Yen 66,754 million at December 31, 2002. Long-term debt (excluding their current portions) amounted to Yen 59,260 million at December 31, 2003, compared to Yen 81,349 million at December 31, 2002.

Substantially all of Canon's short-term loans consist of borrowings from banks under uncommitted lines of credit. Canon's long-term debt generally consists of secured or partially-secured term loans from banks, bearing interest at floating rates, as well as fixed rate-notes and convertible debentures which Canon has issued in the domestic market with original maturities of five to fifteen years. There are no restrictions on the use of any borrowings.

In order to facilitate access to global capital markets, Canon obtains credit ratings from two rating agencies, Moody's Investors Services, Inc. (Moody's) and Standard and Poor's Rating Services (S&P). In addition, Canon maintains a rating from Rating and Investment Information, Inc. (R&I), a rating agency in Japan, for access to the Japanese capital markets.

As of April 30, 2004, Canon's debt ratings are: Moody's: Aa3 (long-term); S&P: AA (long-term, outlook: stable), A-1+ (short-term); and R&I: AA+ (long-term). Canon does not have any rating downgrade triggers that would accelerate the maturity of a material amount of its debt. A downgrade in Canon's credit ratings or outlook could, however, increase the cost of its borrowings.

Capital resources

Capital expenditures in fiscal 2003 amounted to Yen 210,038 million, compared with Yen 198,702 million in fiscal 2002 and Yen 207,674 million in fiscal 2001. In fiscal 2003, capital expenditures were mainly used for next-generation new technology devices for aligners and steppers, construction of facilities by the Company's consolidated subsidiaries, and expansion of production capabilities in Japan and overseas. In addition, Canon has been continually investing in tools and dies for business machines, in which the amount invested is generally the same each year. For fiscal 2004, Canon projects its capital expenditures will be approximately Yen 300,000 million. The capital expenditures include an investment in a new production engineering base and new technology development center in Kanagawa, Japan.

Table of Contents

Employer contributions to Canon's worldwide defined benefit pension plans were Yen 29,944 million in fiscal 2003, Yen 33,661 million in fiscal 2002 and Yen 89,626 million in fiscal 2001. Employer contributions were greater in fiscal 2001 because they included an additional trust fund of cash and equity securities in the amount of Yen 58,954 million in addition to typical employer contributions. During fiscal 2004, Canon expects to make cash contributions of approximately Yen 40,044 million to its domestic defined benefit pension plans, which would be an increase of 34.0% from Yen 29,879 million in fiscal 2003. This expected increase is primarily the result of an anticipated increase in the Company's cash contributions to replenish the shortage of a reserve for the Company's pension.

Working capital in fiscal 2003 increased Yen 200,340 million, to Yen 1,103,474 million, compared with Yen 903,134 million in fiscal 2002 and Yen 776,111 million in fiscal 2001. This increase was primarily a result of a decrease in short-term loans. Canon believes its working capital will be sufficient for its requirements for the foreseeable future. Canon's capital requirements are primarily dependent on management's business plans regarding the levels and timing of capital expenditures and investments. The working capital ratio (ratio of current assets to current liabilities) for fiscal 2003 was 2.33, compared to 2.13 for fiscal 2002 and 1.91 for fiscal 2001.

Return on assets (Net income divided by the average of total assets as of December 31, 2002 and 2003) increased to 9.0% in fiscal 2003, compared to 6.6% in fiscal 2002 and 5.9% in fiscal 2001. This increase was due mainly to an increase in net income. Return on stockholders' equity increased to 15.9% in fiscal 2003, compared with 12.5% in fiscal 2002 and 12.2% in fiscal 2001.

Debt to total assets ratio was 3.1%, 5.0% and 10.4% for fiscal 2003, 2002 and 2001, respectively. Canon had short-term loans and long-term debt of Yen 98,396 million in fiscal 2003, Yen 148,103 million in fiscal 2002 and Yen 295,630 million in fiscal 2001.

C. Research and development, patents and licenses, etc.

Canon is now in Phase II of its Excellent Global Corporation Plan, which started in 2001 and will end in 2005. The management plan aims to guide Canon to the No. 1 position worldwide in all core business areas, to build on its R&D capabilities and to continually create new businesses and to further strengthen its financial position.

With respect to its R&D goals, Canon formulated as part of its management plan the Canon Over IP concept, through which Canon intends to connect its digital products to the Internet and lay the foundations for Internet-businesses for the future. The Company envisions Canon products and systems interconnected over networks, as well as a variety of Web services that expand its business domains while creating new value for customers.

Canon has R&D centers worldwide that closely collaborate in their R&D activities. Some regional R&D centers conduct basic research into technology, and others apply their expertise to develop new products and businesses.

In October 2003, the Company formed a new organization for its R&D activities, Leading-Edge Technology Development Headquarters, from the former Canon Research Center and other R&D divisions. Leading-Edge Technology Development Headquarters aims to create new products for the development of new business areas.

In addition to Leading-Edge Technology Headquarters, the Company's R&D activities are conducted in the following six organizations:

Core Technology Development Headquarters (where component engineering and base technology R&D, such as material engineering, nanotechnology and production engineering, is conducted)

Platform Technology Development Headquarters (where platform technology R&D, such as system Large Scale Integration (LSI) chips and network technology, is conducted)

Device Technology Development Headquarters (where key device R&D, such as for semiconductor devices, is conducted)

SED Development Headquarters (where Surface-conduction Electron-emitter Display R&D is conducted)

Ecology Research Center (where solar cell R&D is conducted)

Advanced Materials Research Center (where advanced materials R&D is conducted)

Canon had R&D expenditures of Yen 259,140 million in fiscal 2003, Yen 233,669 million in fiscal 2002 and Yen 218,616 million in fiscal 2001. The ratio of R&D expenditures to total net sales for the past three years was 8.1%, 7.9% and 7.5%, respectively.

Canon seeks to produce new products that are protected by patents and to set market product standards in order to enhance its market position. The United States Patent and Trademark Office (USPTO) announced that Canon obtained the second-greatest number of private sector patents in 2003. This achievement marks Canon's twelfth consecutive year as one of the top three patent-receiving private-sector organizations.

Canon aims to realize production procedures that dramatically reduce the need for prototypes, in the design process, through the effective utilization of 3D computer aided design (3D-CAD) systems, in order to accelerate product development and curtail costs.

Table of Contents**D. Trend information****Trend information**

For Canon, 2004 marks the fourth year of Phase II of its Excellent Global Corporation Plan (2001-2005), which targets the completion of structural reforms in 2005. As such, Canon will move forward with several initiatives designed to ensure that it meets the goals set out in the plan by 2005, including further efforts to reform its operations, from R&D and production processes to head-office administrative operations, by simultaneously targeting improved productivity and the elimination of waste. In the area of development, Canon will target the further shortening of product-development periods and improvements in design quality. Canon will also continue to strive to substantially reduce product development costs by implementing digital trial production procedures that make it unnecessary to create prototypes. As for production, Canon will focus its energies on the in-house production of key components and development of innovative high-efficiency factory automation equipment to realize even greater cost reductions. With regard to marketing activities, in addition to promoting marketing reforms through structural reorganization and strengthening marketing channels, Canon is also working to expand and strengthen its solutions business and improve its hardware solutions offerings through greater customization to better meet customer needs. Canon also views the protection of the environment as an essential part of its management activities and will continue to develop environmentally-conscious products and introduce resource-recycling systems while actively expanding its green procurement and purchasing programs.

In the office imaging products market, Canon is gradually moving from monochrome office imaging products to color office imaging products in response to market demand. Canon's response to this transition will continue to affect its performance in this market. In the camera market, Canon has experienced a significant increase in sales of digital cameras due to strong worldwide demand, which has more than offset the decline in sales of conventional film cameras. Canon's ability to respond to trends in the comparatively young market for digital cameras will continue to significantly affect the performance of Canon's camera products.

Pursuant to the enactment of the new law concerning defined benefit corporate pension plans in Japan, the Company, on March 1, 2003, obtained from the Minister of Health, Labor and Welfare an exemption from its obligation to pay benefits for future employee services related to the substitutional portion of the Employees' Pension Fund which will result in the transfer of the pension obligation and related assets to the government. The relevant impact is recognized only on the settlement of the substitutional portion when the company returns the past benefit obligation to the government (expected to be sometime in the latter half of 2004). In fiscal 2003, there has been no effect on Canon's consolidated financial statements. The aggregate effect of this separation will be determined based on the Company's total pension benefits obligation as of the date the transfer is completed and the amount of plan assets required to be transferred. Based on the Company's current estimates as to the total amount of such pension benefits obligation and the amount of plan assets required to be transferred, management does not presently expect that this separation will have a significant effect on Canon's financial condition and results of operation. However, the final amount of the impact could be significantly different depending on any change in the amounts of the pension benefit obligation or plan assets to be transferred.

Forward looking statements

The foregoing discussion and other disclosure in this item contains forward-looking statements that reflect management's current views with respect to certain future events and financial performance. Actual results may differ materially from those projected or implied in the forward-looking statements. Further, certain forward-looking statements are based upon assumptions of future events that may not prove to be accurate. The following important factors could cause actual results to differ materially from those projected or implied in any forward-looking

statements: exchange rate fluctuations; the uncertainty of Canon's ability to implement its plans to localize production and other measures to reduce the impact of exchange rate fluctuations; uncertainty as to economic condition, in Canon's major markets; uncertainty of continued demand for Canon's high-value-added products; uncertainty as to the recovery of computer and related markets; uncertainty of recovery in demand for Canon's semiconductor production equipment; Canon's ability to continue to develop products and to market products that incorporate new technology on a timely basis, are competitively priced and achieve market acceptance; the possibility of losses resulting from foreign currency transactions designed to reduce financial risks from changes in foreign exchange rates; and inventory risk due to shifts in market demand.

For other trend information, please see Item 5 Operating and Financial Review and Prospects-A. Operating Results

E. Off-balance sheet arrangements

As part of its ongoing business, Canon does not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Table of Contents**F. Contractual obligations**

The following summarizes Canon's contractual obligations at December 31, 2003.

		(Millions of Yen)				
		Payments Due By Period				
		Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Contractual Obligations:						
Long-Term Debt						
Capital Lease Obligations	Yen	11,267	5,200	5,230	765	72
Other Long-Term Debt		84,188	30,995	22,420	30,711	62
Operating Lease Obligations		43,430	11,769	15,304	9,055	7,302
Purchase commitments for Property Plant and Equipment		54,947	54,947			
Total		Yen 193,832	102,911	42,954	40,531	7,436

Canon provides warranties of generally less than one year against defects in materials and workmanship on most of its consumer products. A liability for estimated product warranty related cost is established at the time revenue is recognized and is included in accrued expenses. Estimates for accrued product warranty cost are primarily based on historical experience, and are affected by ongoing product failure rates, specific product class failures outside of the baseline experience, material usage and service delivery costs incurred in correcting a product failure. As of December 31, 2003, the accrued product warranty cost amounted to Yen 10,512 million.

At December 31, 2003, Canon had outstanding commitments of approximately Yen 54,947 million to purchase property, plant and equipment for use in the ordinary course of its business. Canon anticipates that funds needed to fulfill these commitments will be generated internally through operations.

Canon's management believes that current financial resources, cash generated from operations and Canon's potential capacity for additional debt and/or equity financing will be sufficient to fund current and future capital requirements.

Table of Contents**Item 6. Directors, Senior Management and Employees****A. Directors and senior management**

Directors and corporate auditors of the Company as of March 31, 2004 and their respective business experience are listed below.

Name (Date of birth)	Position (Group executive/function)	Date of commencement	Business experience (*current position/function)
Fujio Mitarai (Sept. 23, 1935)	President & C.E.O.	4/1961 1/1979 3/1981 3/1985 1/1989 3/1989 3/1993 9/1995	Entered the Company President of Canon U.S.A., Inc. Director Managing Director In charge of HQ administration Senior Managing Director Executive Vice President President & C.E.O.*
Yukio Yamashita (May 15, 1939)	Senior Managing Director (Group Executive of Human Resource Management & Organization HQ)	3/1962 8/1980 3/1991 1/1996 3/1997 3/1999	Entered the Company President of Canon (UK) Ltd. Director Group Executive of Human Resource Management & Organization HQ* Managing Director Senior Managing Director*
Toshizo Tanaka (Oct. 8, 1940)	Senior Managing Director (Group Executive of Finance & Accounting HQ)	4/1964 1/1992 3/1995 4/1995 3/1997 3/2001	Entered the Company Deputy Group Executive of Finance & Accounting HQ Director Group Executive of Finance & Accounting HQ* Managing Director Senior Managing Director*
Kinya Uchida (Nov. 21, 1938)	Senior Managing Director	4/1963 6/1987 3/1995 4/1995 3/1999 4/1999 3/2003	Entered the Company President of Canon Singapore Pte. Ltd. Director President of Canon France S.A. Managing Director President of Canon U.S.A., Inc.* Senior Managing Director*

Tsuneji Uchida (Oct. 30, 1941)	Senior Managing Director (Chief Executive of Image Communication Products Operations HQ)	4/1965	Entered the Company
		4/1995	Group Executive of Lens Products Group
		3/1997	Director
		4/1997	Deputy Chief Executive of Camera Operations HQ/Group
			Executive of Photo Products Group
		4/1999	Chief Executive of Camera Operations HQ
		7/1999	In charge of promotion of digital photo business
		1/2000	In charge of promotion of digital photo home business
		1/2001	Chief Executive of Image Communications Products HQ*
		3/2001	Managing Director
3/2003	Senior Managing Director*		
Yusuke Emura (Nov. 30, 1944)	Managing Director (Group Executive of Global Environment Promotion HQ)	4/1967	Entered the Company
		1/1989	Toride plant manager
		3/1993	Director
		4/1994	Ami plant manager
		4/1995	Deputy Chief Executive of Office Imaging Products HQ
		4/1996	Chief Executive of Office Imaging Products HQ
		3/1999	Managing Director*
		4/1999	Group Executive of Production Management HQ
		1/2002	Group Executive of Global Environment Promotion HQ*

Table of Contents

Name (Date of birth)	Position (Group executive/function)	Date of commencement	Business experience (*current position/function)
Nobuyoshi Tanaka (Dec. 23, 1945)	Managing Director (Group Executive of Corporate Intellectual Property & Legal HQ)	4/1970	Entered the Company
		1/1991	Senior General Manager of Semiconductor Production Equipment Development Center
		3/1993	Director
		4/1993	Chief Executive of Optical Products HQ
		4/1999	Group Executive of Corporate Intellectual Property & Legal HQ*
		3/2001	Managing Director*
Junji Ichikawa (Feb. 9, 1943)	Managing Director (Group Executive of Production Management HQ)	4/1965	Entered Shiba Electronics Co., Ltd.
		1/1970	Entered the Company
		4/1994	Group Executive of Peripheral Group 1
		3/1997	Director
		4/1997	Deputy Chief Executive of Peripheral Products HQ
		4/2000	Chief Executive of Peripheral Products HQ
		3/2001	Managing Director*
4/2003	Group Executive of Production Management HQ*		
Hajime Tsuruoka (July 9, 1943)	Managing Director	3/1970	Entered Meiji Seika Kaisha Ltd.
		11/1973	Entered the Company
		4/1995	President of Canon Italia S.p.A.
		3/1997	Director
		10/1997	President of Canon Deutschland GmbH
		3/1999	President of Canon Europa N.V.*
3/2001	Managing Director*		
Akiyoshi Moroe (Sept. 28, 1944)	Managing Director (Group Executive of General Affairs HQ) (Group Executive of Information & Communications Systems HQ)	4/1968	Entered the Company
		7/1996	Deputy Group of Executive of Human Resource Management & Organization HQ
		3/1999	Director
		4/1999	Group Executive of General Affairs HQ*
		10/2000	

		3/2003	Group Executive of Information & Communications Systems HQ* Managing Director*
Kunio Watanabe (Oct. 3, 1944)	Managing Director (Group Executive of Corporate Strategy & Development HQ)	4/1969 4/1995 3/1999 3/2003	Entered the Company Group Executive of Corporate Strategy & Development HQ* Director Managing Director*
Ikuo Soma (Aug. 4, 1946)	Managing Director (Chief Executive of Office Imaging Products HQ)	4/1970 1/1997 3/1999 4/1999 3/2003	Entered the Company Group Executive of Office Imaging Products Group 1 Director Chief Executive of Office Imaging Products HQ*/Group Executive of Office Imaging Products Group 2 Managing Director*
Hironori Yamamoto (Dec. 23, 1943)	Managing Director (Group Executive of Core Technology Development HQ) (Group Executive of Surface-conduction Electron-emitter Display Development HQ) (Group Executive of Leading-Edge Technology Development HQ)	4/1969 1/1998 3/1999 7/1999 4/2001 7/2003 10/2003	Entered the Company Deputy Group Executive of Production Management HQ Director* Group Executive of Core Technology Development HQ*/Deputy Group Executive of Display Development HQ Group Executive of Display Development HQ Group Executive of Surface-conduction Electron-emitter Display Development HQ* Group Executive of Leading-Edge Technology &nb