CANON ANNUAL REPORT 2005

Fiscal Year Ended December 31, 2005

CORPORATE PROFILE

Canon Inc. and the Canon Group develop, produce and market a broad array of products including copying machines, printers, cameras, optical products and industrial equipment. Canon has grown to be a trusted brand in over 180 countries.

In fiscal 2005, under Phase II of our Excellent Global Corporation Plan, we reported for the sixth consecutive year the highest level of sales and net income in our history.

The Canon Group aims to create and commercialize new technologies and original genres of products that foster positive and effective communications around the world. Furthermore, the Group pursues a variety of environmental and philanthropic activities and focuses on fulfilling its duties to investors and society by stressing good corporate governance.

CORPORATE PHILOSOPHY: *Kyosei*

Canon's corporate philosophy is *kyosei*, which can be concisely defined as "Living and working together for the common good." Canon has expanded this definition even further to mean "All people, regardless of race, religion, or culture, harmoniously living and working together into the future." Unfortunately, the world today is imbalanced in areas such as international economic development, wealth distribution, and the natural environment. Canon maintains an awareness of these imbalances in its active pursuit of *kyosei* in all of its business activities.

As a true global corporation employing over 115,000 people worldwide, Canon understands the responsibility of fostering harmonious relations, not only with our customers and the communities in which we operate, but also with nations and the environment. By contributing to global prosperity and the happiness of humanity, Canon hopes to bring the world closer to achieving the ideals of *kyosei*.

CORPORATE GOAL

Fiscal 2006 is the inaugural year of Phase III of our Excellent Global Corporation Plan. Under the theme of "Innovation and Sound Growth," in Phase III Canon intends to strengthen existing businesses, launch strategic new businesses, and identify new business domains to assure continual growth beyond 2010, while maintaining a high profit margin structure. Canon aims to join the ranks of the global top 100 companies by 2010 in terms of such key business performance measures as net sales, profit, stockholders' equity to total assets ratio and market capitalization.

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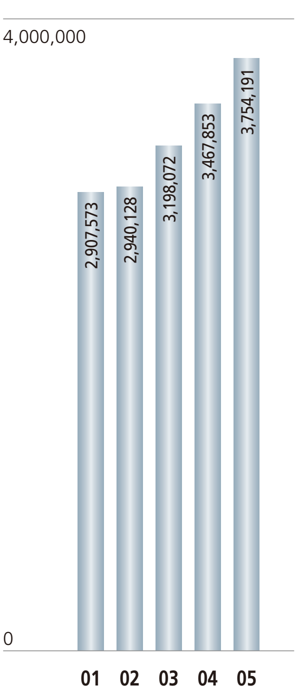
Cover Photos:
Technological strength is the very source of Canon's profits and growth, and the entire Canon Group is working to bolster its technological prowess. While working to reinforce existing business and product competitiveness, Canon is also strengthening its research abilities to search for new business domains.

FINANCIAL HIGHLIGHTS

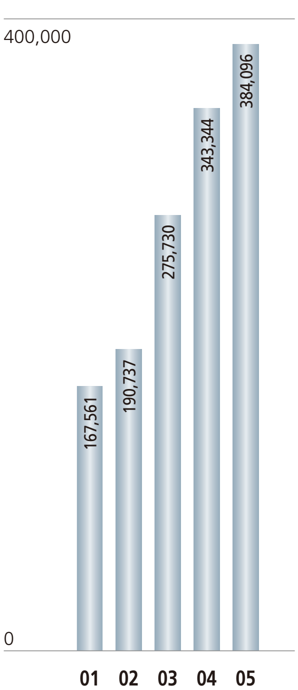
	Millions of yen (except per share amounts) 2005	2004	Change (%)	Thousands of U.S. dollars (except per share amounts) 2005
Net sales	**¥ 3,754,191**	3,467,853	+ 8.3	**$ 31,815,178**
Operating profit	**583,043**	543,793	+ 7.2	**4,941,042**
Income before income taxes and minority interests	**612,004**	552,116	+ 10.8	**5,186,475**
Net income	**384,096**	343,344	+ 11.9	**3,255,051**
Net income per share:				
-Basic	**¥ 432.94**	387.80	+ 11.6	**$ 3.67**
-Diluted	**432.55**	386.78	+ 11.8	**3.67**
Total assets	**¥ 4,043,553**	3,587,021	+ 12.7	**$ 34,267,398**
Stockholders' equity	**¥ 2,604,682**	2,209,896	+ 17.9	**$ 22,073,576**

Notes:
1. Canon's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles.
2. U.S. dollar amounts are translated from yen at the rate of JPY118=U.S.$1, the approximate exchange rate on the Tokyo Foreign Exchange Market as of December 30, 2005, solely for the convenience of the reader.

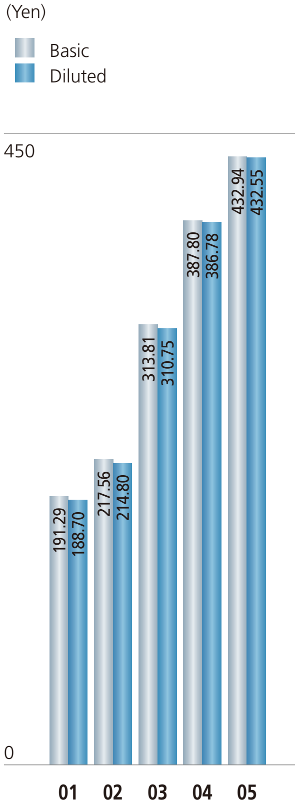
Net Sales
(Millions of yen)



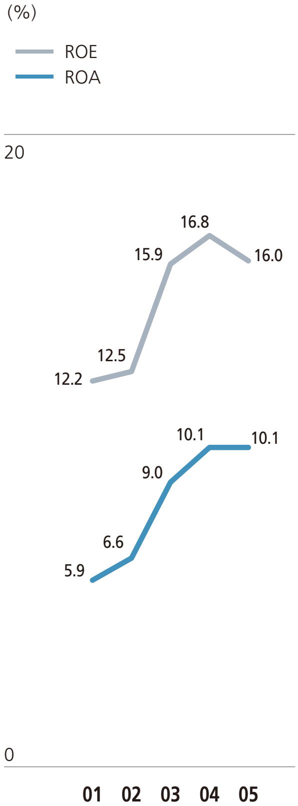
Net Income
(Millions of yen)



Net Income per Share
(Yen)



ROE / ROA
(%)



We have successfully completed Phase II of our Excellent Global Corporation Plan

and started **Phase III**

and started **Phase III**

Canon turned out another exceptional performance in fiscal 2005, the final year of Phase II of our Excellent Global Corporation Plan, achieving record earnings and marking the sixth consecutive year of increases in sales and profits. Consolidated net sales grew 8.3% to ¥3,754.2 billion (US$31,815 million), income before income taxes and minority interests increased 10.8% to ¥612.0 billion (US$5,186 million), and net income reached ¥384.1 billion (US$3,255 million), up 11.9% from the previous year. We recorded higher revenues in all major product segments, as well as in all operating regions.

Overview of Fiscal 2005

The global economy in 2005 enjoyed solid growth in spite of continually high crude oil prices. The U.S. economy demonstrated resilience, China maintained a high annual growth rate, and the European economy regained momentum. Japan's economy showed signs of a recovery with sound corporate capital spending. The average value of the yen for the year was ¥110.58 to the U.S. dollar and ¥137.04 to the euro, representing a year-on-year decrease of almost 2% against both currencies.

Under these circumstances, Canon products were in strong demand and received critical acclaim. Factors contributing to net sales growth included increased sales volume of core products, including multifunction devices (MFDs), color printers, digital cameras, interchangeable camera lenses, and exposure equipment used to produce liquid crystal display (LCD) panels. In terms of sales by product segment, business machines rose 4.8% to ¥2,502.4 billion (US$21,207 million), cameras surged 15.2% to ¥879.2 billion (US$7,451 million), and optical and other products climbed 17.6% to ¥372.6 billion (US$3,158 million).

Despite escalating raw-material prices and other negative factors, the gross profit ratio remained at a high 48.5% owing to cost reductions realized through production- and procurement-reform efforts. The figure represented a year-on-year decrease of 0.9 points.

Basic net income per share amounted to ¥432.94 (US$3.67), an increase of ¥45.14 from a year earlier. Based on these strong results and our financial standing, we increased the annual dividend by ¥35, bringing the total to ¥100 (US$0.85) per share.

Successful Conclusion of Phase II

Over the past 10 years, all members of the Canon Group have been working together to carry out innovations and reforms, aiming to be a corporation worthy of admiration and respect worldwide. Broadly speaking, during Phase I we sought to close out the 20th century by strengthening our financial health with an emphasis on cash flow under the themes of "Total Optimization" and "Focus on Profit." In Phase II we sought to establish a solid foothold for continued advancement in the 21st century with an emphasis on product competitiveness, aiming to become No. 1 in the world in all major areas of our business.

These initiatives have enabled Canon to make great strides in development and in-house production of key components for core products such as digital cameras, inkjet printers and MFDs. By strengthening platform technologies and introducing 3D-CAD design systems, we've been able to improve design precision, shorten development times, and consistently launch competitive products in accordance with market needs. The proportion of sales accounted for by new products has increased from 44% in 2000 to 66% today, enabling us to avoid price declines associated with existing products.

Moving into Phase III

The outstanding results accomplished in Phase I and Phase II can be credited to the efforts of all Canon Group employees worldwide, who have fully exercised their capacities and skills in their respective workplaces. The goals of our Excellent Global Corporation Plan are in sight as we kick off Phase III in fiscal 2006 under the theme "Innovation and Sound Growth."

In 2010, the final year of Phase III, we will target net sales of 5.5 trillion yen, an increase of over 45% compared with 2005, and a return on net sales above 10%. Concrete strategies include launching new display businesses, establishing new production systems and expanding into next-generation business domains.

Through increased effort, we aim to elevate Canon to the ranks of the world's top 100 companies by 2010 in terms of such key business performance measures as net sales, profit, stockholders' equity to total assets ratio and market capitalization.

We will build upon recent achievements, using them as a source of courage and confidence to accomplish our goals, and pool our strengths as we continue our endeavors to attain sustainable growth and create new value for stockholders, customers and communities.

Fujio Mitarai
President and CEO
Canon Inc.

Excellent Global Corporation Plan Phase III
Innovation and Sound Growth

Goal: Join the ranks of global top 100 companies by 2010

Five Important Strategies

- Bolster existing core businesses and establish new display businesses
- Establish new production systems to sustain international competitiveness
- Expand operations through diversification
- Identify new business domains and obtain necessary technologies
- Nurture truly autonomous individuals

The Excellent Global Corporation

Building upon ten years of growth momentum, Canon will create new business domains and pursue sound growth by using opportunities arising from global trends, while maintaining its strong profit structure.

Purposes of the Company's Existence

Canon first embarked upon its Excellent Global Corporation Plan in 1996, with the aim of making continual contributions to society through technological innovation, and becoming a corporation worthy of admiration and respect worldwide. Canon believes there are four purposes to the Company's existence: returning a profit to stockholders, providing stability in the livelihoods of employees, making positive contributions to society, and investment for continued future growth. Profits hold the key to achieving these goals, and Groupwide structural reforms and production innovations implemented in order to generate profits have led to significant improvement in business results.

Ten Years of Excellent Results

Consolidated results from 1995 to 2005 show that net sales expanded 1.8 times, from ¥2.09 trillion to ¥3.75 trillion. The cost-to-sales ratio moved from 61.3% in 1995 to 51.5% in 2005, causing pretax profit to multiply 5.2-fold from ¥117 billion to just over ¥612 billion. Net income also jumped 7 times, from ¥55 billion to over ¥384 billion.

Capitalizing on Global Trends

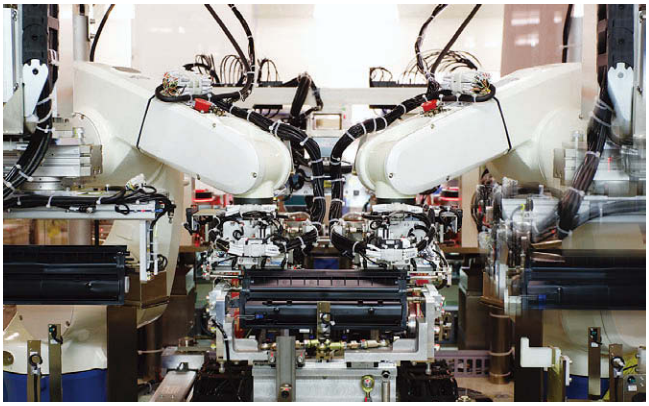
Two major global trends will have a bearing on our future business. The first trend is the diffusion of broadband networks, leading to a world where communication driven by the exchange of strikingly high-quality still and moving images is increasingly prominent. Canon foresees tremendous business opportunities, including high-definition (HD) movies at home, business meetings utilizing multiple TV terminals, and sending and receiving large-volume data and images.

The second broad trend is the continued advance of globalization as economic development spreads to more nations of the world, led by the BRICs economies (Brazil, Russia, India and China). These newly emerging markets obviously possess enormous growth potential, and Canon is actively working toward expanding and diversifying its global sales structure in preparation for future demand.

Plan Phase III

A key part of our display strategy, our prototype 36-inch SED panels earned high acclaim at Canon EXPO in Tokyo for their crisp images and rapid responsiveness

Dress design/YUMI KATSURA



Canon aims to construct fully automated manufacturing lines in Japan to boost production and hold down labor costs

Five Important Strategies

Under the theme of "Innovation and Sound Growth," Canon will implement five important strategies during Phase III with the goal of attaining profitable and sound business growth in the context of global trends.

- Bolster existing core businesses and establish new display businesses

Canon aims to attain the overwhelming No. 1 position in its existing businesses, which support Canon's growth, generate its profits and will continue to be significant driving forces. Product operations will collaborate further with headquarters R&D divisions in order to establish new technological supremacy. In addition, we are bolstering our five Imaging Engines, which are major growth areas for Canon: Image Capturing Engines, Electrophotographic Engines, Inkjet Engines, Photolithographic Engines and Display Engines. We will also focus on the development of key devices and components that determine performance to differentiate our products.

Canon plans to equip digital cameras and camcorders with OLED displays (prototype)

Three types of display operations are major new business fields for Canon: surface-conduction electron-emitter displays (SEDs), projection displays, and organic light-emitting diode (OLED) displays. We have given highest priority to developing manufacturing technologies and production facilities geared to low-cost production of SEDs. Canon ANELVA Corporation was incorporated into the Group in 2005, and is expected to make significant contributions toward those ends through its high-vacuum thin film deposition technology. Projection display systems will target educational, business and other markets, while OLED displays are being rapidly developed for our products.

- Establish new production systems to sustain international competitiveness

New production methods are needed to further boost cost competitiveness. With corporate competition intensifying globally, Canon must work to speedily respond to shifts in technologies and products on the market. Sustained growth requires continual increases in production, further necessitating the construction of robotically driven production lines in order to avoid rising labor costs.

Canon is therefore aiming to create a synergistic foundation integrating development, manufacturing technology and the know-how of the production plant in order to rapidly establish fully automated production lines. As a step in that direction, we have incorporated Canon Machinery Inc. into the Canon Group, anticipating contributions from its sophisticated technologies and expertise. In Japan, we are working to establish fully automated assembly lines that work non-stop producing toner cartridges. We are also eyeing the future prospect of manufacturing products exclusively in the local markets where they are sold.

Canon is conducting collaborative research with the Massachusetts Institute of Technology (MIT) to strengthen cutting-edge technology

• Expand operations through diversification

Canon is working to expand the scope of diversification. Canon will cultivate promising growth businesses including digital TV businesses, solutions businesses centering on our Multifunctional Embedded Application Platform (MEAP), and commercial printers for the print-on-demand (POD) market. We will also forge ahead with full-fledged expansion of our digital radiography business on a global scale.

In global operations, we are equipping our regional marketing headquarters, Canon U.S.A., Inc. and Canon Europa N.V., with development and manufacturing capabilities, and they will move into new business fields by leveraging their respective strengths.

To enable us to rapidly expand our business scope, reinforcing our technologies and human resources is essential. As one means of progressing with Group diversification, Canon will utilize strategic mergers and acquisitions.

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Providing solutions to MeritCare Health System in the U.S.;
MFDs protect patient information and offer efficient document systems

• Identify new business domains and obtain necessary technologies

The discovery of new business domains for growth beyond 2010 is vital, and Canon will redouble its research abilities in order to gain rapid access to breakthrough technologies. We will fully leverage our newly constructed leading-edge research facility to actively pursue initiatives covering basic research through the most advanced technologies. Canon has also been promoting collaborations with research institutes and universities possessing some of the world's most sophisticated technologies.

• Nurture truly autonomous individuals

The undeniable key factor in carrying out our initiatives is each and every Canon employee. Canon has recently been substantially increasing education and training for employees at every level to cultivate capable employees who are trusted by society, while also stepping up efforts to nurture global leaders. Our human resources policies have always been rooted in the concept of fairness, following a merit-based system dating back to our founding.

Canon believes that an internalized sense of duty and ethics among our employees and management is the basis for a sound compliance system.

Basic Policy

Canon recognizes the vital importance of strengthening management supervision functions, with the purpose of maintaining transparency. Numerous measures have been implemented to improve corporate governance as we strive to continuously enhance Canon's corporate value. Canon's directors, having been carefully chosen from among our personnel, are completely familiar with Canon's Guiding Principles and the Canon Group Code of Conduct, and are therefore best positioned to implement corporate governance effectively. Canon's original system of internal audit along with its committees for compliance and internal control combine to form a comprehensive corporate governance structure.

Board of Directors

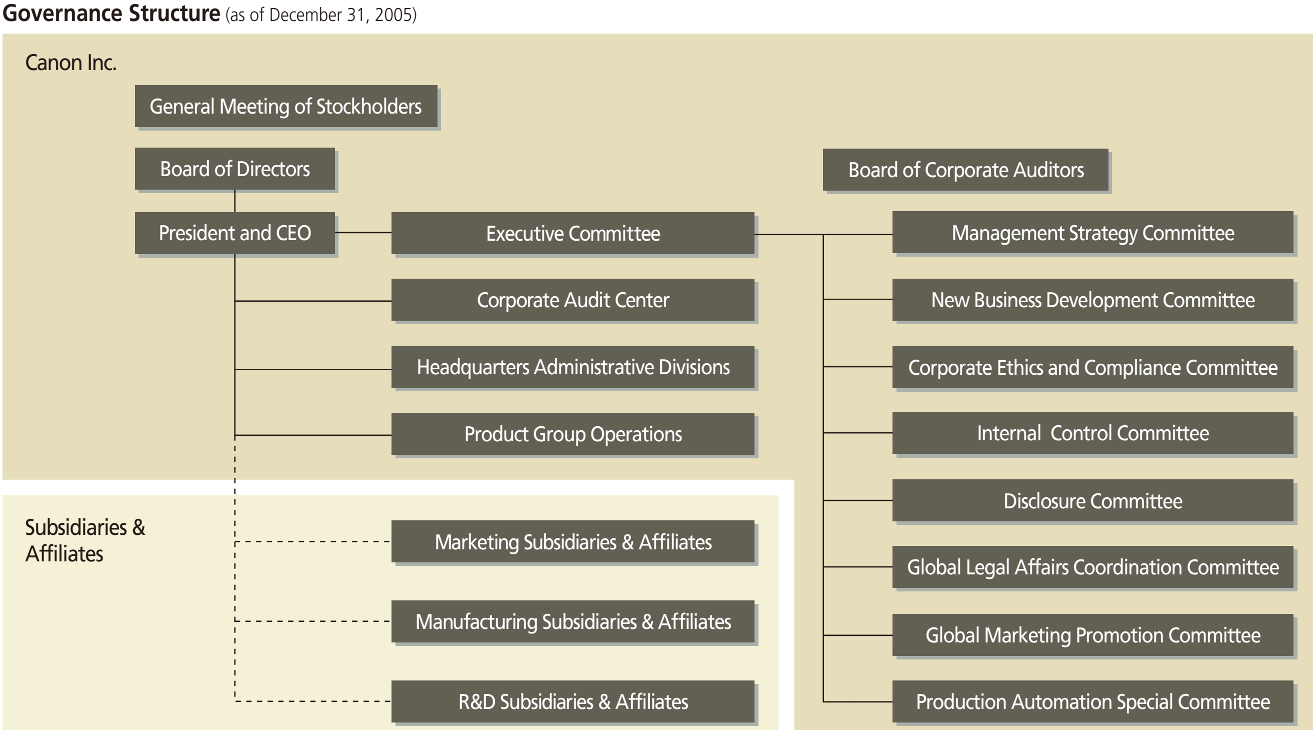
All matters of importance to the Company are decided at Board of Directors' meetings and management meetings attended by all directors. As of December 31, 2005, the Board consists of 25 directors. Canon has not adopted an outside director system in order to realize a more streamlined and efficient management decision-making process. This is the main reason why directors are chosen from among Canon personnel: they have followed these same codes of behavior and have been subject to close scrutiny within the Company over many years. To assure the functions commonly associated with outside directors, we require all directors to undergo a thorough program of compliance education.

Auditing System

Canon's Board of Corporate Auditors consists of four members, two of whom are outside corporate auditors, as of December 31, 2005. The auditors attend board, management and various committee meetings; listen to business reports from the directors; carefully examine documents related to important decisions; and conduct strict audits of the Company's business and assets.

The Corporate Audit Center, which serves as an internal auditing division, conducts audits covering such areas as compliance and internal control systems, and provides assessments and proposals. Various relevant administrative divisions work very closely with the Corporate Audit Center to inspect such areas as

Governance Structure (as of December 31, 2005)

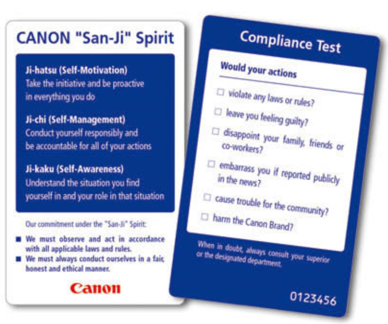


quality, environmental issues, information security, and physical security.

With regard to external audits, we established regulations related to the pre-approval of policies and procedures for both auditing and non-auditing services to secure the independence of our accounting firms. Based on the regulations, the Board of Corporate Auditors must approve in advance the content and related amounts of contracts between the Company and accounting firms.

Committees

The Corporate Ethics and Compliance Committee and the Internal Control Committee were established in 2004, with the President appointed as chairman of both groups. The Corporate Ethics and Compliance Committee carries out comprehensive activities to promote ethical awareness and compliance within Canon. The Internal Control Committee serves to ensure the reliability of the Company's financial reporting in accordance with the Sarbanes-Oxley Act, and also aims to enhance the effectiveness and efficiency of our business operations, compliance with related laws and regulations, as well as the implementation of sound internal controls.



Canon Compliance Cards defining the *San-Ji* spirit are provided to Group employees

Compliance

Since its founding, Canon has relied on its Guiding Principles focusing on the "Three Selfs" concept, known as the "Three Js," or "*San-Ji*" in Japanese: *Ji-hatsu*, which states, "Take the initiative and be proactive in everything you do"; *Ji-chi*, which means "Conduct yourself responsibly and be accountable for all of your actions"; and *Ji-kaku*, which says, "Understand the situation you find yourself in and your role in that situation."

Canon Compliance Cards containing a definition of the *San-Ji* spirit on one side and a compliance test on the other have been translated into 17 languages and distributed to all Group companies. Group employees understand these concepts and put them into practice daily in their work. We believe that this internalized sense of duty and ethics among our employees and management is a deep basis on which to build a sound compliance system.

External Evaluations

Canon is a highly evaluated company and brand worldwide, as indicated by its top marks in numerous business magazines and ratings agencies. For instance, Canon placed 35th in *Business Week*'s "Best Global Brands" of 2005 (August 1, 2005 issue). Moreover, in the *FORTUNE* Global 500, Canon placed 154th in revenues and 96th in profits (July 25, 2005 issue). *FORTUNE* also named Canon CEO Fujio Mitarai as Asian Business Leader of the Year (January 26, 2006 issue). Financial rating agencies also hold Canon in high regard. Standard & Poor's continues to rate Canon's long-term debt at AA, and the Aa2 rating from Moody's Investors Services remains unchanged after being upgraded in 2004. Rating and Investment Information, Inc. (R&I) also maintains its rating of AA+ on Canon's long-term debt.

Canon's Current Ratings

	Long-term rating	Short-term rating
Standard & Poor's	**AA**	**A-1+**
Moody's	**Aa2**	**—**
R&I	**AA+**	**—**

Disclosure

Disclosing accurate, fair and timely information on management, business strategy and financial results to capital markets is a priority at Canon. In February 2005, the Disclosure Committee was established, with the president appointed as chairman, to ensure that Canon is not only in compliance with applicable laws, rules and regulations, but also that information disclosed to shareholders and capital markets is both correct and comprehensive. The President and CEO gives an annual briefing on management policies, while the CFO regularly gives briefings to securities analysts and institutional investors on quarterly financial results. Corporate information on our Website is made available in English, including audio and video information, to respond quickly to the needs of investors. The objective of these IR activities is to gain the trust of capital markets and to shape an appropriate assessment of Canon's stock price. We carefully observe the rules relating to information disclosure to capital markets in Canon's Disclosure Guidelines, strictly controlling undisclosed information and preventing the possibility of insider trading.

Significant Differences in Corporate Governance Practices between Canon and U.S. Companies Listed on the NYSE

Section 303A of the New York Stock Exchange (the "NYSE") Listed Company Manual (the "Manual") provides that companies listed on the NYSE must comply with certain corporate governance standards. However, foreign private issuers whose shares have been listed on the NYSE, such as Canon Inc. (the "Company"), are permitted, with certain exceptions, to follow the laws and practice of their home country in place of the corporate governance practices stipulated under the Manual. In such circumstances, the foreign private issuer is required to disclose the significant differences between the corporate governance practices under Section 303A of the Manual and those required in Japan. A summary of these differences as they apply to the Company is provided below.

1. Directors

Currently, the Company's Board of Directors does not have any director who could be regarded as an "independent director" under the NYSE Corporate Governance Rules for U.S. listed companies. Unlike the NYSE Corporate Governance Rules, the Commercial Code of Japan (the "Code") and the Law for Special Exceptions to the Commercial Code concerning Audit, etc. of Joint-Stock Corporations (the "Special Exception Law") do not require Japanese companies with a board of corporate auditors such as the Company to appoint independent directors as members of the board of directors.

The NYSE Corporate Governance Rules require non-management directors of U.S. listed companies to meet at regularly scheduled executive sessions without the presence of management. Unlike the NYSE Corporate Governance Rules, however, the Code and the Special Exception Law do not require companies to implement an internal corporate organ or committee comprised solely of independent directors. Thus, the Company's Board of Directors currently does not include any non-management directors.

2. Committees

Under the Code and the Special Exception Law, the Company may choose to:

(i) establish an audit committee, nomination committee and compensation committee and abolish the post of corporate auditors; or

(ii) continue to retain a board of corporate auditors.

The Company has elected to retain its Board of Corporate Auditors, whose duties include monitoring and reviewing the management and reporting the results of these activities to the shareholders or Board of Directors of the Company. While the NYSE Corporate Governance Rules provide that U.S. listed companies must have an audit committee, nominating committee and compensation committee, each composed entirely of independent directors, the Code and the Special Exception Law do not require companies to have specified committees, including those that are responsible for director nomination, corporate governance and executive compensation.

The Company's Board of Directors nominates candidates for directorship and submits a proposal at the General Meeting of Shareholders for shareholder approval. Pursuant to the Code, the shareholders then vote to elect directors at the meeting. The Code requires that the total amount or calculation method of compensation for directors and corporate auditors be determined by a resolution of the General Meeting of Shareholders, unless the amount or calculation method is provided under the Articles of Incorporation. As the Articles of Incorporation of the Company do not stipulate the requirements as expressed under the Code, the amount of compensation for the directors and corporate auditors of the Company is determined by a resolution of the General Meeting of Shareholders. The allotment of compensation for each director from the total amount of compensation is determined by the Company's Board of Directors, and the allotment of compensation to each corporate auditor is determined by consultation among the Company's corporate auditors.

3. Audit Committee

The Company avails itself of paragraph (c)(3) of Rule 10A-3 of the Security Exchange Act, which provides that a foreign private issuer which has established a board of corporate auditors shall be exempt from the audit committee requirements, subject to certain requirements which continue to be applicable under Rule 10A-3.

Pursuant to the requirements of the Code and the Special Exception Law, the shareholders elect the corporate auditors by resolution of a general meeting. The Company currently has four corporate auditors, although the minimum number of corporate auditors required pursuant to the Code and the Special Exception Law is three.

Unlike the NYSE Corporate Governance Rules, Japanese laws and regulations, including the Code and the Special Exception Law, do not require corporate auditors to be experts in accounting or to have any other area of expertise. Under the Special Exception Law, a board of corporate auditors may determine the auditing policies and methods for investigating the business and assets of a company, and may resolve other matters concerning the execution of the corporate auditor's duties. The board of corporate auditors prepares auditors' reports and may veto a proposal for the nomination of corporate auditors and accounting auditors put forward by the board of directors.

Under the Special Exception Law, more than half of a company's corporate auditors must be "outside" corporate auditors. These are individuals who are prohibited to have ever been a director, executive officer, manager, or employee of the company or its subsidiaries. As of December 31, 2005, there are four members on the Company's Board of Corporate Auditors, two of whom are outside corporate auditors. The Company's current corporate auditor system meets these requirements. The qualifications for an "outside" corporate auditor under the Special Exception Law are different from the audit committee independence requirement under the NYSE Corporate Governance Rules.

4. Shareholder Approval of Equity Compensation Plans

The NYSE Corporate Governance Rules require that shareholders be given the opportunity to vote on all equity compensation plans and any material revisions of such plans, with certain limited exceptions. Under the Code, however, a company is only required to obtain shareholder approval if it desires to adopt an equity-compensation plan under which stock acquisition rights are granted to the recipient on especially favorable terms (except where such rights are granted to all of its shareholders on a pro-rata basis at the same time). In such circumstances, a company is required to obtain approval by special resolution (as defined in the Code) at its general meeting of shareholders. The Company currently has not adopted any stock option compensation plans.

BOARD OF DIRECTORS

(As of December 31, 2005)

President & CEO

Fujio Mitarai
Chairman, Management Strategy Committee, New Business Development Committee, Corporate Ethics and Compliance Committee, Internal Control Committee, Disclosure Committee

Senior Managing Directors

Yukio Yamashita
Chief, Global Marketing Promotion Committee; Group Executive, Human Resources Management & Organization Headquarters

Toshizo Tanaka
Group Executive, Finance & Accounting Headquarters

Tsuneji Uchida
Chief Executive, Image Communication Products Operations

Managing Directors

Yusuke Emura
Group Executive, Global Environment Promotion Headquarters

Nobuyoshi Tanaka
Chief, Global Legal Affairs Coordination Committee; Group Executive, Corporate Intellectual Property & Legal Headquarters, in charge of Legal Affairs Coordination Division

Junji Ichikawa
Chief Executive, Optical Products Operations

Hajime Tsuruoka
President, Canon Europa N.V.; President & CEO, Canon Europe Ltd.

Akiyoshi Moroe
Group Executive, General Affairs Headquarters, in charge of Corporate Ethics and Compliance Administration Office

Kunio Watanabe
Group Executive, Corporate Planning Development Headquarters

Hironori Yamamoto
Chief, Production Automation Special Committee; Group Executive, Global Manufacturing Headquarters

Yoroku Adachi
President & CEO, Canon U.S.A., Inc.

Yasuo Mitsuhashi
Chief Executive, Peripheral Products Operations

Directors

Katsuichi Shimizu
Chief Executive, Inkjet Products Operations

Ryoichi Bamba
Executive Vice President, Canon U.S.A., Inc.

Tomonori Iwashita
Deputy Chief Executive, Image Communication Products Operations

Toshio Homma
Group Executive, L Printer Business Promotion Headquarters

Shigeru Imaiida
Deputy Group Executive, Global Manufacturing Headquarters

Masahiro Osawa
Group Executive, Global Procurement Headquarters

Keijiro Yamazaki
Group Executive, Information & Communication Systems Headquarters

Shunichi Uzawa
President, SED Inc.

Masaki Nakaoka
Chief Executive, Office Imaging Products Operations

Toshiyuki Komatsu
Group Executive, Leading-Edge Technology Development Headquarters; Group Executive, Core Technology Development Headquarters

Shigeyuki Matsumoto
Group Executive, Device Technology Development Headquarters

Haruhisa Honda
Chief Executive, Chemical Products Operations

Corporate Auditors

Teruomi Takahashi
Kunihiro Nagata
Tadashi Ohe
Tetsuo Yoshizawa

CORPORATE FUNCTIONS

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R&D activities are highly valued at Canon, providing the lifeblood that feeds Canon's growth. Canon consistently delivers technological innovations that support the evolution of business fields.

Research & Development

Canon pays the utmost regard to research and development as the very origin of its profit. For that reason, we dedicate a high proportion of net sales to these activities. In 2005, R&D expenses increased ¥11.2 billion from the previous fiscal year to ¥286.5 billion, corresponding to 7.6% of consolidated net sales. Breaking this down, research and development expenses for business machines amounted to ¥117.2 billion, or 40.9% of total R&D expenses, while expenses for cameras were ¥39.8 billion, or 13.9% of the total. Investment in optical and other products was ¥26.9 billion, or 9.4%, and basic R&D that cannot be allocated by business segment was ¥102.6 billion, or 35.8%.

Developing Next-Generation Technologies

Canon intends to aggressively pursue the development of highly advanced technologies that can be applied in new business domains. To this end, we have established the New Business Domain Committee, which will explore new fields to ensure significant growth from 2010.

Canon's leading-edge technology research center at the headquarters in Tokyo has been completed. Equipped with a cluster computer system and other cutting-edge facilities, the center will conduct basic research and develop technologies such as DNA chips, OLED displays, and nanotechnology.

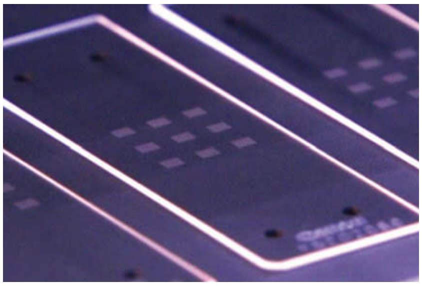
Canon's R&D organizations often work in cooperation with research institutions and universities that possess some of the most sophisticated technological accomplishment in the world. This helps us to get a head start on the development of advanced technologies. Furthermore, such collaboration plays an important role in the speedy establishment of new businesses.

Canon's newly completed leading-edge technology research center in Japan

Strengthening Product Competitiveness

Our five Imaging Engines are a group of technologies that support Canon product businesses.

1. Image Capturing Engines
2. Electrophotographic Engines
3. Inkjet Engines
4. Photolithographic Engines
5. Display Engines

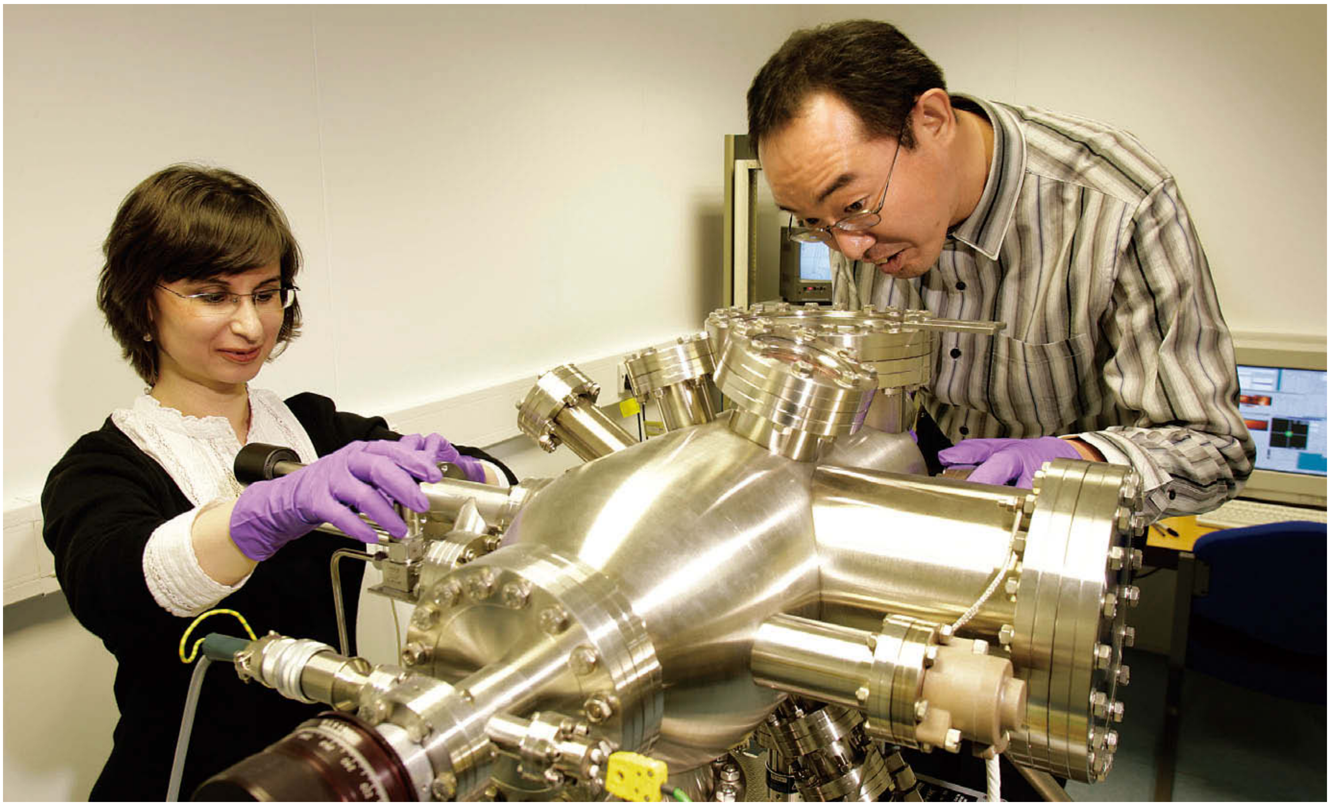


Canon established DNA chip production method using its Bubble Jet printing technology

Each Engine is strengthened by the fusion of various technologies, and contributes to extending our overall technological capacity. As the sources of our competitive advantage, Canon continually cultivates these Engines and focuses on creating new Engines for the next generation. Efforts to upgrade key components and key devices improve the competitiveness of our products. An exemplary result of this process is Canon's CMOS sensors, developed and manufactured entirely in-house. Renowned for their high resolution, low power consumption and noise reduction, Canon's CMOS sensors work with imaging engines to produce highly detailed photos with no false colors.

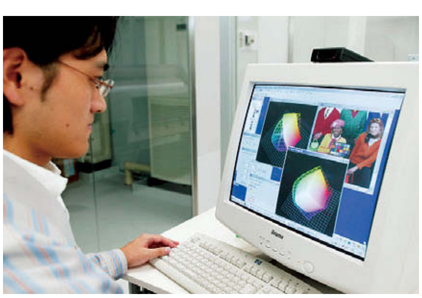
Canon is making significant progress in terms of bolstering shared platform technologies company-wide through its high-precision color management system. All Canon input/output products, from digital cameras, camcorders and scanners to home-use printers and large-format printers, share the unified color management scheme as one of the high-level imaging technologies. This superiority and compatibility of Canon's proprietary technology contributes to the competitive edge of Canon's products.

Canon has made remarkable reforms to its new product development process through the introduction of 3D-CAD



To strengthen research ability in nanotechnology, Canon has dispatched researchers to worldwide leading-edge research institutes such as the University of Cambridge's Nanoscience Centre

systems, and through the unified efforts of the entire Company to implement development reform initiatives. The development process traditionally required the construction of many physical prototypes to check for design flaws. Canon has succeeded in drastically reducing the number of prototypes, however, as a result of improvements to its visualization, measurement, analysis and simulation technologies. This has led to significantly shorter production times and lower development costs.



Canon's unified color management scheme supports high-level color matching

Representing the contributions of our R&D activities in numbers, the proportion of sales accounted for by new products (defined as two years from product launch) has increased from 44% in 2000 to 66% today.

Focused on Originality

Canon's extensive and highly advanced R&D activities have produced a wealth of intellectual property. In fiscal 2005, Canon newly acquired 1,828 patents in the United States, climbing to second rank overall from third in fiscal 2004, and continuing a 14-year streak of placing among the top three patent registrants. We will draw on this accumulated knowledge base to pursue the development of key devices and leading-edge technologies. Furthermore, Canon continuously takes every precaution to prevent the leakage of information concerning production technologies and

Canon developed DIGIC DVII image engine for high-definition images

manufacturing expertise.

As part of Canon's international diversification, we are conducting R&D activities that are closely tied to regional characteristics. Our regional marketing headquarters, Canon U.S.A. and Canon Europa are investing in R&D capabilities, and will aim to employ their respective specialty technical domains and local market attributes in efforts to develop new business ventures.

Canon is working to integrate development, manufacturing technology and know-how from the production plant, with the aim of establishing new production methods.

Toward the Establishment of New Production Methods

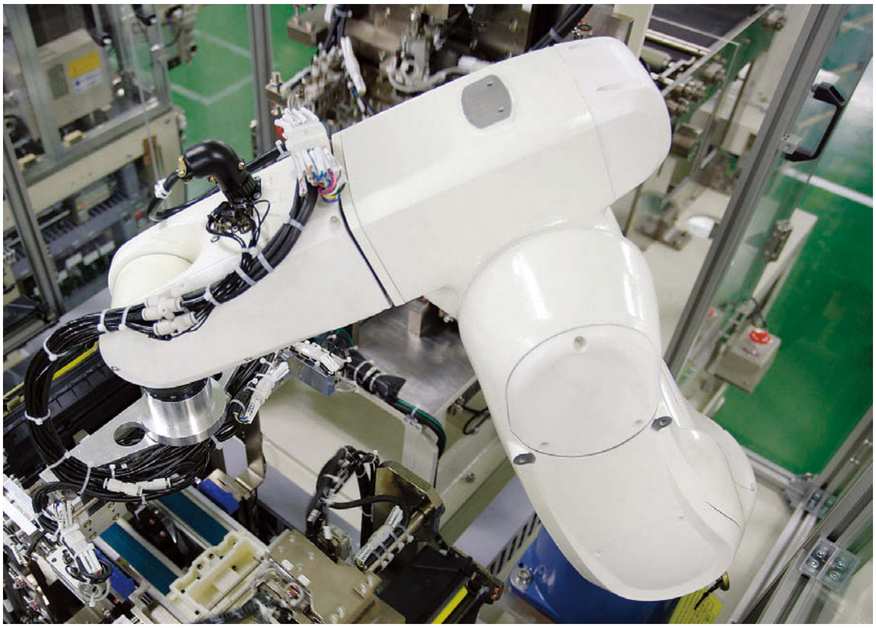
In 2005, Canon established the Production Automation Special Committee to study and solve issues related to automation. We believe that automated machinery will become more important in the future. Expanding production is necessary in order to continue growing, and we must develop new manufacturing systems that are not dependent upon labor in order to meet our future expansion needs. Canon aims to automate assembly procedures through the introduction of highly productive automated machinery and robots. Integrated manufacturing is essential to automation, and Canon's synergistic foundation will integrate development, manufacturing technology and production know-how. As a step in this direction, Oita Canon Materials Inc. in Japan is in the process of establishing automated unmanned manufacturing in toner cartridge operations. We also welcomed Canon Machinery into the consolidated Group. Canon Machinery possesses highly advanced technologies related to the design and production of automated machinery.

Increasing Efficiency in Production

Canon completely abandoned conveyor-belt-based production by the end of 2002 in favor of our cell production system. This innovative approach replaces assembly lines with small teams of workers, or "cells," who assemble products from start to finish. Productivity improves as individual workers become more proficient, enabling fewer workers to complete the assembling tasks. The cell production system offers great flexibility, enabling production of just the required amounts at the necessary times. One of the numerous tangible benefits of the system has been a dramatic reduction of work-in-progress inventory.

As employees master multiple skills under the cell production system, some are able to memorize operating manuals in their entirety and single-handedly assemble our products. Canon recognizes these exceptional workers through the Canon Expert System. Ideas, skills and know-how derived from cell production are being utilized in the automation of production lines.

A multi-skilled worker assembling MFDs in Canon Giessen, Germany



This automated toner cartridge assembly line in Japan strengthens competitiveness by reducing labor costs

Enhancing Cost Competitiveness

Canon continues to create innovative products while achieving cost reductions through in-house production of devices and components. We will further expand

Cell production of inkjet printers at Canon Vietnam, expanded in 2005, is running at full capacity, and construction of a third plant is underway to increase production

the in-house production of manufacturing equipment and molds, accumulate a greater wealth of production engineering technologies, establish exclusive production methods and reinforce product competitiveness.

As a central means of reducing costs, Canon has been undertaking procurement reforms. We are moving ahead with efforts to concentrate and consolidate our suppliers and establish a network system that links together global procurement records and parts information, making possible the sharing of up-to-date information. Canon also adheres to a policy of Green Procurement, striving to purchase environmentally friendly parts and materials.

Toner cartridge production at Canon Virginia

Increasing Production Capacity

Canon is stepping up production capacity in order to meet growing demand. At Oita Canon Inc. in Japan, we will begin construction of new facilities for the production of interchangeable lenses for single lens reflex (SLR) cameras, aiming to fully integrate camera-manufacturing operations. We also plan to complete construction of a second facility at Oita Canon Materials in December 2006, where we will begin manufacturing toner and toner cartridges, as well as printer heads and inkjet cartridges for inkjet printers. In addition, Canon completed construction of a new plant at Utsunomiya, Japan in November 2005 for the manufacturing of lenses.

Oita Canon realizes the ultimate in flexible production for Canon's digital cameras

Looking globally, Canon Vietnam Co., Ltd. completed construction of its second plant at the Que Vo Industrial Zone and commenced operations from April 2006 to increase production capacity of laser beam printers (LBPs). Canon Vietnam will also begin construction of its third plant in order to expand production capacity for inkjet printers.

In response to emerging user needs and market trends, Canon is working to optimize its sales network to the conditions of local regions.

Greater Global Diversification

All over the world, Canon pays careful attention to unique customer needs and proposes solutions geared toward using complex information networks with greater ease and efficiency, in step with the global advance of IT. Now in response to diversifying customer needs and new markets, we are organizing the operations of our global sales network under regional marketing headquarters: Canon U.S.A., Inc. in North and South America; Canon Europe Ltd. and Canon Europa N.V. in Europe, Africa, and the Middle East; Canon (China) Co., Ltd. in Asia excluding Japan; Canon Australia Pty. Ltd. in Oceania; and Canon Sales Co., Inc. in Japan. Under this system, each of Canon's 97 consolidated marketing subsidiaries worldwide are supported and reinforced by their respective regional headquarters.

The Americas

Canon U.S.A. has now been in business for 50 years. Sales grew 8.2% year on year to ¥1,146 billion, representing 30.5% of Canon's consolidated net sales.

Canon U.S.A. celebrates its 50th year of business in 2005

Canon U.S.A. is shifting its business model for the office product segment from a hardware sales-based to a solutions sales-based focus. In addition, it is continuing to integrate user-driven product customization functions into its sales companies. In the consumer market segment, it aimed for improved levels of customer satisfaction by implementing service and support infrastructure development drives and operational reforms.

In 2006, Canon U.S.A. will reconstruct its basic infrastructure. We are planning to introduce a new IT system for the purpose of improving productivity and operational quality. We will also establish an end-to-end supply chain management (SCM) structure, covering SCM from the production plant to the customer, and implement a performance evaluation system for Group companies and divisions in order to optimize the allocation of management resources.

Europe

In 2005, Europe was once again Canon's largest market, with consolidated net sales totaling ¥1,181 billion, a healthy increase of 8.0% over 2004, accounting for 31.5% of Canon's consolidated net

Canon is optimizing European logistics, including this warehouse in Rotterdam

sales. Canon is further strengthening its sales structure in rapidly growing markets, such as Russia and Africa.

In response to the expansion of the EU, Canon departed from its country-specific business approach and engineered a new structure that facilitates efficient business operations on a pan-European scale. Reforms in Europe included efforts to concentrate and integrate information systems and logistics services in order to increase speed and to bring greater consistency to business procedures.

Canon Europa N.V. has integrated European call centers into a single center in Belgium

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With a sales focus on solutions, Canon won SOCIÉTÉ GÉNÉRALE Group as a customer, receiving orders for over 2,500 digital MFDs and color copying machines

Japan, Asia and Oceania

Consolidated net sales in Japan totaled ¥856 billion, representing 22.8% of Canon's sales worldwide. Canon Sales has eliminated redundant sales and service channels and boosted efficiency by restructuring its group operations. Thanks to these structural reforms, the Canon Sales Group succeeded in beefing up its prowess in the arenas of direct sales and the delivery of business solutions.

With new retail shops, Canon expects significant growth in India's market

Backed by a strong tailwind of growth throughout Asia on the whole, combined sales for China, Oceania and Asian countries excluding Japan, together comprising our Other areas segment, increased 22.6% over the previous fiscal year to ¥571 billion. This represents 15.2% of Canon's consolidated net sales, up from 13.4% in 2004. In addition to China, Canon is also fortifying its sales operations in India and Vietnam.

Improving Customer Satisfaction

Keeping in tune with customer needs keeps Canon at the top in its businesses. Canon constantly endeavors to enhance customer service and improve customer satisfaction. We are greatly expanding our solutions-based services in the office imaging business by consulting with clients to customize MFDs using MEAP to create optimal solutions for their document needs. We are also pushing ahead with initiatives to upgrade SCM across our business segments for timelier product delivery. Canon has set up its Web Self-Service System (WSSS), a Web-based system for providing service and support for users of Canon consumer products for troubleshooting, device driver and user guide downloads, and other services.

Canon's corporate philosophy of *kyosei* embodies the very concept of CSR and demonstrates the commitment that Canon has made to creating a better world.

Canon's Approach to CSR

Canon formally introduced its corporate philosophy of *kyosei*—"living and working together for the common good"—in 1988. This concept reaffirms the original aspirations of Canon's founders, and in practice it means cooperating with the many communities where we operate and contributing to society, which amounts to nothing less than fulfilling corporate social responsibility (CSR).

Canon fully understands the importance of transparency in compliance and corporate governance activities (see page 10). At the same time, we are firmly committed to creating a sustainable world by working in collaboration with stockholders, customers, employees, suppliers and local communities to protect the environment and contribute to society.

Training and Nurturing Employees

Since Canon's founding, employees have been trained and evaluated based on the principle of *San-Ji*, or the "Three Selfs"—self-motivation, self-management, and self-awareness.

Training of new employees at Canon Vietnam

The Canon of today grew out of an enterprising spirit. To keep this corporate climate fully alive and well, the Company respects individuality and cultivates the capabilities of all employees, and fairly compensates personnel who have striven to improve their skills and achieve their goals. While Canon has redoubled its efforts in recent years in educating personnel and offering specialized training at all levels, including management and administrative levels, as well as training new employees, we will further strengthen these initiatives. We are also focusing on raising up global leaders. We will continue to cultivate discerning employees who are capable of prospering in all sorts of environments.

Regarding compliance, Canon thoroughly educates its employees to follow the principle of putting public interests and morals ahead of profit.

Environmental Activities

Life Cycle Assessment

Canon believes that technology and economic activity can be effectively used to restore a healthy environmental balance. Canon follows a system of life cycle assessment (LCA) to ensure that our products are environmentally friendly at all stages, from materials procurement and production to use and disposal. As part of our LCA-based system, we established the "Maximization of Resource Efficiency" concept in 2001, under which we seek to extract the maximum value out of minimal resources at every stage of a product's life cycle. LCA considerations of product design have led Canon to develop energy-saving technologies including on-demand fixing and induction-heating (IH) fixing, and are the driving force behind our endeavors to make products more compact and lightweight.

Consolidated Group ISO 14001 Certification

In July 2005, we obtained consolidated ISO certification covering Canon's 46 business sites and affiliated companies in Japan, along with six European sales companies. We plan to completely switch to group certification covering all of our production sites and sales companies worldwide by 2007.

Vision 2010

Canon has established a medium- to long-term environmentally conscious management plan designated as Vision 2010. One of the primary goals and the overriding indicator of the plan is Factor 2: a target of at least doubling resource efficiency associated with Canon's entire scope of business activities by 2010 as compared with the baseline year of 2000. Canon continues to develop technologies and strengthen systems in order to meet this goal.

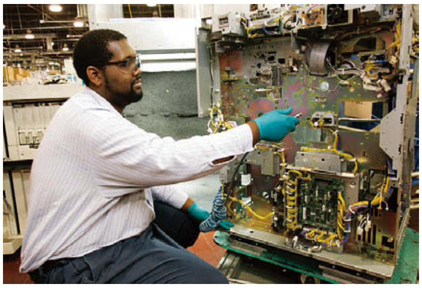
Global Warming Countermeasures through Logistics

Canon conducts its environmental activities from the standpoint of LCA,

As part of Canon's modal shift, products manufactured at plants worldwide are shipped to Rotterdam's port and transported in containers across Europe by rail

applying these principles thoroughly to its logistics operations. Canon is reviewing its product distribution methods, and is actively implementing a modal shift* on a global basis.

Canon analyzes logistics at each stage of business activities, from procurement to sales and recovery of products. For international shipping, we are working to improve the packaging of products, increase the loading efficiency of ocean containers and implement other upgrades.



Used copiers disassembled, cleaned, reassembled and remarketed in almost new condition

*Modal shift
Switching from truck to ship or rail transport lessens the burden on the environment. The amount of CO_2 emissions generated by transporting one ton of freight over one kilometer by rail is 1/9 that of truck transport, while ship transport produces 1/4 the emissions.

Resource Conservation

As a global corporation dedicated to a recycling-oriented society, Canon pioneered the collection and recycling of toner cartridges from copying machines and LBPs. Moreover, Canon has been remanufacturing copying machines on a global scale since 1992. In remanufacturing, collected products are disassembled, reusable and worn parts are separated, parts are replaced, and the machines are cleaned to create final products that meet the same quality standards as new products.

In order to significantly reduce the use of resources in its products, Canon is striving to make products lighter and more compact by utilizing high-precision design for smaller circuit boards, employing more compact batteries, and decreasing motor size.

Elimination of Hazardous Substances

In developing, designing and producing products, we aim to eliminate the use of all hazardous chemicals that have the potential to burden the environment after products are discarded. This goal applies not only to the six substances covered by the EU's RoHS* Directive, but also halogenated flame-retardants, which are

As part of Green Procurement, Canon checks a lead-free plating plant in Suzhou, China substances frequently used in exterior casing plastics that generate dioxins during incineration. In addition, Canon is working to manage information related to chemical materials from the procurement stage in order to meet new standards for the EU's Registration, Evaluation and Authorization of Chemicals (REACH) regulatory framework.

*Restriction of the use of certain Hazardous Substances in electrical and electronic equipment

Canon is assisting the WWF in digitizing its priceless collection of photographs

©WWF/Rob WEBSTER

Contributing to Society

With the corporate philosophy of *kyosei* ever in mind, Canon makes social contributions a natural part of its business activities in every corner of the globe. Some of our ongoing and recent activities were as follows:

UNEP International Photo Competition

Canon has acted as a sponsor of the United Nations Environmental Programme (UNEP) International Photographic Competition since it was first held. The contest aims to raise awareness about global environmental issues. Canon was a joint sponsor of the fourth competition, "Focus on Your World," which saw works with an environmental theme submitted from 169 countries and regions. The awards for the 2004 competition were presented at the 2005 World Exhibition in Aichi, Japan.

UNEP award winning photographs on display in the UN Pavilion at EXPO 2005 in Aichi, Japan

WWF Conservation Partner

Canon became the first Conservation Partner of the World Wildlife Federation (WWF) from 1998. In addition to sponsoring several photo contests and providing equipment to WWF in several nations, Canon also helps WWF to digitize its superb image collection and to make it readily available online to its global network of offices.

Eyes on Yellowstone

Eyes on Yellowstone is a collaborative ecological research and teaching initiative funded by Canon to support important scientific research, endangered species protection, and the application of cutting-edge image equipment and technology essential for the management of park wildlife and ecosystems.

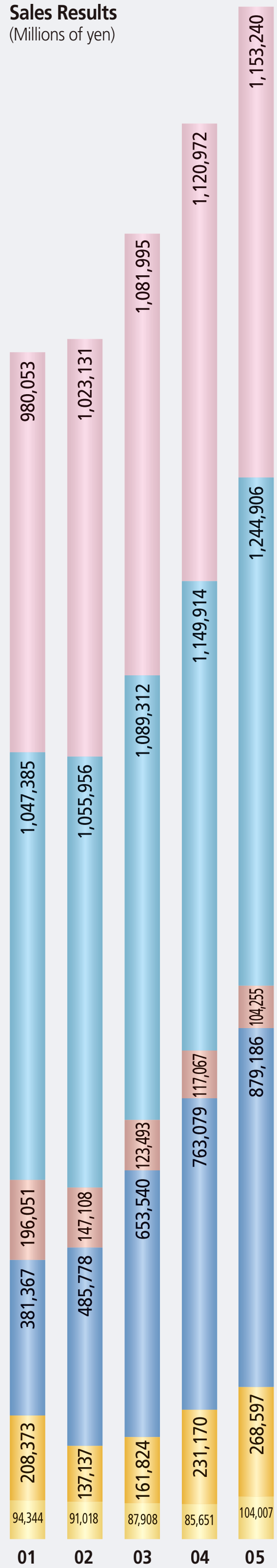
Beijing University Canon Scholarship

Canon established the Beijing University Canon Scholarship Foundation in 1998 to commemorate the 100th anniversary of the founding of the university. By March 2006, 525 students had received support. In recognition of Canon's support for promising young scholars, Canon (China) Co., Ltd. was selected "Best Corporate Citizen" for the second consecutive year by the Chinese economic newspaper *21st Century Business Herald*.

Beijing University students receive scholarships from Canon

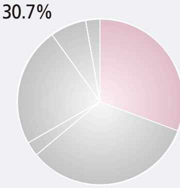
PRODUCT GROUPS

Sales Results
(Millions of yen)



Share of Consolidated Sales

30.7%



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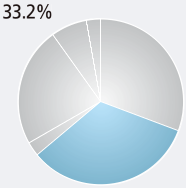
Business Machines
OFFICE IMAGING PRODUCTS 26-27

Office network digital multifunction devices (MFDs)
Color network digital MFDs
Office copying machines
Personal-use copying machines
Full-color copying machines, etc.

33.2%



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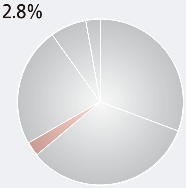
Business Machines
COMPUTER PERIPHERALS 28-29

Laser beam printers (LBPs)
Single-function inkjet printers
Inkjet multifunction peripherals
Image scanners, etc.

2.8%



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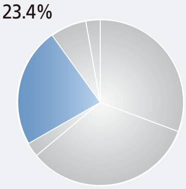
Business Machines
BUSINESS INFORMATION PRODUCTS

Computer information systems
Micrographic equipment
Personal information products, etc.

23.4%



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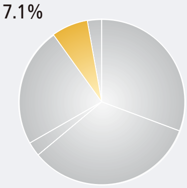
CAMERAS 30-31

Single lens reflex (SLR) cameras
Compact cameras
Digital cameras
Digital video camcorders, etc.

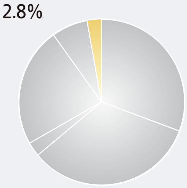
7.1%



OPTICAL AND OTHER PRODUCTS 32-33

Semiconductor production equipment
Mirror projection mask aligners for LCD panels
Broadcasting equipment
Medical equipment, etc.

2.8%



OFFICE IMAGING PRODUCTS

As the concept of an office broadens, Canon is developing its value-added services for the ultimate in document solutions.

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Masaki Nakaoka
Chief Executive, Office Imaging Products Operations

Canon is the world's largest manufacturer of office copying machines and multifunction devices (MFDs), which are business machines with combined operations such as copying, printing, scanning and faxing, as well as sending and storing documents.

Canon made a sound showing in 2005 in the midst of challenging market conditions, and enhanced its brand image and market share in emerging markets. Canon maintained top share in several product categories through increased unit sales and the introduction of strong-selling high-end color models for offices. We bolstered our lineup in the imageRUNNER (iR) series, continuing to develop our proprietary MEAP technology, which makes it possible to customize individual MFDs in response to customers' particular needs. These initiatives contributed to sales growth, as we worked purposefully to offer proposals that enhance efficiency of customers' businesses.

Canon extended its strategic alliance with Microsoft Corporation by entering an agreement to provide Canon's next-generation Kyuanos color management technology for the upcoming Windows Vista™ operating system. This will further enhance our superiority over competitors by contributing to our color matching strategy, through which we are realizing consistent, exact color between digital input and output devices, and enabling high-quality prints through Windows® products.

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imageRUNNER C6870

By continually introducing innovations we believe Canon can maintain steady growth in spite of the general perception that the business machine market has matured. The advance of our information society and the digital era present us with tremendous chances to expand our business domains. As the concept of an office continues to broaden, Canon is aggressively developing its Advanced imageRUNNER products that utilize networks and act as office portals linking a variety of media.

Canon is now increasing activity in print-on-demand (POD) applications. At the same time, we are focusing on leveraging MEAP technology to expand document solution services, where we will consult closely with customers to provide optimal solutions for their specific demands. Our goal is to complement our current mainstay office and SOHO businesses by establishing POD and document solutions businesses as two additional pillars of the Office Imaging segment.

We will also press ahead with efforts to boost profitability by shortening development lead-time, optimizing SCM and reducing inventory levels.

Fiscal 2005 Review

Sales of office imaging products in 2005 totaled ¥1,153 billion, a year-on-year increase of 2.9%.

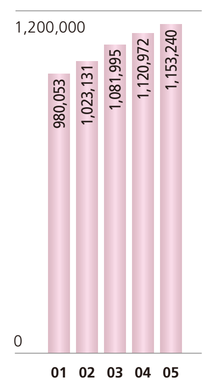
Canon achieved growth despite intensifying pricing competition by realizing targets for increased unit sales. Demand for network digital MFDs remained solid as the office market, including small-scale enterprises, indicated a shift from monochrome to color models, as well as a trend toward higher-end features. Amid color network digital MFDs, the iR C3170 series, featuring high-speed image-processing with a new iR controller, and the iR C3220 series continued to sell well in both Japan and European markets, as did the new high-speed iR C6870 series models. Among monochrome network digital MFDs, mid-level models such as the iR4570 series contributed to expanded sales, along with the iR6570, featuring energy-saving performance and high productivity. New low-end models with enhanced networking, which are targeted at small businesses, were also well received in the Americas and Europe.

In the Americas, newly introduced MFDs equipped with MEAP led double-digit growth of color unit sales. We maintained our No. 1 position for both monochrome and color machines. Our Latin American operations posted record sales and earnings results.

The European market also saw growth in the double-digits for color machines, and strong growth of monochrome machines. We will further develop our operations in the growth markets of Russia and Eastern Europe during 2006.

In Asia, Canon increased its share of unit sales in the Japan market on the back of strong sales of new color models, recording year-on-year sales growth of over 6% in spite of intense competition. While sales in China remained on par with 2004, we recorded significant sales growth in other Asian regions, Australia and other regions. Overall, growth in Other areas reached nearly 8% above 2004.

Sales Results: Office Imaging Products
(Millions of yen)



imageRUNNER C3170

imageRUNNER 4570

Canon Future Technology

High-Speed, High-Image Quality POD Machines

High-speed multifunction POD machines are increasingly in demand in the commercial printing industry as tools to print small volumes of diverse materials, such as pamphlets and other materials that are frequently updated and for which demand is difficult to forecast. Businesses are also expanding the usage of POD machines for in-house production of conference materials and simple manuals. At Canon EXPO 2005, Canon unveiled high-speed, high image quality color POD machines. Canon's multifunction POD models combine not only high image quality and speed, but also expanded options such as gluing, cutting and loading to create a variety of printed materials, as well as advanced editing functions. For example, Canon's POD machines are capable of printing, cutting and binding 1,000 issues of a 16-page magazine in just 10 hours, compared with several days required by an offset press. Canon aims to boost its presence in the commercial printing market.

POD machines
Canon's leading-edge POD machines offer automated, high-quality book-binding, combined with superior durability and reliability. Our models feature large, color LCD touch panels for enhanced user friendliness.

Focusing on Canon photo-quality printing, Canon will expand its lineup of inkjet printers by continually making technological break-throughs.

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Katsuichi Shimizu
Chief Executive, Inkjet Products Operations

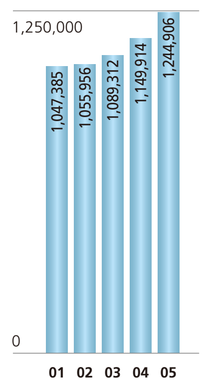
As one of the world's foremost manufacturers of inkjet printers, Canon enjoys two major advantages over competitors. First, it is one of the few companies in the world boasting world-class technologies for both cameras and photo-quality color printers. Second, Canon has made significant strides in manufacturing products internally. Canon is in the process of maximizing these strengths and its strong brand name to become No. 1 in the market for digital photos. Inkjet printer uses are expanding from documents to Web images, home printing of photos and professional printing. Canon will equip its entire lineup of inkjet printers with photo-printing quality to complement its digital camera strengths.

The inkjet printer market experienced moderate growth in 2005. The year saw an extension of the trend away from single-function printers (SFPs) and toward multifunction printers (MFPs) that augment printing functions with copying, scanning, direct printing and other functions. In response to these trends, Canon works tirelessly to distinguish its products from other companies. In 2005, the full-fledged proliferation of Canon's proprietary Full-photolithography Inkjet Nozzle Engineering (FINE), a high-precision technology that achieves high-image quality and speed, got underway as Canon equipped all new models with FINE print heads. We also improved the user-friendliness of our PIXMA series of inkjet printers by equipping models with larger-sized LCD monitors. In addition, Canon added features that enhance user convenience of its ink tanks, enabling users to see when ink is running low even without the use of a PC.

PIXMA iP5200

Canon plans to achieve sustainable revenue and profit growth over the medium term by reinforcing its entire scope of operations, from printers to consumables including ink tanks and paper. We will adhere to key principles including achieving low cost operations, adding value from the customer's perspective and expanding business domains by leveraging our inkjet technologies. Growth sectors include compact photo printers, as well as professional-grade printers and digital TV printers. We will raise efficiency by concentrating development operations, and advancing with automated and in-house production initiatives. To meet the demand for inkjet printers, Canon also plans to expand production operations in Vietnam. Canon will work to increase competitiveness by augmenting its lineup of products incorporating original technologies, aiming to gain greater market share while maintaining cost effectiveness and increasing earnings.

Sales Results: Computer Peripherals
(Millions of yen)



Fiscal 2005 Review

Sales in the computer peripherals business during 2005 saw an increase of 8.3% over the previous year for a total of ¥1,245 billion, owing to the reinforcement of our MFP lineup.

In inkjet printers, Canon saw strong sales of both SFPs and MFPs in Europe and the Americas, leading to an increase of more than 10% in overall unit sales. New MFP models introduced included the PIXMA MP800, which features a 3.5-inch LCD monitor, and compact entry-level models such as the PIXMA MP150 in global markets. New models, including the PIXMA iP4200 SFP and high-speed all-in-one models such as the PIXMA MP500, contributed to a stronger product lineup and fueled sales growth in value terms. We also launched our ChromaLife100 system, combining Canon genuine ink with Canon's premium-quality photo paper to realize the long-lasting beauty of photos.

In laser beam printers (LBPs), Canon enjoyed a year of strong demand, with color models growing more than 30% and attaining record levels in unit sales and sales value. Unit sales grew in Japan and all other major regions. Monochrome machines also posted record unit sales, with particularly robust demand for low-end models. Sales in value terms also rose despite fierce price competition in the market shift toward lower-priced models. All major regions saw increased unit sales, with the rapidly expanding Asia market, led by China, growing to a market scale on par with that of North America and Europe. Sales in the toner cartridge business increased in 2005, supported by significant sales growth of color models.

In flatbed scanners, though the overall market is shifting due to the move toward MFPs, Canon maintains a solid reputation by continually introducing high-resolution models.

PIXMA MP800

LBP3000

CanoScan 9950F

Canon Future Technology

Digital TV Printer

With the shift to digital TV in the U.S.A., Europe and other regions, and the introduction of digital terrestrial broadcasting in Japan during 2006, an increasing number of households worldwide are purchasing televisions equipped with tuners for interactive digital broadcasts. With its high image and sound quality, multi-channel capacity, and the ability to freely download information useful for daily living, interactive digital has wide appeal. As broadcasts that include data become increasingly convenient, more people will be able to make printouts of information even if it is not displayed on their screens.

At Canon EXPO 2005, we exhibited a digital TV printer concept model, demonstrating our determination to respond to this market opportunity embodied in the proliferation of digital TV. Equipped with superb image quality, Canon's digital TV printers will emphasize user convenience. We will launch models in Japan in the near future, followed by models for the U.S. and European markets, expecting to achieve significant growth in this business over the next five years.

Digital TV Printer concept model
With a digital TV printer, you can print out on a single page detailed digital program information in an easily readable format. Canon's inkjet digital TV printers will have a slim and stylish design similar to a DVD recorder or player.

Canon will lead the digital imaging world through its wide array of input and output devices.

Deleted due to portrait rights.

Tsuneji Uchida
Chief Executive, Image Communication Products Operations

Canon is the world's leading manufacturer of compact digital cameras and digital single lens reflex (SLR) cameras. Canon's 70 years of camera manufacturing know-how combined with its advanced digital technologies has led to the Company's success in digital cameras.

Though prices in the industry continue to decline, Canon introduces innovative, high-value-added products and reinforces its brand strength. In 2005, Canon leaped to new heights in its No. 1 position in the global market for compact digital cameras. We have also gained overwhelming dominance in digital SLR cameras by expanding our lineup for users from beginners to advanced amateurs and professionals, supporting significant sales growth. This has accordingly led to strong sales of interchangeable lenses, with cumulative production of lenses topping 30 million in January 2006. The new XL H1 high-definition (HD) digital video camcorder also won rapid praise from the market.

Interchangeable Lenses

Canon continues to unveil appealing new models, develop exclusive technologies and expand operations to outpace and outclass competitors. Canon independently develops and manufactures energy-efficient CMOS sensors with high-speed processing abilities. Our DIGIC II imaging engine technology enables reproduction of natural colors through instantaneous processing of high-resolution images. Our accumulated optical technologies are applied to projectors and an array of other products, enabling us to offer the utmost in image quality.

XL H1

A key concept for our next stage of growth is "Renewing our challenges," through which we will continue to implement structural reforms and make further advances in leading-edge technologies. We plan to commence fully integrated production of cameras by manufacturing lenses at Oita Canon, aiming to increase efficiency and flexibility. We will accelerate development times by strengthening simulation technologies, boost efficiency in launching new products, reduce manufacturing costs and optimize inventory levels through precise production and sales plans. While providing speed and quality in response to changing user needs, we will enhance our lineup of output devices such as projectors and compact photo printers, and lead the digital imaging world by expanding compatibility with input devices.

Deleted due to portrait rights.

EOS-1Ds Mark II

Fiscal 2005 Review

Sales in the cameras segment totaled ¥879 billion, a year-on-year increase of 15.2%.

In compact digital cameras, Canon attained record sales of around 15 million units. We introduced seven new models in the PowerShot series, meeting a broad range of picture-taking styles through a diverse lineup. In addition, we launched six new models in the Digital ELPH (Digital IXUS in some areas) series, renowned for their stylish and compact design. These new models contributed to steady sales growth.

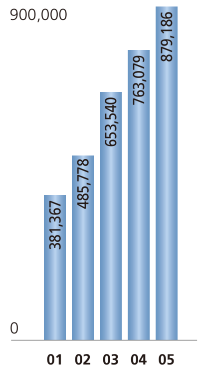
Sales of Canon digital SLR cameras were robust worldwide, rising more than 0.6 million units over 2004 to surpass 1.9 million units. Canon remains the No. 1 choice of users through the strength of its lineup, offering highly acclaimed models for beginners and professionals alike. Canon introduced the EOS DIGITAL REBEL XT (EOS 350D in some areas) entry-level model in the first half, followed by the EOS 5D for advanced amateurs, as well as the EOS-1D Mark II N.

Demand for digital video camcorders grew stronger in Europe and Asia. Canon's new models registered strong performances, including the XL H1, a professional-class HD video camcorder, the DC20 and DC10, Canon's first DVD camcorders, and the OPTURA600 (MVX4i in some areas), Canon's first 4-megapixel Mini DV camcorder.

We bolstered our presence in compact digital photo printers by introducing the new SELPHY CP600 equipped with the DIGIC II imaging engine, providing for higher speed and image quality than previous models.

In the LCD projector market, Canon's SX50 projector from the liquid crystal on silicon (LCOS) genre of projectors became a market leader in the SXGA class (1,400 X 1,050 pixels). Powered by Canon's exclusive Aspectual Illumination System (AISYS) optical engine for bright, brilliant images, the SX50 has won numerous awards around the globe.

Sales Results: Cameras
(Millions of yen)



EOS DIGITAL REBEL XT (EOS 350D in some areas)

REALiS SX50 (XEED SX50 in some areas)

Canon Future Technology

Intelligent Vision Systems

At Canon EXPO 2005, we demonstrated new face identification and tracking technology and smile detection features, technologies that broaden the possibilities for future cameras. Canon's Intelligent Vision systems with powerful embedded intelligence are able to distinguish faces and recognize facial expressions. As the basic technology, we developed original algorithms to detect localized features such as eyes, mouth and facial contours.

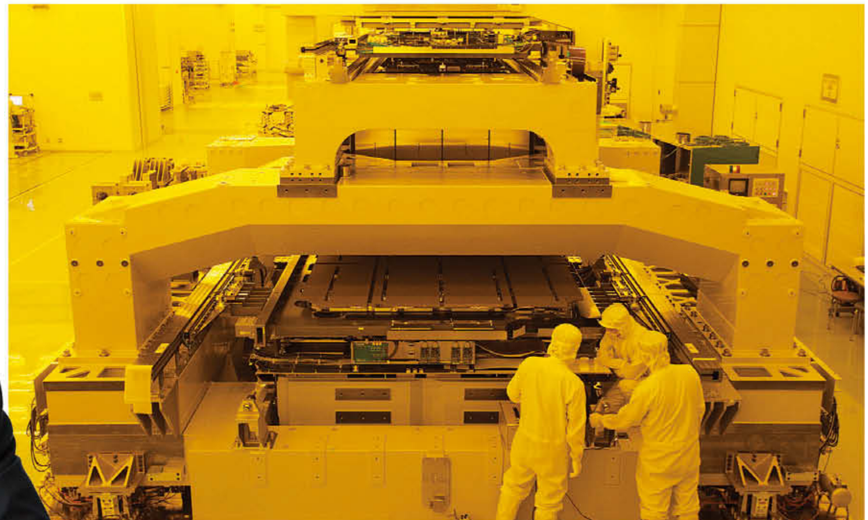
We are also working on facial expression recognition technologies offering high reliability despite changes in facial size and angle. We hope to use such technologies to help prevent missed photo opportunities. If recognition processes can be made faster and more energy-efficient, they can potentially be employed in the "eyes" of robots and other futuristic applications.

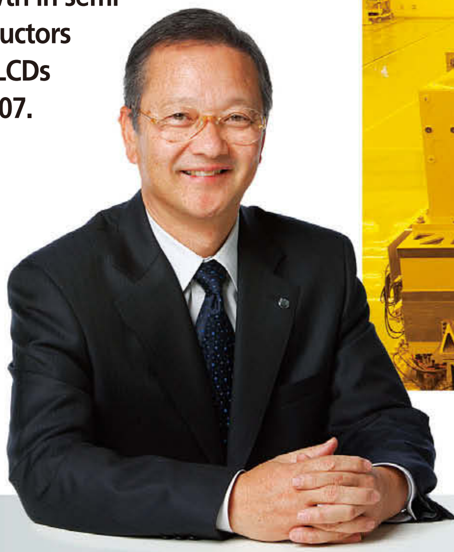
Canon will continue introducing functions that enhance user-friendliness and enjoyment of the picture-taking experience, and that hold potential for expanded applications.

Intelligent Vision system
Our automated Intelligent Vision system can distinguish faces and recognize facial expressions, including smiles. The system's embedded intelligence can be programmed to detect faces and automatically snap a photo the instant a smile appears, and pause when blinking eyes are detected.

OPTICAL AND OTHER PRODUCTS

Canon will bolster its lineup of next-generation products in preparation for significant growth in semiconductors and LCDs in 2007.





Junji Ichikawa
Chief Executive, Optical Products Operations

Semiconductor production equipment and LCD production equipment are two of the major product categories in Canon's Optical and Other Products segment. The segment recorded increases in both sales and profits in 2005.

Canon's MPA series of mirror projection aligners for large-scale LCD panels continued to enjoy a high reputation from users. Canon made full-scale shipments of the MPA-8000 series for sixth and seventh generation panels in 2005, significantly contributing to sales growth.

Due to slight overinvestment by LCD panel makers, we expect sales of LCD production equipment to edge down in 2006, with a market recovery in 2007 during the lead-up to the 2008 Beijing Olympics. In 2006, we will adapt to market conditions and leverage our ability to lower costs, enabling us to increase profits despite a drop-off in sales. We will work to develop equipment for next generation panels, which are expected to go on sale in 2007.

FPA-6000AS4

Steppers, which are used to expose circuits on silicon substrates, are Canon's mainstay products in the business of semiconductor production equipment. The industry trends toward high resolution and higher speed equipment will likely continue. Canon strives to manage these trends by maximizing its in-house production expertise.

Canon has launched the FPA-6000AS4, its fastest argon fluoride (ArF) excimer-laser scanning stepper, also featuring a high-level numerical aperture of 0.85 and an ultra-low aberration lens system. At the top of its class, the FPA-6000AS4 is targeted for the most advanced Large Scale Integration (LSI) and memory mass-production.

Canon will continue to make greater developments in advanced technologies and cutting-edge products. Maintaining a focus on quality, we will earn the further trust of semiconductor manufacturers through innovations that meet customer needs. We plan to launch a next-generation ArF stepper in 2006 that can be installed in half the time of current steppers. Canon is also making strides in the development of immersion lithography, and aims to launch sales of a stepper equipped with this technology in 2007. Canon continues to move closer to creating equipment that utilizes Extreme Ultraviolet (EUV) light sources, leading industry initiatives to develop key technology for next-generation lithography.

Fiscal 2005 Review

Sales in the Optical and Other Products segment in 2005 surged 17.6% compared with 2004, totaling ¥373 billion.

The LCD panel market was robust in 2005, seeing significant increases over the previous year in unit sales for notebook and desktop PCs, as well as for LCD televisions, which dropped sharply in price, creating stronger demand and more than doubling unit sales. Coupled with the introduction of new products, this overall market strength supported notable sales growth of Canon's mask aligners for LCD panels in terms of both volume and value. Additionally, the vacuum thin-film deposition and processing equipment produced by Canon ANELVA contributed to expanded sales.

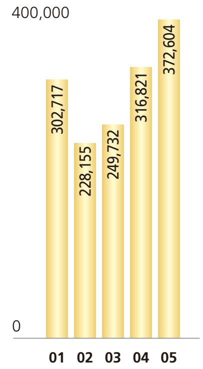
Though relatively weak investment by semiconductor manufacturers in 2005 slowed sales of Canon's steppers, unit base market share increased slightly compared with the previous year. As one of its latest 300mm-compatible lithography tools, Canon introduced the FPA-6000ES6a, a krypton fluoride scanning stepper enabling volume production at the 90nm process node.

In the medical equipment business, market demand for digital retinal cameras increased, and Canon achieved record units sales for its non-mydriatic retinal cameras in 2005, maintaining top market share. Canon also introduced the CF-60Dsi digital mydriatic retinal camera, and boosted share in all markets for retinal cameras.

Major products in Canon's digital radiography device lineup, including the CXDI-50G, saw increased sales in regions outside Japan during 2005, helping Canon to maintain top share in the worldwide market. We are working to expand the domain of X-ray digital cameras, and expect sound sales growth in the digital radiography devices market.

Canon maintained its leading position in the market for broadcast television lenses, supported by strong demand in Europe due to the acceleration of the shift to high-definition television (HDTV). The HJ22ex7.6B portable lens for HDTV broadcasting contributed to increased sales.

Sales Results: Optical and Other Products
(Millions of yen)



CXDI-50G

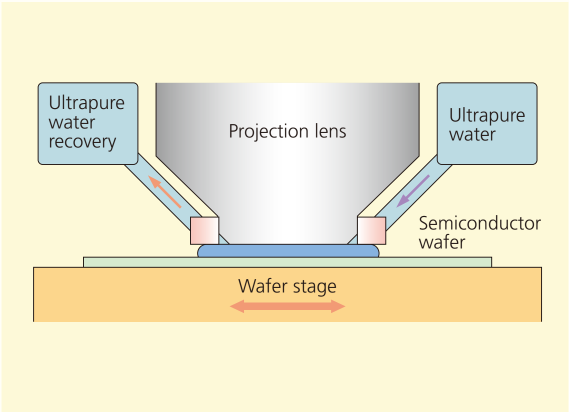
HJ22ex7.6B

Canon Future Technology

Immersion Lithography Technology

Immersion lithography technology that employs ArF excimer lasers enables more precise circuit patterns, while significantly reducing investment costs. The technology involves filling the space between a projection lens and the wafer with ultrapure water, which increases the refractive index so that the lens numerical aperture increases at the same angle even for light. The method holds the potential to reduce circuit linewidth down to 45nm for extremely fine exposure. The limit for ArF excimer laser light sources of 193nm wavelengths was previously thought to be circuit linewidth of 65nm.

Canon is focusing on practical applications of the localized immersion method, "Liquid Film Flow" method, and the ultra-high NA catadioptric lens. Finding a liquid with a high refractive index and further developing projection lenses open the possibility of approaching a circuit width of 32nm using 193nm lasers, the same region as EUV light sources.



Localized immersion method
Immersion technology creates possibilities for more precise circuit patterns, enabling extremely fine exposure. By filling the space between the projection lens and the wafer with ultrapure water, the lens numerical aperture is significantly increased.

MAJOR CONSOLIDATED SUBSIDIARIES

(As of December 31, 2005)

MANUFACTURING

Canon Electronics Inc.
Canon Finetech Inc.
Nisca Corporation
Canon Semiconductor Equipment Inc.
Canon Ecology Industry Inc.
Canon Chemicals Inc.
Canon Components, Inc.
Canon Precision Inc.
Oita Canon Inc.
Nagahama Canon Inc.
Oita Canon Materials Inc.
Ueno Canon Materials Inc.
Fukushima Canon Inc.
Canon Optron, Inc.
Igari Mold Co. Ltd.
Canon Machinery Inc.
Canon ANELVA Corporation
SED Inc.
Canon Virginia, Inc.
Custom Integrated Technology, Inc.
Industrial Resource Technologies, Inc.
Canon Giessen GmbH
Canon Bretagne S.A.S.
Canon Inc., Taiwan
Canon Dalian Business Machines, Inc.
Canon Zhuhai, Inc.
Canon Zhongshan Business Machines Co., Ltd.
Tianjin Canon Co., Ltd.
Canon (Suzhou) Inc.
Canon Opto (Malaysia) Sdn. Bhd.
Canon Hi-Tech (Thailand) Ltd.
Canon Ayutthaya (Thailand) Ltd.
Canon Engineering (Thailand) Ltd.
Canon Vietnam Co., Ltd.
Canon Electronic Business Machines (H.K.) Co., Ltd.
Canon Engineering Singapore Pte. Ltd.
Canon Engineering Hong Kong Co., Ltd.

RESEARCH & DEVELOPMENT

Canon Development Americas, Inc.
Canon Technology Europe Ltd.
Canon Research Centre France S.A.S.
Canon Information Systems Research Australia Pty. Ltd.
Canon Information Technology (Beijing) Co., Ltd.
Canon (Suzhou) System Software Inc.

MARKETING & OTHER

Canon Sales Co., Inc.
Canon System and Support Inc.
Canon System Solutions Inc.
Canon Software Inc.
Canon U.S.A., Inc.
Canon Canada, Inc.
Canon Mexicana, S. de R.L. de C.V.
Canon Latin America, Inc.
Canon do Brasil Industria e Comercio Limitada
Canon Chile, S.A.
Canon Panama, S.A.
Canon Argentina, S.A.
Canon Business Solutions-Central, Inc.
Canon Business Solutions-West, Inc.
Canon Business Solutions-East, Inc.
Canon Financial Services, Inc.
Canon Information Technology Services, Inc.
Canon Europa N.V.
Canon Europe Ltd.
Canon (UK) Ltd.
Canon Deutschland GmbH
Canon France S.A.S.
Canon Italia S.p.A.
Canon España S.A.
Canon Nederland N.V.
Canon Danmark A/S
Canon Belgium N.V./S.A.
Canon (Schweiz) AG
Canon Gesellschaft m.b.H.
Canon Svenska AB
Canon Oy
Canon North-East Oy
Canon Norge A.S.
Canon CEE GmbH
Canon Middle East FZ-LIC
Canon South Africa Pty. Ltd.
Canon Australia Pty. Ltd.
Canon New Zealand Ltd.
Canon Finance Australia Ltd.
Canon Finance New Zealand Ltd.
Canon (China) Co., Ltd.
Canon Singapore Pte. Ltd.
Canon Hongkong Co., Ltd.
Canon Marketing (Malaysia) Sdn. Bhd.
Canon Marketing (Philippines), Inc.
Canon Marketing (Thailand) Co., Ltd.
Canon Marketing (Taiwan) Co., Ltd.
Canon India Pte. Ltd.
Canon Semiconductor Engineering Korea Inc.
Canon Semiconductor Equipment Taiwan Inc.

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GENERAL

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

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 2005, the U.S. economy continued to display growth despite concern over the economic impact of escalating crude oil prices and the damage caused by Hurricane Katrina, with healthy employment conditions and continued growth in consumer spending. In Europe, while the recovery in consumer spending appeared to falter, such factors as growth in the production sector amid strong exports indicate a trend toward moderate recovery. As for Asia, China continued to achieve a high rate of economic growth, mainly fueled by exports, while other Asian economies also recorded generally favorable performances. In Japan, the economy continued to gradually recover owing to such factors as increased corporate investment supported by favorable corporate profits and improved consumer spending.

Market Environment

With respect to the markets in which Canon operates, demand in the digital camera segment for single lens reflex ("SLR") models continued to grow significantly during fiscal 2005. Sales of digital compact cameras also remained strong to realize healthy overall growth for the segment. Demand for network digital multifunction devices ("MFDs") remained solid as the office market, including small-scale enterprises, moved toward color and multifunctionality. Although sales of computer peripherals, including printers, grew for both multifunction and color models, the segment suffered amid a shift in further demand toward high-performance low-priced machines and severe price competition. Demand for steppers, used in the production of semiconductors, tapered off after the summer of 2004 as the chip manufacturing market entered a correction phase. The market for projection aligners, which are used in the production of liquid crystal display ("LCD") panels, enjoyed stable growth, fueled by increased investment by LCD panel manufacturers amid the rapid expansion of the LCD television market. The average value of the yen for the year was ¥110.58 to the U.S. dollar and ¥137.04 to the euro, representing a year-on-year decrease of almost 2% against both currencies.

Summary of Operations

Canon achieved record highs in both consolidated net sales and net income, and a sixth consecutive year of sales and profit growth, mainly due to a significant increase in sales of digital cameras and color network digital MFDs, along with an increase in sales of projection aligners. In fiscal 2005, Canon achieved 8.3% growth in net sales, to ¥3,754,191 million (U.S.$31,815 million), and an 11.9% increase in net income, to ¥384,096 million (U.S.$3,255 million). Canon's gross profit increased by 6.2%, to ¥1,819,043 million (U.S.$15,416 million).

Key Performance Indicators

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

Revenues

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

Net sales is one such KPI. Canon derives net sales primarily from the sale of products and, to a lesser extent, providing 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 to be 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 efficiency enhancements in production. Canon believes that these achievements have contributed to improving Canon's gross profit ratio, and Canon intends to continue to pursue further shortening of product development lead times and reductions in production costs.

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

Cash Flow Management

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

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

Canon's management seeks to meet its liquidity and capital requirements primarily with cash flow from operations 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.

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

KEY PERFORMANCE INDICATORS	2005	2004	2003	2002	2001
Net sales (Millions of yen)	**¥3,754,191**	¥3,467,853	¥3,198,072	¥2,940,128	¥2,907,573
Gross profit to net sales ratio	**48.5%**	49.4%	50.3%	47.6%	44.0%
R&D expense to net sales ratio	**7.6%**	7.9%	8.1%	7.9%	7.5%
Operating profit to net sales ratio	**15.5%**	15.7%	14.2%	11.8%	9.7%
Inventory turnover within days	**47 days**	49 days	49 days	51 days	57 days
Debt to total assets ratio	**0.8%**	1.1%	3.1%	5.0%	10.4%
Stockholders' equity to total assets ratio	**64.4%**	61.6%	58.6%	54.1%	51.3%

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles, and based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. Canon believes that the following are 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 generates revenue principally through the sale of consumer products, equipment, supplies and related services under separate contractual arrangements. Canon recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred and title and risk of loss have been transferred to the customer, the sales price is fixed or determinable, and collectibility is probable.

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

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

Revenue from sales of optical equipment such as steppers and aligners sold with customer acceptance provisions related to their functionality is recognized when the equipment is installed at the customer site and the specific criteria of the equipment functionality are successfully tested and demonstrated by Canon. Service revenue is derived primarily from maintenance contracts on equipment sold to customers and is recognized over the term of the contract.

Most office imaging products are sold with service maintenance contracts for which the customer typically pays a base service fee plus a variable amount based on usage. Revenue from these service maintenance contracts is recognized as services are provided.

Revenue from the sale of equipment under sales-type leases is recognized at the inception of the lease. Income on sales-type leases and direct-financing leases is recognized over the life of each respective lease using the interest method. Leases not qualifying as sales-type leases or direct-financing leases are accounted for as operating leases and related revenue is recognized over the lease term.

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

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

Allowance for Doubtful Receivables

Allowance for doubtful receivables is determined using a combination of factors to ensure that Canon's trade and financing receivables are not overstated due to uncollectibility. Canon maintains 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.

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.

Valuation of Deferred Tax Assets

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

Employee Retirement and Severance Benefit Plans

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

Actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect future pension expenses. While management believes that the assumptions used are appropriate, the differences may affect employee retirement and severance benefit costs in the future.

In preparing its financial statements for fiscal 2005, Canon estimated a discount rate of 2.7% and an expected long-term rate of return on plan assets of 4.6%. In estimating the discount rate, Canon uses available information about rates of return on high-quality fixed-income governmental and corporate bonds currently available and expected to be available during the period to the maturity of the pension benefits. Canon establishes the expected long-term rate of return on plan assets based on management's expectations of the long-term return of the various plan asset categories in which it invests. Management develops expectations with respect to each plan asset category based on actual historical returns and its current expectations for future returns.

Decreases in discount rates lead to increases in actuarial pension benefit obligations which, in turn, could lead to an increase in service cost and amortization cost through amortization of actuarial gain or loss, a decrease in interest cost and vice versa. A decrease of 50 basis points in the discount rate increases the projected benefit obligation by approximately 11%. The net effect of changes in the discount rate, as well as the net effect of other changes in actuarial assumptions and experience, are deferred until subsequent periods, as permitted by the Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions."

Decrease in expected return on plan assets may increase net periodic benefit cost by decreasing expected return amounts, while differences between expected value and actual fair value of those assets could affect pension expense in the following years, and vice versa. For fiscal 2006, 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 ¥2,730 million in net periodic benefit cost. Canon multiplies management's expected long-term rate of return on plan assets by the value of its plan assets, to arrive at the expected return on plan assets that is included in pension income (expense). Canon defers recognition of the difference between this expected return on plan assets and the actual return on plan assets. The net deferral of unrecognized actuarial gains (losses) affects the value of plan assets in future fiscal years and, ultimately, future pension income (expense).

CONSOLIDATED RESULTS OF OPERATIONS

SUMMARY OF OPERATIONS

	Millions of yen 2005	change	2004	change	2003	Thousands of U.S. dollars 2005
Net sales	**¥3,754,191**	**+8.3%**	3,467,853	+8.4%	3,198,072	**$31,815,178**
Operating profit	**583,043**	**+7.2**	543,793	+19.7	454,424	**4,941,042**
Income before income taxes and minority interests	**612,004**	**+10.8**	552,116	+23.2	448,170	**5,186,475**
Net income	**384,096**	**+11.9**	343,344	+24.5	275,730	**3,255,051**

Sales

Canon's consolidated net sales in fiscal 2005 totaled ¥3,754,191 million (U.S.$31,815 million). This represents an 8.3% increase from the previous fiscal year, reflecting significant growth in sales of digital cameras, color network digital MFDs and projection aligners.

Overseas operations are significant to Canon's operating results and generated approximately 74% of total net sales in fiscal 2005. Such sales are denominated in the applicable local currency and are subject to fluctuations in the value of the yen in relation to such other currencies. Despite efforts to reduce the impact of currency fluctuations on operating results, including localizing some manufacturing and procuring parts and materials from overseas suppliers, Canon believes such fluctuations have had and will continue to have a significant effect on results of operations.

The average value of the yen in fiscal 2005 was ¥110.58 to the U.S. dollar, and ¥137.04 to the euro, representing a depreciation of 2% against both currencies, compared with the previous year. These effects of foreign exchange rate fluctuations favorably impacted net sales by approximately ¥66,400 million. Net sales denominated in foreign currency increased by approximately ¥41,500 million in U.S. dollars, increased by ¥16,300 million in euro, and increased by ¥8,600 million in other foreign currencies.

Cost of Sales

Cost of sales principally reflects the cost of raw materials, parts and labor used by Canon in the manufacture of its products. A portion of the raw materials used by Canon is imported or includes imported materials. Such raw materials are subject to fluctuations in world market prices and exchange rates that may affect Canon's cost of sales. Other components of cost of sales include depreciation expenses from plants, maintenance expenses, light and fuel expenses and rent expenses. The ratio of cost of sales to net sales for fiscal 2005, 2004 and 2003 was 51.5%, 50.6% and 49.7%, respectively.

Gross Profit

Canon's gross profit in fiscal 2005 increased by 6.2% to ¥1,819,043 million (U.S.$15,416 million) from fiscal 2004. Despite such negative factors as escalating prices of raw materials and a severe price competition, gross profit ratio for the year remained at high, with a decrease of 0.9 points from the previous year, owing to cost reductions realized through ongoing production-reform and procurement-reform efforts.

Selling, General and Administrative Expenses and Research and Development Expenses

The major components of selling, general and administrative expenses are payroll, R&D, advertising expenses and other marketing expenses. Although R&D expenses grew 4.1% from the previous year to ¥286,476 million (U.S.$2,428 million), keeping spending growth below the growth rate for net sales, the selling, general and administrative expenses to net sales ratio improved 0.7 points. In general, Canon maintains a high level of R&D expenditure to strengthen its R&D capabilities. R&D expenditures grew in fiscal 2005 from the previous year, resulting from increased R&D activities.

Operating Profit

Operating profit in fiscal 2005 increased by 7.2% to ¥583,043 million (U.S.$4,941 million) from fiscal 2004. Operating profit in fiscal 2005 was 15.5% of net sales, compared with 15.7% in fiscal 2004.

Other Income (Deductions)

Other income (deductions) improved by ¥20,638 million (U.S.$175 million), attributable to an increase of interest revenue, resulting from such factors as an increase in surplus funds accompanying the improved balance sheet and a rise in interest rates in the United States, along with a decrease in currency exchange losses.

Income Before Income Taxes and Minority Interests

Income before income taxes and minority interests in fiscal 2005 was ¥612,004 million (U.S.$5,186 million), a 10.8% increase from fiscal 2004, and constituted 16.3% of net sales.

Income Taxes

Provision for income taxes increased by ¥18,771 million (U.S.$159 million) from fiscal 2004, primarily as a result of the increase in income before income taxes and minority interests. The effective tax rate during fiscal 2005 declined by 0.3% compared with fiscal 2004.

Net Income

Net income in fiscal 2005 increased by 11.9% to ¥384,096 million (U.S.$3,255 million), which exceeds the growth rate of income before income taxes and minority interests. This represents a 10.2% return on net sales.

Product Information

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

- **The business machines product group** includes office imaging products, computer peripherals and business information products.
  Office imaging products include 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 cameras product group** includes 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 2004, Canon has changed classification of product categories with regards to information system business, which had been classified in "Optical and other products," to "Business machines (Office imaging products)" in order to better reflect the current relation with those products. Accordingly, information for previous fiscal years has been reclassified to conform with the current classification.

Sales by Product

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

SALES BY PRODUCT

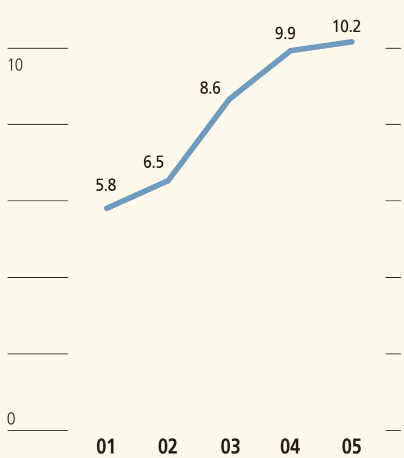
	Millions of yen 2005	change	2004	change	2003	Thousands of U.S. dollars 2005
Business machines:						
Office imaging products	**¥1,153,240**	**+2.9%**	1,120,972	+3.6%	1,081,995	**$ 9,773,220**
Computer peripherals	**1,244,906**	**+8.3**	1,149,914	+5.6	1,089,312	**10,550,051**
Business information products	**104,255**	**–10.9**	117,067	–5.2	123,493	**883,517**
	2,502,401	**+4.8**	2,387,953	+4.1	2,294,800	**21,206,788**
Cameras	**879,186**	**+15.2**	763,079	+16.8	653,540	**7,450,729**
Optical and other products	**372,604**	**+17.6**	316,821	+26.9	249,732	**3,157,661**
Total	**¥3,754,191**	**+8.3**	3,467,853	+8.4	3,198,072	**$31,815,178**

Sales of business machines, constituting 66.7% of consolidated net sales, increased 4.8%, to ¥2,502,401 million (U.S.$21,207 million) in fiscal 2005.

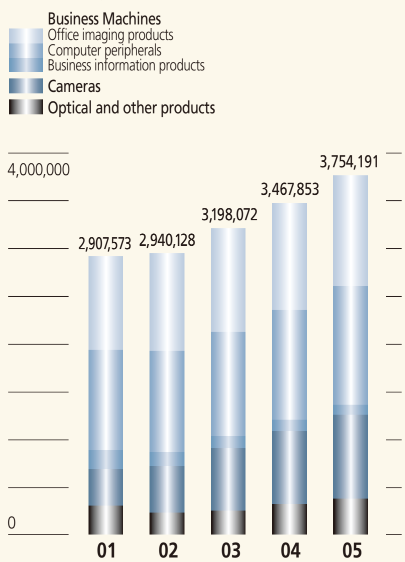
Sales of office imaging products increased 2.9%, to ¥1,153,240 million (U.S.$9,773 million). Demand for network digital MFDs continues to shift from monochrome machines to color models, as well as towards higher-end features. The Color imageRUNNER ("iR") C3170/2570 series, equipped with a new high-speed image-processing chip, and the iR C3220/2620 series continued to sell well in both Japan and European markets, as did the new high-speed iR C6870/5870 series models. Among monochrome network digital MFDs, mid-level models such as the iR4570/3570/2870/2270 series contributed to expanded sales, along with the iR6570/5570, featuring energy-saving performance and high productivity, and the iR2020/2016 series, with enhanced networking features. Color office imaging products accounted for 28% and 24% and monochrome office imaging products accounted for 56% and 62% of office imaging products sales in fiscal 2005 and 2004, respectively. Sales of facsimiles and information system business accounted for 16% and 14% of sales of office imaging products in both fiscal 2005 and 2004, respectively.

Sales of computer peripherals increased 8.3% to ¥1,244,906 million (U.S.$10,550 million). Laser beam printers enjoyed a year-on-year increase in unit sales, with color models growing more than 30% and monochrome machines, particularly low-end models, also recording healthy growth. Sales in value terms also rose despite the effect of the shift in market demand toward lower priced models. Inkjet printers recorded an increase in unit sales of more than 10%, with the PIXMA iP3000/4000 and, in markets outside of Japan, the PIXMA MP110/130 maintaining brisk sales. Additionally, newly

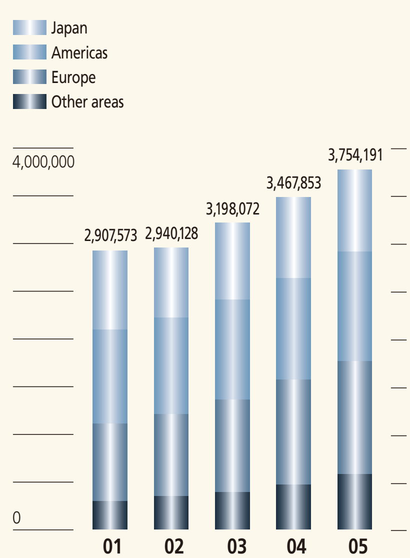
Return on Sales
(%)



Sales by Product
(Millions of yen)



Sales by Region
(Millions of yen)



introduced models, including the PIXMA iP4200, the PIXMA iP1600 in overseas markets, and high-speed all-in-one models such as the PIXMA MP500, contributed to a stronger product lineup, which also fueled sales growth in value terms.

Sales of business information products decreased 10.9%, to ¥104,255 million (U.S.$884 million) in fiscal 2005, mainly due to the intentional curtailing of personal computer sales in the domestic market.

Sales of cameras continued to achieve significant sales growth of 15.2%, totaling ¥879,186 million (U.S.$7,451 million). The continued strong demand for digital SLR cameras has fueled robust growth, with the EOS DIGITAL REBEL XT, launched in the first half of 2005, and the EOS 5D, launched in the second half, recording particularly strong sales along with continued healthy sales of the EOS 20D, launched in the previous period. This, in turn, has led to expanded sales of interchangeable lenses for SLR cameras. Sales of compact-model digital cameras also continued to expand steadily, with healthy demand for the PowerShot SD400 and PowerShot A520, launched in the first half of 2005, as well as the PowerShot SD550 and PowerShot SD450 models, introduced in the second half. As a result, unit sales of digital cameras grew by more than 20% compared with the previous year. Digital cameras accounted for 72% and 69% and conventional film cameras accounted for 17% and 16% of camera sales in fiscal 2005 and 2004, respectively. In the field of digital video camcorders, newly introduced Mini DV, DVD, and HDV models, including the Optura 600, the DC20/10, and the XL H1 registered strong performances. Video camcorders accounted for the remaining 11% and 15% of camera sales in fiscal 2005 and 2004, respectively. Sales of cameras constituted 23.4% of consolidated net sales in fiscal 2005.

Sales of optical and other products increased 17.6%, to ¥372,604 million (U.S.$3,158 million). In the optical and other products segment, demand for steppers, used in the production of semiconductors, has continued to lag since the summer of 2004, resulting in a drop in the number of units sold and, consequently, a decrease in sales value. Sales of aligners, however, which are used in the production of LCD panels realized notable growth in terms of both volume and value owing to increased investments by LCD manufacturers in response to the rapidly expanding LCD television market. Additionally, the vacuum thin-film deposition and processing equipment produced by the Company’s newly consolidated subsidiaries contributed to expanded sales. Sales of optical and other products constituted 9.9% of consolidated net sales in fiscal 2005.

Sales by Region

A geographical analysis indicates that net sales in fiscal 2005 increased in every region.

In Japan, net sales increased by 0.8% in fiscal 2005 from fiscal 2004. The results were mainly attributable to increased sales of office imaging products, computer peripherals, and digital cameras. Color network digital MFDs which include the Color imageRUNNER (“iR”) C3170/2570 series, equipped with a new high-speed image-processing chip, and the iR C3220/2620 series lineup, have contributed to increased sales of office imaging products.

In the Americas, net sales increased by 5.7% on a local currency basis, mainly due to increased sales of digital cameras, and laser beam printers. Sales of digital cameras experienced continued strong demand and benefited from the effect of newly-launched products such as PowerShot-series models and Canon’s digital SLR. On a yen basis, after accounting for the appreciation of the yen against the U.S. dollar, net sales in the Americas increased by 8.2%.

In Europe, net sales increased by 6.1% on a local currency basis mainly due to increased sales of digital cameras and laser beam printers. On a yen basis, after accounting for the depreciation of the yen against the euro, net sales in Europe grew 8.0% in fiscal 2005.

Sales in other areas increased by 22.6% on a yen basis in fiscal 2005, reflecting overall sales growth, particularly in digital cameras and semiconductor equipment.

A summary of net sales by region is provided below:

SALES BY REGION

	Millions of yen 2005	change	2004	change	2003	Thousands of U.S. dollars 2005
Japan	¥ 856,205	+0.8%	849,734	+6.0%	801,400	$ 7,255,975
Americas	1,145,950	+8.2	1,059,425	+1.4	1,045,166	9,711,441
Europe	1,181,258	+8.0	1,093,295	+12.8	969,042	10,010,661
Other areas	570,778	+22.6	465,399	+21.7	382,464	4,837,101
Total	¥3,754,191	+8.3	3,467,853	+8.4	3,198,072	$31,815,178

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

SEGMENT INFORMATION BY PRODUCT

Millions of yen		Business machines	Cameras	Optical and other products	Corporate and Eliminations	Consolidated
2005:	Net sales:					
	Unaffiliated customers	**¥2,502,401**	**879,186**	**372,604**	**—**	**3,754,191**
	Intersegment	**—**	**—**	**158,114**	**(158,114)**	**—**
	Total	**2,502,401**	**879,186**	**530,718**	**(158,114)**	**3,754,191**
	Operating cost and expenses	**1,960,373**	**705,480**	**491,898**	**13,397**	**3,171,148**
	Operating profit	**¥ 542,028**	**173,706**	**38,820**	**(171,511)**	**583,043**
	Assets	**¥1,427,277**	**480,957**	**517,527**	**1,617,792**	**4,043,553**
	Depreciation and amortization	**123,037**	**27,662**	**28,011**	**47,231**	**225,941**
	Capital expenditure	**201,887**	**57,678**	**15,955**	**108,264**	**383,784**
2004:	Net sales:					
	Unaffiliated customers	¥2,387,953	763,079	316,821	—	3,467,853
	Intersegment	—	—	138,419	(138,419)	—
	Total	2,387,953	763,079	455,240	(138,419)	3,467,853
	Operating cost and expenses	1,866,869	632,281	426,408	(1,498)	2,924,060
	Operating profit	¥ 521,084	130,798	28,832	(136,921)	543,793
	Assets	¥1,338,817	399,207	418,418	1,430,579	3,587,021
	Depreciation and amortization	115,830	21,880	24,895	30,087	192,692
	Capital expenditure	134,128	39,783	52,264	92,555	318,730
2003:	Net sales:					
	Unaffiliated customers	¥2,294,800	653,540	249,732	—	3,198,072
	Intersegment	—	—	132,389	(132,389)	—
	Total	2,294,800	653,540	382,121	(132,389)	3,198,072
	Operating cost and expenses	1,809,235	527,222	392,004	15,187	2,743,648
	Operating profit	¥ 485,565	126,318	(9,883)	(147,576)	454,424
	Assets	¥1,266,881	317,672	412,117	1,185,478	3,182,148
	Depreciation and amortization	118,806	17,712	20,276	26,810	183,604
	Capital expenditure	106,013	25,894	31,170	46,961	210,038

Thousands of U.S. dollars		Business machines	Cameras	Optical and other products	Corporate and Eliminations	Consolidated
2005:	Net sales:					
	Unaffiliated customers	**$21,206,788**	**7,450,729**	**3,157,661**	**—**	**31,815,178**
	Intersegment	**—**	**—**	**1,339,949**	**(1,339,949)**	**—**
	Total	**21,206,788**	**7,450,729**	**4,497,610**	**(1,339,949)**	**31,815,178**
	Operating cost and expenses	**16,613,330**	**5,978,644**	**4,168,627**	**113,535**	**26,874,136**
	Operating profit	**$ 4,593,458**	**1,472,085**	**328,983**	**(1,453,484)**	**4,941,042**
	Assets	**$12,095,568**	**4,075,907**	**4,385,822**	**13,710,101**	**34,267,398**
	Depreciation and amortization	**1,042,686**	**234,424**	**237,381**	**400,263**	**1,914,754**
	Capital expenditure	**1,710,907**	**488,797**	**135,212**	**917,491**	**3,252,407**

Notes:

1. General corporate expenses of ¥171,522 million (U.S.$1,454 million), ¥136,929 million and ¥147,616 million in the years ended December 31, 2005, 2004 and 2003, respectively, are included in "Corporate and Eliminations." For the fiscal year ended December 31, 2004, a gain of ¥17,141 million is also included, which relates to the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities.
2. Corporate assets of ¥1,239,255 million (U.S.$10,502 million), ¥1,430,599 million and ¥1,185,506 million as of December 31, 2005, 2004 and 2003, respectively, which mainly consist of cash and cash equivalents, marketable securities, investments and corporate properties, are included in "Corporate and Eliminations."
3. The segments are defined under Japanese GAAP. In grouping of segment information by product, Japanese GAAP requires that consideration be given to similarities of product types and characteristics, manufacturing methods, sales markets, and other factors that are similar.

SEGMENT INFORMATION BY GEOGRAPHIC AREA

Millions of yen	Japan	Americas	Europe	Others	Corporate and Eliminations	Consolidated
2005: Net sales:						
Unaffiliated customers	**¥ 979,748**	**1,139,784**	**1,178,672**	**455,987**	**—**	**3,754,191**
Intersegment	**2,046,173**	**7,424**	**2,206**	**646,530**	**(2,702,333)**	**—**
Total	**3,025,921**	**1,147,208**	**1,180,878**	**1,102,517**	**(2,702,333)**	**3,754,191**
Operating cost and expenses	**2,362,019**	**1,110,415**	**1,147,658**	**1,071,155**	**(2,520,099)**	**3,171,148**
Operating profit	**¥ 663,902**	**36,793**	**33,220**	**31,362**	**(182,234)**	**583,043**
Assets	**¥2,419,012**	**406,101**	**569,750**	**312,472**	**336,218**	**4,043,553**
2004: Net sales:						
Unaffiliated customers	¥ 919,153	1,057,066	1,090,712	400,922	—	3,467,853
Intersegment	1,882,973	8,863	4,161	591,677	(2,487,674)	—
Total	2,802,126	1,065,929	1,094,873	992,599	(2,487,674)	3,467,853
Operating cost and expenses	2,206,141	1,025,628	1,071,552	965,080	(2,344,341)	2,924,060
Operating profit	¥ 595,985	40,301	23,321	27,519	(143,333)	543,793
Assets	¥1,793,679	341,616	533,865	271,566	646,295	3,587,021
2003: Net sales:						
Unaffiliated customers	¥ 856,851	1,044,998	968,938	327,285	—	3,198,072
Intersegment	1,662,172	8,101	3,861	503,119	(2,177,253)	—
Total	2,519,023	1,053,099	972,799	830,404	(2,177,253)	3,198,072
Operating cost and expenses	2,025,442	998,492	946,282	806,281	(2,032,849)	2,743,648
Operating profit	¥ 493,581	54,607	26,517	24,123	(144,404)	454,424
Assets	¥1,600,726	306,140	546,625	249,755	478,902	3,182,148

Thousands of U.S. dollars	Japan	Americas	Europe	Others	Corporate and Eliminations	Consolidated
2005: Net sales:						
Unaffiliated customers	**$ 8,302,949**	**9,659,186**	**9,988,746**	**3,864,297**	**—**	**31,815,178**
Intersegment	**17,340,449**	**62,916**	**18,695**	**5,479,067**	**(22,901,127)**	**—**
Total	**25,643,398**	**9,722,102**	**10,007,441**	**9,343,364**	**(22,901,127)**	**31,815,178**
Operating cost and expenses	**20,017,110**	**9,410,297**	**9,725,916**	**9,077,584**	**(21,356,771)**	**26,874,136**
Operating profit	**$ 5,626,288**	**311,805**	**281,525**	**265,780**	**(1,544,356)**	**4,941,042**
Assets	**$20,500,102**	**3,441,534**	**4,828,390**	**2,648,068**	**2,849,304**	**34,267,398**

Notes:

1. General corporate expenses of ¥171,522 million (U.S.$1,454 million), ¥136,929 million and ¥147,616 million in the years ended December 31, 2005, 2004 and 2003, respectively, are included in "Corporate and Eliminations." For the fiscal year ended December 31, 2004, a gain of ¥17,141 million is also included, which relates to the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities.
2. Corporate assets of ¥1,239,255 million (U.S.$10,502 million), ¥1,430,599 million and ¥1,185,506 million as of December 31, 2005, 2004 and 2003, respectively, which mainly consist of cash and cash equivalents, marketable securities, investments and corporate properties, are included in "Corporate and Eliminations."
3. Segment information by geographic area is determined by the location of the Company or its relevant subsidiary making the sale. The segments are defined under Japanese GAAP. In grouping of segment information by geographic area, Japanese GAAP requires that consideration be given to geographic proximity, as well as similarities of economic activities, interrelationships of business activities and other similar factors.

Operating Profit by Product

Operating profit for business machines in fiscal 2005 increased ¥20,944 million (U.S.$177 million) to ¥542,028 million (U.S.$4,593 million). The gross profit ratio remained at a previous year level, due to cost reduction efforts, and the sales-to-expense ratio declined, contributing to an increase in operating profit.

Operating profit for cameras increased ¥42,908 million (U.S.$364 million) to ¥173,706 million (U.S.$1,472 million). The gross profit ratio improved, due to an increase in unit sales of digital cameras.

Optical and other products in fiscal 2005 increased ¥9,988 million (U.S.$85 million) to ¥38,820 million (U.S.$329 million). The gross profit ratio increased compared to the previous year, due to an increase in sales of aligners.

FOREIGN OPERATIONS AND FOREIGN CURRENCY TRANSACTIONS

Canon's marketing activities are performed by subsidiaries in various regions in local currencies, while the cost of sales 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 consolidation adjustments 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 2005, 2004 and 2003 were 3.0%, 2.8% and 3.2%, respectively. This compares with returns of 10.2%, 9.9% and 8.6% on total operations for the respective years.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents in fiscal 2005 increased ¥117,179 million (U.S.$993 million) to ¥1,004,953 million (U.S.$8,517 million), compared with ¥887,774 million in fiscal 2004 and ¥690,298 million in fiscal 2003. Canon's cash and cash equivalents are typically 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 2005 increased by ¥44,149 million (U.S.$374 million) from the previous year to ¥605,678 million (U.S.$5,133 million), reflecting the substantial growth in sales and increased cash proceeds from sales, combined with a substantial increase in net income and an improvement in working capital. Cash flow from operating activities consisted of the following components: the major component of Canon's cash inflow is cash received from customers, while the major components of Canon's cash outflow are payments for parts and materials, selling, general and administrative expenses, and income taxes.

For fiscal 2005, cash inflow from cash received from customers increased, due to the 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 the effects of cost reduction. Cost reduction reflects a decline in unit prices of parts and raw materials, as well as a streamlining of the process of using these parts and materials through promoting efficiency in operations. Cash outflow for payroll payments increased, due to the increase in the number of employees. The employees in the Asian region increased, due to the expansion of production in the regions. Cash outflow for payments for selling, general and administrative expenses increased, but the increase was within the range of the increase in net sales, due to cost-cutting efforts. Cash outflow for payments of income taxes increased, due to the increase in taxable income.

Net cash used in investing activities in fiscal 2005 was ¥401,141 million (U.S.$3,400 million), compared with ¥252,967 million in fiscal 2004 and ¥199,948 million in fiscal 2003, consisting primarily of capital expenditures. Capital expenditures in fiscal 2005 totaled ¥383,784 million (U.S.$3,252 million), which was used mainly to expand production capabilities in Japan and overseas regions and to strengthen the Company's R&D-related infrastructure. As a result, free cash flow, or cash flow from operating activities minus cash flow from investing activities, totaled ¥204,537 million (U.S.$1,733 million) for fiscal 2005 as compared to ¥308,562 million for fiscal 2004.

Net cash used in financing activities totaled ¥93,939 million (U.S.$796 million) in fiscal 2005, mainly resulting from a decrease in loan repayments accompanying the company's strengthened financial position despite a large increase in the dividend payout. The Company paid dividends in fiscal 2005 of ¥100 (U.S.$0.85) per share, which was an increase of ¥35 (U.S.$0.30) per share over the prior year.

Canon seeks to meet its liquidity and capital requirements principally with cash flow from operations. 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 current portion of long-term debt) amounted to ¥5,059 million (U.S.$43 million) at December 31, 2005 compared to ¥9,879 million at December 31, 2004. Long-term debt (excluding their current portions) amounted to ¥27,082 million (U.S.$230 million) at December 31, 2005 compared to ¥28,651 million at December 31, 2004.

Canon's long-term debt generally consists of secured or partially-secured term loans from banks, bearing interest at fixed rates, lease obligations, as well as fixed-rate notes and convertible debentures which Canon has issued in the domestic market with original maturities of ten to fifteen years.

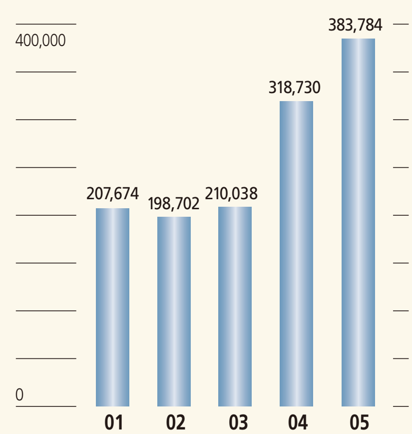
In order to facilitate access to global capital markets, Canon obtains credit ratings from two rating agencies, Moody's Investors Services, Inc. ("Moody's") and Standard and Poor's Rating Services ("S&P"). In addition, Canon maintains a rating from Rating and Investment Information, Inc. ("R&I"), a rating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

As of December 31, 2005, Canon's debt ratings are: Moody's: Aa2 (long-term); S&P: AA (long-term), 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 expenditure in fiscal 2005 amounted to ¥383,784 million (U.S.$3,252 million) compared with ¥318,730 million in fiscal 2004 and ¥210,038 million in fiscal 2003. In fiscal 2005, capital expenditures were mainly used to expand production capabilities in both domestic and overseas regions, and to bolster the Company's R&D-related infrastructure. In addition, Canon has been continually investing in tools and dies for business machines, in which the amount invested is generally the same each year. For fiscal 2006, Canon projects its capital expenditures will be approximately ¥465,000 million (U.S.$3,941 million). The capital expenditures include investments in new production plants and new facilities of Canon.

Employer contributions to Canon's worldwide defined benefit pension plans were ¥40,059 million (U.S.$339 million) in fiscal 2005, ¥31,018 million in fiscal 2004, ¥29,944 million in fiscal 2003. During fiscal 2006, Canon expects to make cash contributions of approximately ¥45,352 million (U.S.$384 million) to its defined benefit pension plans.

Capital Expenditure
(Millions of yen)



Working capital in fiscal 2005 increased ¥130,954 million (U.S.$1,110 million), to ¥1,379,941 million (U.S.$11,694 million), compared with ¥1,248,987 million in fiscal 2004 and ¥1,103,474 million in fiscal 2003. This increase was primarily a result of an increase in cash and cash equivalents. 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 2005 was 2.28 compared to 2.27 for fiscal 2004 and 2.33 for fiscal 2003.

Return on assets (Net income divided by the average of total assets as of December 31, 2005, 2004 and 2003) recorded 10.1% in fiscal 2005, compared to 10.1% in fiscal 2004 and 9.0% in fiscal 2003.
Return on stockholders' equity was 16.0% in fiscal 2005 compared with 16.8% in fiscal 2004 and 15.9% in fiscal 2003.

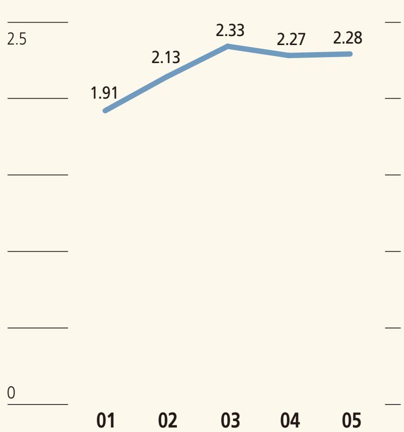
Debt to total assets ratio was 0.8%, 1.1% and 3.1% as of December 31, 2005, 2004 and 2003, respectively. Canon had short-term loans and long-term debt of ¥32,141 million as of December 31, 2005, ¥38,530 million as of December 31, 2004 and ¥98,396 million as of December 31, 2003.

OFF-BALANCE SHEET ARRANGEMENTS

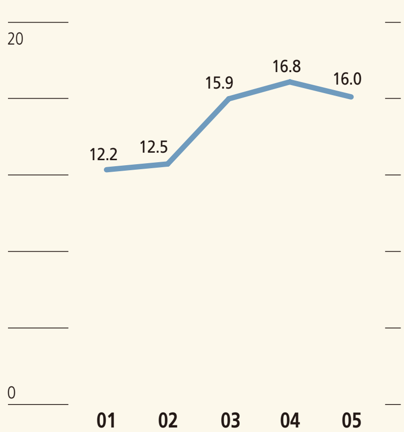
As part of its ongoing business, Canon does not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating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

Canon provides guarantees to third parties of bank loans of its employees, affiliates and other companies. Canon would have to perform under a guarantee, if the borrower defaults on a payment within the contract periods of 1 year to 30 years in the case of employees with housing loans, and of 1 year to 10 years in the case of affiliates and other companies. The maximum amount of undiscounted payments Canon would have had to make in the event of default by all borrowers was ¥38,550 million (U.S.$327 million) at December 31, 2005. The carrying amounts of the liabilities recognized for Canon's obligations as a guarantor under those guarantees are insignificant.

Working Capital Ratio



Return on Stockholders' Equity
(%)



CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following summarizes Canon's contractual obligations at December 31, 2005.

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	¥ 8,784	**4,159**	**4,064**	**538**	**23**
Other long-term debt	23,290	**833**	**21,605**	**774**	**78**
Operating lease obligations	52,589	**14,571**	**18,693**	**9,823**	**9,502**
Purchase commitments for					
Property plant and equipment	87,244	**87,244**	**—**	**—**	**—**
Parts and raw materials	67,831	**67,831**	**—**	**—**	**—**
Total	¥239,738	**174,638**	**44,362**	**11,135**	**9,603**

Thousands of U.S. dollars

		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	$ 74,440	**35,246**	**34,440**	**4,559**	**195**
Other long-term debt	197,373	**7,059**	**183,093**	**6,560**	**661**
Operating lease obligations	445,669	**123,483**	**158,415**	**83,245**	**80,526**
Purchase commitments for					
Property plant and equipment	739,356	**739,356**	**—**	**—**	**—**
Parts and raw materials	574,839	**574,839**	**—**	**—**	**—**
Total	$2,031,677	**1,479,983**	**375,948**	**94,364**	**81,382**

Canon provides warranties generally less than one year against defects in materials and workmanship on most of its consumer products. Estimated product warranty related costs are established at the time revenue is recognized and are included in selling, general and administrative expenses. Estimates for accrued product warranty costs 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, 2005, accrued product warranty costs amounted to ¥16,746 million (U.S.$142 million).

At December 31, 2005, commitments outstanding for the purchase of property, plant and equipment approximated ¥87,244 million ($739 million), and commitments outstanding for the purchase of parts and raw materials approximated ¥67,831 million ($575 million), both 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.

RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

Year 2005 marks the final year of Phase II of the Excellent Global Corporation Plan, which started in 2001. The plan aims to guide Canon to the No.1 position worldwide in all core business areas and to build on its R&D capabilities to continually create new businesses. While working to bring Phase II to a successful conclusion, Canon is also making thorough preparations to pursue sound growth, its new target for Phase III, which begins in 2006.

With respect to its R&D goals, Canon formulated a vision, which is to create a borderless environment between people and devices where images and information are exchanged in a way that lets us live and work the way we want, virtually anytime, anywhere. Toward the realization of its vision, Canon has accelerated the development and commercialization of display devices. In particular, Canon has developed SED devices with the aim of the mass production at SED Inc., established in 2004. In addition, Canon has strengthened its R&D of such items as projectors and organic light-emitting diodes ("OLEDs"). Furthermore, Canon continues to promote activities giving rise to its next-generation businesses pursuing its search for new business domains, as well as to reinforce its R&D infrastructure.

In regard to its R&D efficiencies, Canon has utilized of 3D-CAD systems, in order to accelerate product development and curtail costs. Moreover, Canon enhanced and evolved its simulation, measurement and analysis technologies, introducing a high-performance cluster computer and other leading-edge facilities in 2005. As such, Canon has succeeded in greatly reducing the need for prototypes, dramatically lowering costs and shortening development lead times.

Canon has R&D centers worldwide, including the USA, 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.

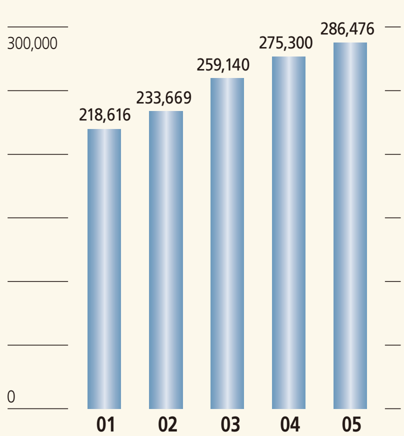
The Company's R&D activities are conducted in the following four organizations:

- Core Technology Development Headquarters (where component engineering and base technology R&D, such as optics technology, nanotechnology and production engineering, is conducted)
- Leading-Edge Technology Development Headquarters (where most advanced technology R&D, aiming to create new technological capabilities, is conducted)
- Platform Technology Development Headquarters (where platform technology R&D, such as system Large Scale Integration ("LSI") chips, network technology and visual information technology, is conducted)
- Device Technology Development Headquarters (where key device R&D, such as for semiconductor devices, is conducted)

Canon had R&D expenditures of ¥286,476 million (U.S.$2,428 million) in fiscal 2005, ¥275,300 million in fiscal 2004 and ¥259,140 million in fiscal 2003. The ratios of R&D expenditure to total net sales for fiscal 2005, 2004 and 2003 were 7.6%, 7.9% and 8.1%, respectively.

Canon believes that new products protected by seminal patents will not easily allow competitors to catch up with, and have advantages in establishing standards in the market and the industry. The United States Patent and Trademark Office announced that Canon obtained the second-greatest number of private sector patents in 2005. This achievement marks Canon's fourteenth consecutive year as one of the top three patent-receiving private-sector organizations.

R&D Expenditure
(Millions of yen)



RECENT DEVELOPMENTS

Canon acquired all of the issued and outstanding shares of ANELVA Corporation, which possesses advanced vacuum technology, and made it into a subsidiary as of September 30, 2005. ANELVA Corporation's corporate name was changed to Canon ANELVA Corporation as of October 1, 2005. By making Canon ANELVA Corporation a subsidiary of the Company, Canon aims to promote the in-house production of manufacturing equipment which Canon believes is indispensable to differentiate Canon products from products of its competitors in various fields, including Canon's new display business.

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

MARKET RISK EXPOSURE

Canon is exposed to market risks, including changes in foreign currency exchange rates, interest rates and prices of marketable securities and investments. In order to hedge the risks of changes in foreign currency exchange rates and interest rates, Canon uses derivative financial instruments.

Equity Price Risk

Canon holds marketable securities included in current assets as short-term investments, which consist generally of highly-liquid and low-risk instruments. Investments included in noncurrent assets are held as long-term investments. Canon does not hold marketable securities and investments for trading purposes.

Maturities and fair values of such marketable securities and investments were as follows at December 31, 2005.

Foreign Currency Exchange Rate and Interest Rate Risk

Canon operates internationally, exposing it to the risk of changes in foreign currency exchange rates and interest rates. Derivative financial instruments are comprised principally of foreign currency exchange contracts and interest rate swaps utilized by the Company and certain of its subsidiaries to reduce these risks. Canon assesses foreign currency exchange rate risk and interest rate risk by continually monitoring changes in these exposures and by evaluating hedging opportunities. Canon does not hold or issue derivative financial instruments for trading purposes. Canon is also exposed to credit-related losses in the event of non-performance by counterparties to derivative financial instruments, but it is not expected that any counterparties will fail to meet their obligations, because most of the counterparties are internationally recognized financial institutions and contracts are diversified across a number of major financial institutions.

Available-for-sale securities	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥ 71	71	$ 602	602
Due after one year through five years	1,811	3,243	15,347	27,483
Due after five years	3,352	3,376	28,407	28,610
Equity securities	11,474	26,550	97,237	225,000
	¥16,708	33,240	$141,593	281,695

Held-to-maturity securities	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due after one year through five years	¥20,961	20,961	$177,636	177,636

Canon's international operations expose Canon to the risk of changes in foreign currency exchange rates. Canon uses foreign exchange contracts to manage certain foreign currency exchange exposures principally from the exchange of U.S. dollar and euro into Japanese yen. These contracts are primarily used to hedge the foreign currency exposure of forecasted intercompany sales and intercompany trade receivables which are denominated in foreign currencies. In accordance with Canon's policy, a specific portion of foreign currency exposure resulting from forecasted intercompany sales are hedged using foreign exchange contracts which principally mature within three months.

The following table provides information about Canon's major derivative financial instruments related to foreign currency exchange transactions existing at December 31, 2005. All of the foreign exchange contracts described in the following table have a contractual maturity date in 2006.

				Millions of yen
Forwards to sell foreign currencies:	U.S.$	euro	Others	Total
Contract amounts	¥361,072	251,195	32,921	645,188
Estimated fair value	(4,829)	(1,459)	(352)	(6,640)
Forwards to buy foreign currencies:				
Contract amounts	¥ 30,033	5,974	10,417	46,424
Estimated fair value	17	(296)	(893)	(1,172)

				Thousands of U.S. dollars
Forwards to sell foreign currencies:	U.S.$	euro	Others	Total
Contract amounts	$3,059,932	2,128,771	278,992	5,467,695
Estimated fair value	(40,924)	(12,364)	(2,983)	(56,271)
Forwards to buy foreign currencies:				
Contract amounts	$ 254,517	50,627	88,280	393,424
Estimated fair value	144	(2,508)	(7,568)	(9,932)

Canon's exposure to the risk of changes in interest rates relates primarily to its debt obligations. The variable-rate debt obligations expose Canon to variability in their cash flows due to change in interest rates. To manage the variability in cash flows caused by interest rate changes, Canon enters into interest rate swaps when it is determined to be appropriate based on market conditions. The interest rate swaps change variable-rate debt obligations to fixed-rate debt obligations by primarily entering into pay-fixed, receive-variable interest rate swaps.

For debt obligations, the table below presents principal cash flows by expected maturity dates and related weighted average interest rates, as of December 31, 2005.

Derivative financial instruments designated as fair value hedges principally relate to interest rate swaps associated with fixed-rate debt obligations. Changes in fair values of the hedged debt obligations and derivative instruments designated as fair value hedges of these debt obligations are recognized in other income (deductions). There is no hedging ineffectiveness or net gains or losses excluded from the assessment of hedge effectiveness for fiscal 2004 and 2003 as the critical terms of the interest rate swaps match the terms of the hedged debt obligations. Canon had no fair value hedges in 2005.

Changes in the fair value of derivative financial instruments designated as cash flow hedges, including foreign exchange contracts associated with forecasted intercompany sales and interest rate swaps associated with variable rate debt obligations, are reported in accumulated other comprehensive income (loss). These amounts are subsequently reclassified into earnings through other income (deductions) in the same period as the hedged items affect earnings. Substantially all amounts recorded in accumulated other comprehensive income (loss) at year-end is expected to be recognized in earnings over the next twelve months. Canon excludes the time value component from the assessment of hedge effectiveness.

The amounts of the hedging ineffectiveness are not material for the years ended December 31, 2005, 2004 and 2003. The amounts of net gains or losses excluded from the assessment of hedge effectiveness which are recorded in other income (deductions) are net losses of ¥3,725 million (U.S.$32 million), ¥2,096 million and ¥490 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Canon has entered into certain foreign currency exchange contracts to manage its foreign currency exposures. These foreign currency exchange contracts have not been designated as hedges. Accordingly, the changes in fair values of the contracts are recorded in earnings immediately.

LOOKING FORWARD

Through Phase I (1996 to 2000) and Phase II (2001 to 2005) of its "Excellent Global Corporation Plan," the Canon Group pursued total optimization. Under the policy of putting profits ahead of sales, we pushed forward selection and concentration measures and, amid ongoing product digitalization, worked to enhance our product competitiveness and establish corporate structure for high profitability.

The business environment the Canon Group will face in the future will likely be characterized by ongoing economic globalization against the background of stable economic growth at the global level, as well as further adoption of broadband network and explosive growth of the digital imaging business sector.

Viewing these conditions as a business opportunity, the Canon Group will continuously try to boldly apply the operational, technological, personnel, financial and other business resources it has built up in ways that make further sound growth possible. Toward that end, we have formulated a new five-year plan—Phase III (2006 to 2010) of our "Excellent Global Corporation Plan."

LONG-TERM DEBT (including due within one year)

Millions of yen

	Weighted average interest rates	Total	Expected maturity date 2006	2007	2008	2009	2010	Thereafter	Estimated Fair Value
Japanese yen notes	2.61%	¥20,000	—	10,000	10,000	—	—	—	20,848
Japanese yen convertible debentures	1.30%	649	—	—	649	—	—	—	3,052
Other long-term debt	2.40%	11,425	4,992	3,318	1,702	895	417	101	11,294
Total		¥32,074	4,992	13,318	12,351	895	417	101	35,194

LONG-TERM DEBT (including due within one year)

Thousands of U.S. dollars

	Weighted average interest rates	Total	Expected maturity date 2006	2007	2008	2009	2010	Thereafter	Estimated Fair Value
Japanese yen notes	2.61%	$169,492	—	84,746	84,746	—	—	—	176,678
Japanese yen convertible debentures	1.30%	5,500	—	—	5,500	—	—	—	25,864
Other long-term debt	2.40%	96,821	42,305	28,118	14,423	7,585	3,534	856	95,712
Total		$271,813	42,305	112,864	104,669	7,585	3,534	856	298,254

Note: All long-term debt is fixed rate.

Chief among the priority strategies contained in this plan is making all of our current core businesses the overwhelming No.1 position and establishing our display technologies as businesses, a major new business for the Canon Group. And we aim to review our production systems in Japan through steps like the introduction and promotion of high-productivity automated systems, and we will establish new production systems to sustain international competitiveness. We will also expand our business operations through diversification and establish a Three Regional Headquarters System based in Japan, the U.S. and Europe, identify new business domains and accumulate the required technologies. Furthermore, we will also focus on nurturing strong individuals promoting these everlasting corporate reforms.

By forcefully advancing these priority strategies, the Canon Group aims to create business operations that can prosper in perpetuity and make us a truly excellent global corporation.

Business Machines Segment

Office imaging products

In the office imaging products segment, it has become more important to provide added value in the form of networking, integration, color printing, and multifunction models. Also, in addition to the mid segment products for office market which enjoys steady growth, Canon expects that the market of higher-end models and low-end multifunction models will expand as well. The market for color digital devices continued to grow rapidly, and sales of monochrome digital MFDs were stable, reflecting the market trend shifting from single-function to multifunction. Recently, there has been a new, printer-based MFP market created by other printer vendors as they seek to enter the copier and MFD market.

To maintain and enhance a competitive edge and to meet more sophisticated customer demands, Canon is strengthening its marketing capabilities by reinforcing its hardware and software product lineups and by improving functionality. In 2005, Canon strengthened the product lineups of its color digital devices in addition to its existing full line of monochrome machines and maintained its market share by executing business strategies in line with the current market trend.

While competitors seek to transfer manufacturing facilities to China, Canon regards its manufacturing bases in Japan important, in order to reduce total cost, through strengthening and reinforcing its technology, in particular through the collaboration of its R&D, manufacturing and quality management divisions. In fiscal 2005, Canon established a new global mother factory in Toride, to achieve the above-mentioned goal.

Computer peripheral products

The inkjet printer market continues to grow steadily. Canon expects a continuation of declines in market prices, a shift from single-function printers to MFPs, and an expansion of the digital photo market. To manage these trends, Canon has established a line of MFPs from flagship to entry models in order to expand its printer sales.

Canon's laser beam printer business holds a strong position in the market. In the monochrome laser beam printer market, Canon expects that the transition to a low price segment will expand sales in the micro-business/home office market and in the emerging markets. In the color laser beam printer market, Canon expects continued strong growth in demand. In general, competition will become more intense as competitors implement aggressive price strategies in order to establish themselves as market leaders. Canon seeks to remain competitive by developing technologies that can be deployed in a timely fashion to produce innovative products in all segments. Canon is also working to lower costs by automating production of consumables and to secure procurement of essential parts through internal sourcing.

Although Canon expects that the size of the scanner market will continue to contract, the stylish and compact CanoScan LiDE series and Hyper CCD models with ultrahigh-resolution were both introduced in fiscal 2005 in order to increase Canon's share of this market.

The size of the worldwide facsimile market has remained stable, as expansion in Asia, mainly China, has offset declines in other regions. Due to price declines for inkjet MFPs with facsimile function, prices are also declining for stand-alone machines.

Business information products

With regard to personal computers, demand from corporate clients in the Japanese market held steady in fiscal 2005, but a decline in sales was caused by Canon's change in marketing strategy from selling single products to a solutions business involving the proposal of unique combinations of various products. This trend is expected to continue in fiscal 2006.

Cameras Segment

The entire digital camera market continues to expand. While the growth rate has slowed in Japan and the United States, emerging markets, especially China and Eastern Europe, have experienced strong growth. In addition, the emergence of new photo imaging systems has contributed to this growth as well, such as PC-free direct printing systems, by expanding the digital imaging functionality through network connectivity, along with the improvement of the user-friendly image processing interfaces and software.

The digital camera industry is seeing growth on various fronts. As with most other digital consumer electronics, the digital camera market is now confronted with a fierce price war and intensified technological competition in terms of picture quality and functions. Profit margins have been shrinking for the overall industry, but Canon has been able to maintain higher margins through reforms of its production and procurement systems.

Canon expects the market for compact digital cameras to expand in the intermediate term. However, profit margins for the overall industry are moving lower as prices fall and competition increases. Therefore, Canon plans to continue cutting production costs while expanding our presence in terms of quantity.

There are signs of rapid growth in the market for compact photo printers, which present a new business opportunity. By creating a strong product line over the mid-term, Canon believes that it will be able to take a significant role in this market and turn the compact photo printer business into a new earnings source for Canon.

Canon played a major role in the continued expansion of the digital SLR market in fiscal 2005. This market is expected to continue growing for the time being. However, Canon expects the growth rate to fall once this new demand has peaked.

The market for film cameras is contracting as a result of the rapid shift to digital cameras. Canon anticipates this trend to continue, both for film SLR cameras and for film compact cameras.

Canon expects the interchangeable lens market to grow as a result of the rapid market penetration of digital SLR cameras. In response to the rapid growth of the SLR camera market, Canon has strengthened its line of interchangeable lenses exclusively for digital SLR cameras, and currently has five models in this market. Canon seeks to expand its sales and market share by introducing products especially made for popular class digital SLR cameras.

For video camcorders, analog camcorder sales have been further replaced by sales of digital camcorders in the United States in fiscal 2005, where the speed of transition used to be moderate. Against this background two new trends have emerged in the market. First, the introduction of video cameras using DVDs, HDDs, SD cards and other new forms of media has resulted in a trend in which convenience offered by the products is more emphasized. Second, the trend towards higher picture quality has evolved, provided by products using HDV and other high-resolution recording methods. Canon believes that these two trends are stimulating the market by responding to more diverse user needs and will likely contribute to further growth for the overall digital video market.

Canon will seek to continue sales growth with a stronger product line for the Mini DV market as well as for the DVD and HDV market, while continuing to invest in R&D to follow new trends in the market.

Canon expects that the market for liquid crystal projectors will continue to grow by about 20% per year on a unit basis, while market prices will continue to decline, resulting in moderate growth in monetary terms. Our independently developed SX50 high-resolution projector, which was introduced at the end of last year, has been winning praise on the market thanks to its picture quality and compact dimensions. This product is helping Canon capture a significant share of the market for high-resolution projectors. Canon will continue to make distinctive products that meet the demands of the projector market, such as greater brightness and resolution.

Optical and Other Products Segment

Canon expects new orders for semiconductor-production equipment to increase in fiscal 2006, as the market turns to the recovery phase following to the adjustment period in fiscal 2005. In general, the trend toward high resolution and higher speed equipment will likely to continue in the semiconductor industry. In order to manage these trends, Canon introduced the FPA-6000AS4 in fiscal 2004, and the FPA-6000ES6a in fiscal 2005. Canon will continue to focus on developing new products in order to satisfy the semiconductor manufacturers who have various device patterns.

For fiscal 2005, sales of aligners for the production of LCDs realized significant growth as the PC monitor industry continued to shift from CRT to LCD displays, and the LCD television market continued to expand. However, in the LCD production mask aligner market, demand is expected to decline gradually as the trend toward increased capital investment tapers off, and also due to the timing of the release of the brand-new models scheduled sometime next year, the order is expected to show a moderate decline.

The TV lens market is enjoying a gradual recovery thanks to the improving economy and new demand as more broadcasting equipment switches over to digital. In fact, in 2005 the market returned to roughly the same level seen four years ago just before the September 11. Growth in demand for HDTV lenses until now has come mainly from Japan and the U.S., but Canon is now starting to see greater demand in Europe as well. Canon also expects to see new demand in China and other Asian markets thanks to the shift to digitalization. Though Canon already has a major market share worldwide for this class of lens, it intends to continue to strengthen its position in this market.

Forward-Looking Statements

The foregoing discussion and other disclosure in this report 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: foreign currency exchange rate fluctuations; the uncertainty of Canon's ability to implement its plans to localize production and other measures to reduce the impact of foreign currency exchange rate fluctuations; uncertainty as to economic conditions, 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 currency exchange rates; and inventory risk due to shifts in market demand.

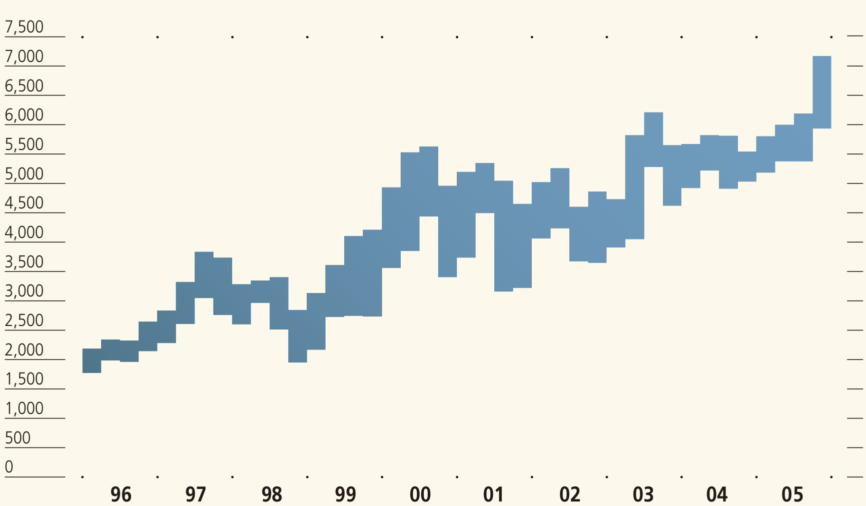
TEN-YEAR FINANCIAL SUMMARY

Millions of yen except per share amounts

	2005	2004	2003	2002
Net sales:				
Domestic	¥ 856,205	849,734	801,400	732,551
Overseas	2,897,986	2,618,119	2,396,672	2,207,577
Total	3,754,191	3,467,853	3,198,072	2,940,128
Percentage of previous year	108.3%	108.4	108.8	101.1
Net income	384,096	343,344	275,730	190,737
Percentage of sales	10.2%	9.9	8.6	6.5
Advertising	106,250	111,770	100,278	71,725
Research and development	286,476	275,300	259,140	233,669
Depreciation of property, plant and equipment	205,727	174,397	168,636	158,469
Capital expenditure	383,784	318,730	210,038	198,702
Long-term debt, excluding current installments	27,082	28,651	59,260	81,349
Stockholders' equity	2,604,682	2,209,896	1,865,545	1,591,950
Total assets	4,043,553	3,587,021	3,182,148	2,942,706
Per share data:				
Income before cumulative effect of change in accounting principle:				
Basic	432.94	387.80	313.81	217.56
Diluted	432.55	386.78	310.75	214.80
Net income:				
Basic	432.94	387.80	313.81	217.56
Diluted	432.55	386.78	310.75	214.80
Cash dividends declared	100.00	65.00	50.00	30.00
Stock price:				
High	7,170	5,820	6,210	5,250
Low	5,190	4,910	3,910	3,620
Average number of common shares in thousands	887,174	885,365	878,649	876,716
Number of employees	115,583	108,257	102,567	97,802

Common Stock Price Range (Tokyo Stock Exchange)

(Yen)



2001	2000	1999	1998	1997	1996	Thousands of U.S. dollars except per share amounts 2005
827,288	779,366	718,513	725,063	811,455	784,917	**$ 7,255,975**
2,080,285	1,917,054	1,812,383	2,011,021	1,858,079	1,687,920	**24,559,203**
2,907,573	2,696,420	2,530,896	2,736,084	2,669,534	2,472,837	**31,815,178**
107.8	106.5	92.5	102.5	108.0	118.6	**108.3%**
167,561	134,088	70,234	109,569	118,813	94,177	**3,255,051**
5.8	5.0	2.8	4.0	4.5	3.8	**10.2%**
66,837	67,840	67,544	76,911	75,800	68,354	**900,424**
218,616	194,552	177,922	176,967	170,793	150,085	**2,427,763**
147,286	144,043	155,682	159,888	137,777	117,263	**1,743,449**
207,674	170,986	200,386	221,401	219,779	176,357	**3,252,407**
95,526	142,925	165,277	180,320	226,889	192,254	**229,508**
1,458,476	1,298,914	1,202,003	1,155,520	1,109,511	1,007,434	**22,073,576**
2,844,756	2,832,125	2,587,532	2,728,329	2,872,779	2,644,452	**34,267,398**
187.07	153.66	80.66	126.10	137.73	111.29	**3.67**
184.55	151.51	79.50	123.93	134.60	106.96	**3.67**
191.29	153.66	80.66	126.10	137.73	111.29	**3.67**
188.70	151.51	79.50	123.93	134.60	106.96	**3.67**
25.00	21.00	17.00	17.00	17.00	15.00	**0.85**
5,330	5,620	4,200	3,400	3,820	2,630	**60.76**
3,150	3,400	2,170	1,930	2,280	1,780	**43.98**
875,960	872,606	870,699	868,916	862,664	846,224	
93,620	86,673	81,009	79,799	78,767	75,628	

Note: U.S. dollar amounts are translated from yen at the rate of U.S.$1 = ¥118, the approximate exchange rate on the Tokyo Foreign Exchange Market as of December 30, 2005.

CONSOLIDATED BALANCE SHEETS

CANON INC. AND SUBSIDIARIES

December 31, 2005 and 2004

	Millions of yen		Thousands of U.S. dollars (note 2)
ASSETS	2005	2004	2005
Current assets:			
Cash and cash equivalents	¥1,004,953	887,774	$ 8,516,551
Marketable securities (note 4)	172	1,554	1,458
Trade receivables, net (note 5)	689,427	602,790	5,842,602
Inventories (note 6)	510,195	489,128	4,323,686
Prepaid expenses and other current assets (notes 8 and 14)	253,822	250,906	2,151,034
Total current assets	2,458,569	2,232,152	20,835,331
Noncurrent receivables (note 20)	14,122	14,567	119,678
Investments (notes 4 and 11)	104,486	97,461	885,475
Property, plant and equipment, net (notes 7, 8 and 11)	1,148,821	961,714	9,735,771
Other assets (notes 8, 9, 10, 13 and 14)	317,555	281,127	2,691,143
Total assets	¥4,043,553	3,587,021	$34,267,398
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Short-term loans and current portion of long-term debt (note 11)	¥ 5,059	9,879	$ 42,873
Trade payables (note 12)	505,126	465,396	4,280,729
Income taxes (note 14)	110,844	105,565	939,356
Accrued expenses (note 20)	248,205	205,296	2,103,432
Other current liabilities (note 14)	209,394	197,029	1,774,525
Total current liabilities	1,078,628	983,165	9,140,915
Long-term debt, excluding current installments (note 11)	27,082	28,651	229,508
Accrued pension and severance cost (note 13)	80,430	132,522	681,610
Other noncurrent liabilities (note 14)	52,395	45,993	444,026
Total liabilities	1,238,535	1,190,331	10,496,059
Minority interests	200,336	186,794	1,697,763
Commitments and contingent liabilities (note 20)			
Stockholders' equity:			
Common stock Authorized 2,000,000,000 shares; issued 888,742,779 shares in 2005 and 887,977,251 shares in 2004 (note 15)	174,438	173,864	1,478,288
Additional paid-in capital (note 15)	403,246	401,773	3,417,339
Legal reserve (note 16)	42,331	41,200	358,737
Retained earnings (note 16)	2,018,289	1,699,634	17,104,144
Accumulated other comprehensive income (loss) (note 17)	(28,212)	(101,312)	(239,085)
Treasury stock, at cost 1,145,682 shares in 2005 and 1,120,867 shares in 2004	(5,410)	(5,263)	(45,847)
Total stockholders' equity	2,604,682	2,209,896	22,073,576
Total liabilities and stockholders' equity	¥4,043,553	3,587,021	$34,267,398

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

CANON INC. AND SUBSIDIARIES

Year ended December 31, 2005, 2004 and 2003

	Millions of yen			Thousands of U.S. dollars (note 2)
	2005	2004	2003	2005
Net sales	¥3,754,191	3,467,853	3,198,072	$31,815,178
Cost of sales (notes 10, 13 and 20)	1,935,148	1,754,510	1,589,172	16,399,559
Gross profit	1,819,043	1,713,343	1,608,900	15,415,619
Selling, general and administrative expenses (notes 1, 10, 13 and 20)	949,524	894,250	895,336	8,046,814
Research and development expenses	286,476	275,300	259,140	2,427,763
Operating profit	583,043	543,793	454,424	4,941,042
Other income (deductions):				
Interest and dividend income	14,252	7,118	9,284	120,780
Interest expense	(1,741)	(2,756)	(4,627)	(14,754)
Other, net (notes 1, 4 and 19)	16,450	3,961	(10,911)	139,407
	28,961	8,323	(6,254)	245,433
Income before income taxes and minority interests	612,004	552,116	448,170	5,186,475
Income taxes (note 14)	212,785	194,014	162,653	1,803,263
Income before minority interests	399,219	358,102	285,517	3,383,212
Minority interests	15,123	14,758	9,787	128,161
Net income	¥ 384,096	343,344	275,730	$ 3,255,051
	Yen			U.S. dollars (note 2)
Net income per share (note 18)				
Basic	¥ 432.94	387.80	313.81	$ 3.67
Diluted	432.55	386.78	310.75	3.67
Cash dividends per share	100.00	65.00	50.00	0.85

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

CANON INC. AND SUBSIDIARIES

Year ended December 31, 2005, 2004 and 2003

	Millions of yen			Thousands of U.S. dollars (note 2)
	2005	2004	2003	**2005**
Common stock:				
Balance at beginning of year	**¥ 173,864**	168,892	167,242	**$ 1,473,424**
Conversion of convertible debt	**574**	4,972	1,650	**4,864**
Balance at end of year	**174,438**	173,864	168,892	**1,478,288**
Additional paid-in capital:				
Balance at beginning of year	**401,773**	396,939	394,088	**3,404,856**
Conversion of convertible debt and other	**574**	4,966	1,649	**4,864**
Stock exchanged under exchange offering	**—**	114	—	**—**
Capital transactions by consolidated subsidiaries and affiliated companies	**899**	(246)	1,202	**7,619**
Balance at end of year	**403,246**	401,773	396,939	**3,417,339**
Legal reserve:				
Balance at beginning of year	**41,200**	39,998	38,803	**349,152**
Transfers from retained earnings	**1,131**	1,202	1,195	**9,585**
Balance at end of year	**42,331**	41,200	39,998	**358,737**
Retained earnings:				
Balance at beginning of year	**1,699,634**	1,410,442	1,164,445	**14,403,678**
Net income for the year	**384,096**	343,344	275,730	**3,255,051**
Cash dividends	**(64,310)**	(52,950)	(28,538)	**(545,000)**
Transfers to legal reserve	**(1,131)**	(1,202)	(1,195)	**(9,585)**
Balance at end of year	**2,018,289**	1,699,634	1,410,442	**17,104,144**
Accumulated other comprehensive income (loss):				
Balance at beginning of year	**(101,312)**	(143,275)	(166,467)	**(858,576)**
Other comprehensive income (loss) for the year, net of tax	**73,100**	41,963	23,192	**619,491**
Balance at end of year	**(28,212)**	(101,312)	(143,275)	**(239,085)**
Treasury stock:				
Balance at beginning of year	**(5,263)**	(7,451)	(6,161)	**(44,601)**
Repurchase, net	**(147)**	(503)	(1,290)	**(1,246)**
Stock exchanged under exchange offering	**—**	2,691	—	**—**
Balance at end of year	**(5,410)**	(5,263)	(7,451)	**(45,847)**
Total stockholders' equity	**¥2,604,682**	2,209,896	1,865,545	**$22,073,576**
Disclosure of comprehensive income:				
Net income for the year	**¥ 384,096**	343,344	275,730	**$ 3,255,051**
Other comprehensive income (loss) for the year, net of tax (note 17)				
Foreign currency translation adjustments	**53,979**	4,050	(15,277)	**457,449**
Net unrealized gains and losses on securities	**(1,397)**	686	7,952	**(11,839)**
Net gains and losses on derivative instruments	**(481)**	(396)	37	**(4,076)**
Minimum pension liability adjustments	**20,999**	37,623	30,480	**177,957**
Other comprehensive income (loss)	**73,100**	41,963	23,192	**619,491**
Total comprehensive income for the year	**¥ 457,196**	385,307	298,922	**$ 3,874,542**

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

CANON INC. AND SUBSIDIARIES

Year ended December 31, 2005, 2004 and 2003

	Millions of yen			Thousands of U.S. dollars (note 2)
	2005	2004	2003	2005
Cash flows from operating activities:				
Net income	¥ 384,096	343,344	275,730	$ 3,255,051
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	225,941	192,692	183,604	1,914,754
Loss on disposal of property, plant and equipment	13,784	24,597	12,639	116,814
Deferred income taxes	(766)	9,060	(3,035)	(6,492)
Increase in trade receivables	(48,391)	(53,595)	(36,638)	(410,093)
(Increase) decrease in inventories	27,558	(40,050)	(15,823)	233,542
Increase in trade payables	16,018	65,873	1,129	135,746
Increase in income taxes	1,998	21,689	3,441	16,932
Increase in accrued expenses	31,241	8,196	37,131	264,754
Increase (decrease) in accrued pension and severance cost	(16,221)	(16,924)	29,445	(137,466)
Other, net	(29,580)	6,647	(21,974)	(250,678)
Net cash provided by operating activities	605,678	561,529	465,649	5,132,864
Cash flows from investing activities:				
Purchases of fixed assets	(395,055)	(256,714)	(199,720)	(3,347,924)
Proceeds from sale of fixed assets	14,827	7,431	9,354	125,653
Purchases of available-for-sale securities	(5,680)	(388)	(249)	(48,136)
Purchases of held-to-maturity securities	—	(21,544)	—	—
Proceeds from sale of available-for-sale securities	12,337	9,735	6,544	104,551
Acquisitions of subsidiaries, net of cash acquired	(17,657)	—	—	(149,636)
Proceeds from sale of subsidiary common stock	—	9,731	—	—
Purchases of other investments	(19,531)	(8,628)	(24,341)	(165,517)
Other, net	9,618	7,410	8,464	81,509
Net cash used in investing activities	(401,141)	(252,967)	(199,948)	(3,399,500)
Cash flows from financing activities:				
Proceeds from issuance of long-term debt	1,716	2,115	4,132	14,542
Repayments of long-term debt	(15,187)	(43,175)	(25,301)	(128,703)
Decrease in short-term loans	(12,011)	(3,046)	(49,224)	(101,788)
Dividends paid	(64,310)	(52,950)	(28,538)	(545,000)
Purchases of treasury stock, net	(147)	(494)	(1,071)	(1,246)
Other, net	(4,000)	(4,718)	(2,037)	(33,898)
Net cash used in financing activities	(93,939)	(102,268)	(102,039)	(796,093)
Effect of exchange rate changes on cash and cash equivalents	6,581	(8,818)	5,365	55,771
Net increase in cash and cash equivalents	117,179	197,476	169,027	993,042
Cash and cash equivalents at beginning of year	887,774	690,298	521,271	7,523,509
Cash and cash equivalents at end of year	¥ 1,004,953	887,774	690,298	$ 8,516,551
Supplemental disclosure for cash flow information (note 22):				
Cash paid during the year for:				
Interest	¥ 1,919	2,981	4,570	$ 16,263
Income taxes	211,540	164,450	162,247	1,792,712

See accompanying notes to consolidated financial statements.

(1) Basis of Presentation and Significant Accounting Policies

(a) Description of Business

Canon Inc. (the "Company") and subsidiaries (collectively "Canon") is one of the world's leading manufacturers in such fields as office imaging products, computer peripherals, business information products, cameras, and optical related products. Office imaging products consist mainly of copying machines and digital multifunction devices. Computer peripherals consist mainly of laser beam and inkjet printers. Business information products consist mainly of computer information systems, micrographics and calculators. Cameras consist mainly of single lens reflex ("SLR") cameras, compact cameras, digital cameras and video camcorders. Optical related products include steppers and aligners used in semiconductor chip production, projection aligners used in the production of liquid crystal displays ("LCDs"), broadcasting lenses and medical equipment. Canon's consolidated net sales for the years ended December 31, 2005, 2004 and 2003 were distributed as follows: office imaging products 31%, 33% and 34%, computer peripherals 33%, 33% and 34%, business information products 3%, 3% and 4%, cameras 23%, 22% and 20%, and optical and other products 10%, 9% and 8%, respectively.

Sales are made principally under the Canon brand name, almost entirely through sales subsidiaries. These subsidiaries are responsible for marketing and distribution, and primarily sell to retail dealers in their geographical area. Approximately 74%, 73% and 73% of consolidated net sales for the years ended December 31, 2005, 2004 and 2003 were generated outside Japan, with 30%, 30% and 33% in the Americas, 32%, 31% and 30% in Europe, and 12%, 12% and 10% in other areas, respectively.

Canon sells laser beam printers on an OEM basis to Hewlett-Packard Company; such sales constituted approximately 21%, 21% and 20% of consolidated net sales for the years ended December 31, 2005, 2004 and 2003, respectively.

Canon's manufacturing operations are conducted primarily at 23 plants in Japan and 17 overseas plants which are located in countries or regions such as the United States, Germany, France, Taiwan, China, Malaysia, Thailand and Vietnam.

(b) Basis of Presentation

The Company and its domestic subsidiaries maintain their books of account in conformity with financial accounting standards of Japan. Foreign subsidiaries maintain their books of account in conformity with financial accounting standards of the countries of their domicile.

Certain adjustments and reclassifications have been incorporated in the accompanying consolidated financial statements to conform with U.S. generally accepted accounting principles. These adjustments were not recorded in the statutory books of account.

(c) Principles of Consolidation

The consolidated financial statements include the accounts of the Company, its majority owned subsidiaries and those variable interest entities where the Company is the primary beneficiary under FASB Interpretation No. 46 (revised December 2003) ("FIN 46R"), "Consolidation of Variable Interest Entities." All significant intercompany balances and transactions have been eliminated.

(d) Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant estimates and assumptions are reflected in valuation and disclosure of revenue recognition, allowance for doubtful receivables, valuation of inventories, environmental liabilities, valuation of deferred tax assets and employee retirement and severance benefit plans. Actual results could differ materially from those estimates.

(e) Cash Equivalents

All highly liquid investments acquired with an original maturity of three months or less are considered to be cash equivalents.

(f) Translation of Foreign Currencies

Assets and liabilities of the Company's subsidiaries located outside Japan with functional currencies other than Japanese yen are translated into Japanese yen at the rates of exchange in effect at the balance sheet date. Income and expense items are translated at the average exchange rates prevailing during the year. Gains and losses resulting from translation of financial statements are excluded from earnings and are reported in other comprehensive income (loss).

Gains and losses resulting from foreign currency transactions, including foreign exchange contracts, and translation of assets and liabilities denominated in foreign currencies are included in other income (deductions). Foreign currency exchange losses, net were ¥3,710 million ($31,441 thousand), ¥17,800 million and ¥20,311 million for the years ended December 31, 2005, 2004 and 2003, respectively.

(g) Marketable Securities and Investments

Canon classifies investments in debt and marketable equity securities as available-for-sale, or held-to-maturity securities. Canon does not hold any trading securities which are bought and held primarily for the purpose of sale in the near term. Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, are reported as a separate component of other comprehensive income (loss) until realized. Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts.

Available-for-sale and held-to-maturity securities are regularly reviewed for other-than-temporary declines in carrying value based on criteria that include the length of time and the extent to which the market value has been less than cost, the financial condition and near-term prospects of the issuer and Canon's intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in market value. When such a decline exists, Canon recognizes an impairment loss to the extent by which the cost basis of the investment exceeds the fair value of the investment. Fair value is determined based on quoted market prices, projected discounted cash flows or other valuation techniques as appropriate.

Realized gains and losses are determined on the average cost method and reflected in earnings.

Other securities are stated at cost and reviewed periodically for impairment.

(h) Allowance for Doubtful Receivables

Allowance for doubtful trade and finance receivables is maintained for all customers based on a combination of factors, including aging analysis, macroeconomic conditions, significant one-time events, and historical experience. An additional reserve for individual accounts is recorded when Canon becomes aware of a customer's inability to meet its financial obligations, such as in the case of bankruptcy filings. If circumstances related to customers change, estimates of the recoverability of receivables would be further adjusted. When all collection options are exhausted including legal recourse, the accounts or portions thereof are deemed to be uncollectible and charged against the allowance.

(i) 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.

(j) Investments in Affiliated Companies

Investments in affiliated companies over which Canon has the ability to exercise significant influence, but does not hold a controlling financial interest, are accounted for by the equity method.

(k) Impairment of Long-Lived Assets

Long-lived assets, such as property, plant and equipment, and acquired intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of by sale are reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

(l) Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is calculated principally by the declining-balance method, except for certain assets which are depreciated by the straight-line method over the estimated useful lives of the assets. The depreciation period ranges from 3 years to 60 years for buildings and 2 years to 20 years for machinery and equipment.

Assets leased to others under operating leases are stated at cost and depreciated to the estimated residual value of the assets by the straight-line method over the period ranging from 2 years to 5 years.

(m) Goodwill and Other Intangible Assets

Goodwill and intangible assets with indefinite useful lives are not amortized, but are instead tested for impairment annually in the fourth quarter of each year, or more frequently if indicators of potential impairment exist. Intangible assets with finite useful lives, consisting primarily of software and license fees, are amortized using the straight-line method over the estimated useful lives, which range from 3 years to 5 years for software and 5 years to 10 years for license fees. Certain costs incurred in connection with developing or obtaining internal use software are capitalized. These costs consist of payments made to third parties and the salaries of employees working on such software development. Costs incurred in connection with developing internal use software are capitalized at the application development stage. In addition, Canon develops or obtains certain software to be sold where related costs are capitalized after establishment of technological feasibility.

(n) Environmental Liabilities

Liabilities for environmental remediation and other environmental costs are accrued when environmental assessments or remedial efforts are probable and the costs can be reasonably estimated. Such liabilities are adjusted as further information develops or circumstances change. Costs of future obligations are not discounted to their present values.

(o) Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Canon records a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not realizable.

(p) Issuance of Stock by Subsidiaries and Equity Investees

The change in the Company's proportionate share of a subsidiary's or equity investee's equity resulting from the issuance of stock by the subsidiary or equity investee is accounted for as an equity transaction.

(q) Net Income per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during each year. Diluted net income per share includes the effect from potential issuance of common stock based on the assumption that all convertible debentures were converted into common stock.

(r) Revenue Recognition

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

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

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

Revenue from sales of optical equipment such as steppers and aligners sold with customer acceptance provisions related to their functionality is recognized when the equipment is installed at the customer site and the specific criteria of the equipment functionality are successfully tested and demonstrated by Canon. Service revenue is derived primarily from maintenance contracts on equipment sold to customers and is recognized over the term of the contract.

Most office imaging products are sold with service maintenance contracts for which the customer typically pays a base service fee plus a variable amount based on usage. Revenue from these service maintenance contracts is recognized as services are provided.

Revenue from the sale of equipment under sales-type leases is recognized at the inception of the lease. Income on sales-type leases and direct-financing leases is recognized over the life of each respective lease using the interest method. Leases not qualifying as sales-type leases or direct-financing leases are accounted for as operating leases and related revenue is recognized over the lease term.

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

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

(s) Research and Development Costs

Research and development costs are expensed as incurred.

(t) Advertising Costs

Advertising costs are expensed as incurred. Advertising expenses were ¥106,250 million ($900,424 thousand), ¥111,770 million and ¥100,278 million for the years ended December 31, 2005, 2004 and 2003, respectively.

(u) Shipping and Handling Costs

Shipping and handling costs totaled ¥50,052 million ($424,169 thousand), ¥46,953 million and ¥40,660 million for the years ended December 31, 2005, 2004 and 2003, respectively, and are included in selling, general and administrative expenses in the consolidated statements of income.

(v) Derivative Financial Instruments

All derivatives are recognized at fair value and are included in prepaid expenses and other current assets, or other current liabilities on the consolidated balance sheets. On the date the derivative contract is entered into, Canon designates the derivative as either a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment ("fair value" hedge), or a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow" hedge). Canon formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking various hedge transactions. Canon also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, Canon discontinues hedge accounting prospectively.

Changes in the fair value of a derivative that is designated and qualifies as a fair-value hedge, along with the loss or gain on the hedged asset or liability or unrecognized firm commitment of the hedged item that is attributable to the hedged risk, are recorded in earnings. Changes in the fair value of a derivative that is designated and qualifies as a cash-flow hedge are recorded in other comprehensive income (loss), until earnings are affected by the variability in cash flows of the hedged item. Gains and losses from hedging ineffectiveness are included in other income (deductions). Gains and losses excluded from the assessment of hedge effectiveness (time value component) are included in other income (deductions).

Canon also uses certain derivative financial instruments which are not designated as hedges. Canon records these derivative financial instruments on the consolidated balance sheets at fair value. The changes in fair values are immediately recorded in earnings.

(w) Guarantees

Canon recognizes, at the inception of a guarantee, a liability for the fair value of the obligation it has undertaken in issuing guarantees.

(x) New Accounting Standards

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs-an amendment of ARB No. 43, Chapter 4" ("SFAS 151"). SFAS 151 amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as stated in ARB No. 43. Additionally, SFAS 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for fiscal years beginning after June 15, 2005 and is required to be adopted by Canon in the first quarter beginning January 1, 2006. Canon is currently evaluating the effect that the adoption of SFAS 151 will have on its consolidated results of operations and financial condition but does not expect SFAS 151 to have a material impact.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets-an amendment of APB Opinion No. 29" ("SFAS 153"). SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, "Accounting for Nonmonetary Transactions," and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for the fiscal periods beginning after June 15, 2005 and was adopted by Canon in the third quarter ended September 30, 2005. The adoption of SFAS 153 did not have a material impact on the consolidated results of operations and financial condition of Canon.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes" and SFAS No. 3 "Reporting Accounting Changes in Interim Financial Statements," and provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS 154 establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by Canon in the first quarter beginning January 1, 2006. Canon is currently evaluating the effect that the adoption of SFAS 154 will have on its consolidated results of operations and financial condition but does not expect SFAS 154 to have a material impact.

In June 2005, the FASB issued FSP FAS 143-1, "Accounting for Electronic Equipment Waste Obligations" ("FSP 143-1"). FSP 143-1 provides guidance on the accounting for certain obligations associated with the Waste Electrical and Electronic Equipment Directive (the "Directive"), adopted by the European Union ("EU"). Under the Directive, the waste management obligation for historical equipment (products put on the market on or prior to August 13, 2005) remains with the commercial user until the customer replaces the equipment. FSP 143-1 is required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the Directive's adoption into law by the applicable EU member countries. Canon adopted FSP 143-1 in the third quarter ended September 30, 2005 and has determined that its effect did not have a material impact on its consolidated results of operations and financial condition in 2005.

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("FSP 115-1"). FSP 115-1 provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 is required to be applied to reporting periods beginning after December 15, 2005 and is required to be adopted by Canon in the first quarter beginning January 1, 2006. Canon is currently evaluating the effect that the adoption of FSP 115-1 will have on its consolidated results of operations and financial condition but does not expect FSP 115-1 to have a material impact.

(2) Basis of Financial Statement Translation

The consolidated financial statements presented herein are expressed in Japanese yen and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ¥118 = U.S.$1, the approximate exchange rate prevailing on the Tokyo Foreign Exchange Market on December 30, 2005. This translation should not be construed as a representation that the amounts shown could be converted into United States dollars at such rate.

(3) Foreign Operations

Amounts included in the consolidated financial statements relating to subsidiaries operating in foreign countries are summarized as follows:

	Millions of yen			Thousands of U.S. dollars
	2005	2004	2003	2005
Total assets	¥1,751,011	1,500,197	1,339,854	$14,839,076
Net assets	767,711	632,657	564,041	6,506,025
Net sales	2,774,443	2,548,700	2,341,221	23,512,229
Net income	81,916	70,227	74,274	694,203

(4) Marketable Securities and Investments

The cost, gross unrealized holding gains, gross unrealized holding losses and fair value for available-for-sale securities and held-to-maturity securities by major security type at December 31, 2005 and 2004 were as follows:

December 31 Millions of yen	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2005: Current:				
Available-for-sale:				
Bank debt securities	¥ 71	—	—	71
Equity securities	101	—	—	101
	¥ 172	—	—	172
Noncurrent:				
Available-for-sale:				
Government bonds	¥ 525	7	—	532
Corporate debt securities	85	3	—	88
Fund trusts	4,553	1,446	—	5,999
Equity securities	11,373	15,086	10	26,449
	16,536	16,542	10	33,068
Held-to-maturity:				
Corporate debt securities	20,961	—	—	20,961
	¥37,497	16,542	10	54,029

Millions of yen		Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2004:	Current:				
	Available-for-sale:				
	Corporate debt securities	¥ 138	—	—	138
	Bank debt securities	71	—	—	71
	Fund trusts	92	40	—	132
	Equity securities	1,117	100	4	1,213
		¥ 1,418	140	4	1,554
	Noncurrent:				
	Available-for-sale:				
	Government bonds	¥ 536	26	25	537
	Corporate debt securities	56	19	—	75
	Fund trusts	2,064	574	12	2,626
	Equity securities	9,185	16,628	76	25,737
		11,841	17,247	113	28,975
	Held-to-maturity:				
	Corporate debt securities	21,460	—	—	21,460
		¥33,301	17,247	113	50,435

Thousands of U.S. dollars		Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2005:	Current:				
	Available-for-sale:				
	Bank debt securities	**$ 602**	**—**	**—**	**602**
	Equity securities	**856**	**—**	**—**	**856**
		$ 1,458	**—**	**—**	**1,458**
	Noncurrent:				
	Available-for-sale:				
	Government bonds	**$ 4,449**	**59**	**—**	**4,508**
	Corporate debt securities	**720**	**26**	**—**	**746**
	Fund trusts	**38,585**	**12,254**	**—**	**50,839**
	Equity securities	**96,381**	**127,848**	**85**	**224,144**
		140,135	**140,187**	**85**	**280,237**
	Held-to-maturity:				
	Corporate debt securities	**177,636**	**—**	**—**	**177,636**
		$317,771	**140,187**	**85**	**457,873**

Maturities of debt securities and fund trusts classified as available-for-sale and held-to-maturity were as follows at December 31, 2005:

Available-for-sale securities

	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥ 71	71	$ 602	602
Due after one year through five years	1,811	3,243	15,347	27,483
Due after five years	3,352	3,376	28,407	28,610
	¥5,234	6,690	$44,356	56,695

Held-to-maturity securities

	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due after one year through five years	¥20,961	20,961	$177,636	177,636

The gross realized gains for the year ended December 31, 2005 and 2004 were ¥11,049 million ($93,636 thousand) and ¥3,867 million, respectively. The gross realized gains for the year ended December 31, 2003 and the gross realized losses for the years ended December 31, 2005, 2004 and 2003 were not significant.

At December 31, 2005, substantially all of the available-for-sale and held-to-maturity securities with unrealized losses had been in a continuous unrealized loss position for less than 12 months.

Aggregate cost of non-marketable equity securities accounted for under the cost method totaled ¥16,714 million ($141,644 thousand) and ¥14,635 million at December 31, 2005 and 2004, respectively. Investments with an aggregate cost of ¥16,702 million ($141,542 thousand) were not evaluated for impairment because (a) Canon did not estimate the fair value of those investments as it was not practicable to estimate the fair value of the investments and (b) Canon did not identify any events or changes in circumstances that might have had significant adverse effects on the fair value of those investments.

Investments in affiliated companies accounted for by the equity method amounted to ¥31,418 million ($266,254 thousand) and ¥26,546 million at December 31, 2005 and 2004, respectively. Canon's share of the net earnings (losses) in affiliated companies accounted for by the equity method, included in other income (deductions), are earnings of ¥1,646 million ($13,949 thousand) and ¥1,921 million for the years ended December 31, 2005 and 2004 and losses of ¥1,124 million for the year ended December 31, 2003, respectively.

(5) Trade Receivables

Trade receivables are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Notes	¥ 27,328	30,261	$ 231,593
Accounts	673,827	584,186	5,710,399
	701,155	614,447	5,941,992
Less allowance for doubtful receivables	(11,728)	(11,657)	(99,390)
	¥689,427	602,790	$5,842,602

(6) Inventories

Inventories comprised the following:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Finished goods	¥359,934	352,656	$3,050,288
Work in process	132,520	121,613	1,123,051
Raw materials	17,741	14,859	150,347
	¥510,195	489,128	$4,323,686

(7) Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation and are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Land	¥ 199,595	182,330	$ 1,691,483
Buildings	997,351	824,969	8,452,127
Machinery and equipment	1,164,480	1,053,121	9,868,474
Construction in progress	59,558	74,599	504,729
	2,420,984	2,135,019	20,516,813
Less accumulated depreciation	(1,272,163)	(1,173,305)	(10,781,042)
	¥ 1,148,821	961,714	$ 9,735,771

(8) Finance Receivables and Operating Leases

Finance receivables represent financing leases which consist of sales-type leases and direct-financing leases resulting from the marketing of Canon's and complementary third-party products. These receivables typically have terms ranging from 1 to 6 years. The components of the finance receivables, which are included in prepaid expenses and other current assets, and other assets in the accompanying consolidated balance sheets, are as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Total minimum lease payments receivable	¥ 204,774	180,707	$1,735,373
Unguaranteed residual values	13,849	10,816	117,364
Executory costs	(2,785)	(2,533)	(23,602)
Unearned income	(23,632)	(20,880)	(200,271)
	192,206	168,110	1,628,864
Less allowance for doubtful receivables	(8,372)	(6,068)	(70,949)
	183,834	162,042	1,557,915
Less amount due within one year	(69,211)	(61,187)	(586,534)
	¥ 114,623	100,855	$ 971,381

The cost of equipment leased to customers under operating leases at December 31, 2005 and 2004 was ¥60,839 million ($515,585 thousand) and ¥67,364 million, respectively. Accumulated depreciation on equipment under operating leases at December 31, 2005 and 2004 was ¥45,285 million ($383,771 thousand) and ¥52,493 million, respectively.

The following is a schedule by year of the future minimum lease payments to be received under financing leases and noncancelable operating leases at December 31, 2005.

Year ending December 31	Millions of yen		Thousands of U.S. dollars	
	Financing leases	Operating leases	Financing leases	Operating leases
2006	¥ 81,967	3,691	$ 694,636	31,280
2007	58,998	1,846	499,983	15,644
2008	38,347	1,131	324,975	9,585
2009	18,314	533	155,203	4,517
2010	6,483	40	54,941	339
Thereafter	665	9	5,635	76
	¥204,774	7,250	$1,735,373	61,441

(9) Acquisitions

In 2005, the Company acquired two companies for a total cost of ¥20,205 million ($171,229 thousand), which was paid in cash. Those companies are engaged in the development, manufacturing and sales of semiconductor manufacturing equipment, factory automation equipment and vacuum equipment for production of electronic parts, including semiconductors, flat panel displays, magnetic heads and hard disc drives. In connection with those transactions, the Company recognized goodwill of ¥4,885 million ($41,398 thousand) and intangible assets of ¥16,382 million ($138,831 thousand), which were classified as other assets in the accompanying consolidated financial statements. Intangible assets consist primarily of developed technology, and are subject to a weighted average amortization period of approximately 9 years.

In 2004, the Company acquired all of the outstanding common shares of a precision plastic mold manufacturer, in an exchange offering for 577,920 shares of the Company's common stock. The aggregate value of the shares exchanged was approximately ¥2,805 million. In connection with this transaction, the Company recognized goodwill of ¥1,585 million, which was classified as other assets in the accompanying consolidated financial statements.

Canon has included the results of operations of these transactions prospectively from the respective dates of transactions. Canon has not presented the pro forma results of operations of the acquired businesses because the results are not material to its consolidated results of operations on either an individual or an aggregate basis.

(10) Goodwill and Other Intangible Assets

Intangible assets acquired during the year ended December 31, 2005 totaled ¥42,393 million ($359,263 thousand), which are subject to amortization and, in addition to those recorded from acquired businesses, primarily consist of internal use software of ¥23,383 million ($198,161 thousand) and license fees of ¥1,116 million ($9,458 thousand). The weighted average amortization period for internal use software and license fees is approximately 4 years and 8 years, respectively.

The components of acquired intangible assets subject to amortization included in other assets at December 31, 2005 and 2004 were as follows:

December 31	2005		2004	
Millions of yen	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Software	**¥121,729**	**70,535**	¥121,546	79,517
License fees	**20,567**	**11,329**	24,603	14,183
Other	**23,291**	**4,997**	6,976	3,585
	¥165,587	**86,861**	¥153,125	97,285

Thousands of U.S. dollars	2005 Gross Carrying Amount	2005 Accumulated Amortization
Software	**$1,031,602**	**597,754**
License fees	**174,297**	**96,008**
Other	**197,381**	**42,348**
	$1,403,280	**736,110**

Aggregate amortization expense for the years ended December 31, 2005, 2004 and 2003 was ¥20,214 million ($171,305 thousand), ¥18,295 million and ¥12,438 million, respectively. Estimated amortization expense for the next five years ending December 31 is ¥23,117 million ($195,907 thousand) in 2006, ¥17,286 million ($146,492 thousand) in 2007, ¥12,911 million ($109,415 thousand) in 2008, ¥8,386 million ($71,068 thousand) in 2009, and ¥4,366 million ($37,000 thousand) in 2010.

Intangible assets not subject to amortization other than goodwill at December 31, 2005 and 2004 were not significant.

The changes in the carrying amount of goodwill for the years ended December 31, 2005 and 2004 were as follows:

Year ended December 31	Millions of yen 2005	Millions of yen 2004	Thousands of U.S. dollars 2005
Balance at beginning of year	**¥24,233**	22,067	**$205,364**
Goodwill acquired during the year	**15,391**	3,156	**130,432**
Impairment losses	**—**	(42)	**—**
Recognition of acquired company’s tax benefits	**—**	(1,298)	**—**
Translation adjustments	**537**	350	**4,551**
Balance at end of year	**¥40,161**	24,233	**$340,347**

During the year ended December 31, 2004, Canon recognized ¥1,298 million of deferred tax benefits relating to preexisting net operating tax losses of a company acquired in 2003. In connection therewith, Canon reduced the related goodwill by the same amount.

(11) Short-Term Loans and Long-Term Debt

Short-term loans consisting of bank borrowings at December 31, 2005 were ¥67 million ($568 thousand). The weighted average interest rate on short-term loans outstanding at December 31, 2005 was 2.14%.

Long-term debt consisted of the following:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Loans, principally from banks, maturing in installments through 2018; bearing weighted average interest of 1.40% and 3.05% at December 31, 2005 and 2004, respectively, partially secured by mortgage of property, plant and equipment	¥ 2,641	2,949	$ 22,381
1.88% Japanese yen notes, due 2005	—	5,000	—
1.71% Japanese yen notes, due 2005	—	200	—
2.95% Japanese yen notes, due 2007	10,000	10,000	84,746
2.27% Japanese yen notes, due 2008	10,000	10,000	84,746
1.20% Japanese yen convertible debentures, due 2005	—	309	—
1.30% Japanese yen convertible debentures, due 2008	649	1,487	5,500
Capital lease obligations	8,784	8,585	74,440
	32,074	38,530	271,813
Less amount due within one year	(4,992)	(9,879)	(42,305)
	¥27,082	28,651	$229,508

The aggregate annual maturities of long-term debt outstanding at December 31, 2005 were as follows:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2006	¥ 4,992	$ 42,305
2007	13,318	112,864
2008	12,351	104,669
2009	895	7,585
2010	417	3,534
Thereafter	101	856
	¥32,074	$271,813

Certain property, plant and equipment with a net book carrying value of ¥7,423 million ($62,907 thousand) at December 31, 2005 were mortgaged to secure loans from banks.

Canon entered into an agreement whereby certain assets were deposited into an irrevocable trust to meet the debt service requirements of the: 2.95% Japanese yen notes; and 2.27% Japanese yen notes in the aggregate amount of ¥20,000 million ($169,492 thousand). The assets contributed by Canon were debt securities with carrying amounts of ¥20,961 million ($177,636 thousand), at December 31, 2005. Cash flows from such investments will be used solely to satisfy the principal and interest obligations for the debts. Accordingly, the debt securities are included in the consolidated balance sheet under the caption of investments.

Both short-term and long-term bank loans are made under general agreements which provide that security and guarantees for present and future indebtedness will be given upon request of the bank, and that the bank shall have the right to offset cash deposits against obligations that have become due or, in the event of default, against all obligations due to the bank. Long-term agreements with lenders other than banks also generally provide that Canon must provide additional security upon request of the lender.

The 1.30% Japanese yen convertible debentures due 2008 are convertible into approximately 434,000 shares of common stock at a conversion price of ¥1,497.00 ($12.69) per share at December 31, 2005. The debentures are redeemable at the option of the Company between January 1, 2006 and December 31, 2007 at declining premiums ranging from 2% to 1%, and at par thereafter.

(12) Trade Payables

Trade payables are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Notes	¥ 17,567	51,081	$ 148,873
Accounts	487,559	414,315	4,131,856
	¥505,126	465,396	$4,280,729

(13) Employee Retirement and Severance Benefits

The Company and certain of its subsidiaries have contributory and noncontributory defined benefit plans covering substantially all employees after one year of service. Other subsidiaries sponsor unfunded retirement and severance plans. Benefits payable under the plans are based on employee earnings and years of service.

The contributory plans in Japan mainly represent the Employees' Pension Fund plans ("EPFs"), composed of the substitutional portions based on the pay-related part of the old age pension benefits prescribed by the Welfare Pension Insurance Law and the corporate portions based on contributory defined benefit pension arrangements established at the discretion of the Company and its subsidiaries. The substitutional portions of the EPFs represent welfare pension plans carried on behalf of the Japanese government. These contributory and noncontributory plans are funded in conformity with the funding requirements of applicable Japanese governmental regulations.

In January 2003, the Emerging Issues Task Force reached a final consensus on Issue No. 03-2 ("EITF 03-2"), "Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities," which addresses accounting for a transfer to the Japanese government of a substitutional portion of an EPF. During the year ended December 31, 2003, the Company and certain of its domestic subsidiaries received approval from the government for an exemption from the obligation to pay benefits for future employee service related to the substitutional portion. During the year ended December 31, 2004, the Company and certain of its domestic subsidiaries received approval to separate the remaining substitutional portion related to past service by their employees. During the year ended December 31, 2004, the Company and certain of its domestic subsidiaries also completed the transfer of the substitutional portion of the benefit obligation and the related government-specified portion of the plan assets which were computed by the government, and were relieved of all related obligations. Canon has accounted for the entire process at the completion of the transfer to the government of the substitutional portion of the benefit obligation and the related plan assets as a single settlement transaction in accordance with EITF 03-2. As a result, Canon recognized a settlement loss of ¥69,651 million for the year ended December 31, 2004, which is determined based on the proportion of the projected benefit obligation settled to the total projected benefit obligation immediately prior to the separation. Canon also recognized a subsidy from the government of ¥86,792 million, which is calculated as the difference between the obligation settled and the assets transferred to the government. The net gain of ¥17,141 million is included in selling, general and administrative expenses for the year ended December 31, 2004.

Canon uses a measurement date of October 1 for the majority of its plans.

Net periodic benefit cost for Canon's employee retirement and severance defined benefit plans for the years ended December 31, 2005, 2004 and 2003 consisted of the following components:

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2005	2004	2003	2005
Service cost — benefits earned during the year	¥ 25,801	26,571	29,024	$ 218,652
Interest cost on projected benefit obligation	16,172	19,108	20,806	137,051
Expected return on plan assets	(19,651)	(17,054)	(13,959)	(166,534)
Amortization of unrecognized net obligation at transition	345	344	344	2,924
Amortization of prior service cost	(8,007)	(6,814)	(5,515)	(67,856)
Recognized actuarial loss	10,542	12,505	15,807	89,339
Settlement loss resulting from plan termination	—	2,784	—	—
Settlement loss resulting from transfer of substitutional portion of EPFs to the Japanese government	—	69,651	—	—
	¥ 25,202	107,095	46,507	$ 213,576

Reconciliations of beginning and ending balances of the benefit obligations and the fair value of the plan assets are as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Change in benefit obligations:			
Benefit obligations at beginning of year	¥ 582,212	752,390	$ 4,934,000
Service cost	25,801	26,571	218,652
Interest cost	16,172	19,108	137,051
Plan participants' contributions	1,161	1,142	9,839
Amendments	(6,212)	(2,781)	(52,644)
Actuarial gain	3,340	(5,728)	28,305
Benefits paid	(12,239)	(14,143)	(103,720)
Settlement on plan termination	—	(6,482)	—
Transfer of substitutional portion of EPFs to the Japanese government	—	(191,784)	—
Acquisition	10,106	84	85,644
Foreign currency exchange rate changes	167	3,957	1,415
Other	(15)	(122)	(127)
Benefit obligations at end of year	620,493	582,212	5,258,415
Change in plan assets:			
Fair value of plan assets at beginning of year	418,798	472,228	3,549,136
Actual return on plan assets	93,844	32,744	795,288
Employer contributions	40,059	31,018	339,483
Plan participants' contributions	1,161	1,142	9,839
Benefit paid	(12,239)	(14,143)	(103,720)
Settlement on plan termination	—	(2,274)	—
Transfer of substitutional portion of EPFs to the Japanese government	—	(104,992)	—
Acquisition	3,486	—	29,542
Foreign currency exchange rate changes	409	3,075	3,466
Fair value of plan assets at end of year	545,518	418,798	4,623,034
Funded status	(74,975)	(163,414)	(635,381)
Unrecognized actuarial loss	110,424	191,376	935,796
Unrecognized prior service cost	(101,552)	(102,427)	(860,610)
Unrecognized net transition obligation being recognized over 22 years	3,955	4,300	33,517
Net amount recognized	¥ (62,148)	(70,165)	$ (526,678)
Amounts recognized in the consolidated balance sheets consist of:			
Prepaid pension cost	¥ 3,089	3,142	$ 26,178
Accrued pension and severance cost	(80,430)	(132,522)	(681,610)
Intangible assets	—	57	—
Accumulated other comprehensive income (loss)	15,193	59,158	128,754
Net amount recognized	¥ (62,148)	(70,165)	$ (526,678)

The accumulated benefit obligation for all defined benefit plans was as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Accumulated benefit obligation	¥578,627	540,615	$ 4,903,619

The projected benefit obligations and the fair value of plan assets for the pension plans with projected benefit obligations in excess of plan assets, and the accumulated benefit obligations and the fair value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets are as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Plans with projected benefit obligations in excess of plan assets:			
Projected benefit obligations	¥ 587,162	577,022	$ 4,975,949
Fair value of plan assets	510,287	411,918	4,324,466
Plans with accumulated benefit obligations in excess of plan assets:			
Accumulated benefit obligations	545,375	512,216	4,621,822
Fair value of plan assets	506,634	386,921	4,293,508

Assumptions

Weighted-average assumptions used to determine benefit obligations are as follows:

December 31	2005	2004
Discount rate	2.7%	2.7%
Assumed rate of increase in future compensation levels	3.3%	3.0%

Weighted-average assumptions used to determine net periodic benefit cost are as follows:

Year ended December 31	2005	2004	2003
Discount rate	2.7%	2.7%	2.7%
Assumed rate of increase in future compensation levels	3.0%	2.0%	2.0%
Expected long-term rate of return on plan assets	4.6%	3.6%	3.6%

Canon determines the expected long-term rate of return based on the expected long-term return of the various asset categories in which it invests. Canon considers the current expectations for future returns and the actual historical returns of each plan asset category.

Plan assets

The weighted-average asset allocations of Canon's benefit plans at December 31, 2005 and 2004 and target asset allocation by asset category are as follows:

December 31	2005	2004	Target allocation
Asset category:			
Equity securities	50.8%	43.0%	46.3%
Debt securities	34.6%	37.2%	35.6%
Cash	0.7%	1.7%	0.3%
Life insurance company general accounts	13.5%	14.5%	17.1%
Other	0.4%	3.6%	0.7%
	100.0%	100.0%	100.0%

Canon's investment policies are designed to ensure adequate plan assets are available to provide future payments of pension benefits to eligible participants. Taking into account the expected long-term rate of return on plan assets, Canon formulates a "model" portfolio comprised of the optimal combination of equity securities and debt securities. Plan assets are invested in individual equity and debt securities using the guidelines of the "model" portfolio in order to produce a total return that will match the expected return on a mid-term to long-term basis. Canon evaluates the gap between expected return and actual return of invested plan assets on an annual basis to determine if such differences necessitate a revision in the formulation of the "model" portfolio. Canon revises the "model" portfolio when and to the extent considered necessary to achieve the expected long-term rate of return on plan assets.

The plan's equity securities include common stock of the Company and certain of its subsidiaries in the amounts of ¥1,311 million ($11,110 thousand) and ¥946 million at December 31, 2005 and 2004, respectively.

Contributions

Canon expects to contribute ¥45,352 million ($384,339 thousand) to its defined benefit plans for the year ending December 31, 2006.

Estimated future benefit payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2006	¥ 9,798	$ 83,034
2007	10,658	90,322
2008	12,237	103,703
2009	13,328	112,949
2010	14,629	123,975
2011 — 2015	93,055	788,602

(14) Income Taxes

Domestic and foreign components of income before income taxes and minority interests, and the current and deferred income tax expense (benefit) attributable to such income are summarized as follows:

Year ended December 31	Millions of yen		
	Japanese	Foreign	Total
2005: Income before income taxes and minority interests	**¥492,709**	**119,295**	**612,004**
Income taxes:			
Current	**¥172,595**	**40,956**	**213,551**
Deferred	**3,441**	**(4,207)**	**(766)**
	¥176,036	**36,749**	**212,785**
2004: Income before income taxes and minority interests	¥447,864	104,252	552,116
Income taxes:			
Current	¥162,679	22,275	184,954
Deferred	(1,065)	10,125	9,060
	¥161,614	32,400	194,014
2003: Income before income taxes and minority interests	¥337,093	111,077	448,170
Income taxes:			
Current	¥132,204	33,484	165,688
Deferred	(5,828)	2,793	(3,035)
	¥126,376	36,277	162,653

	Thousands of U.S. dollars		
	Japanese	Foreign	Total
2005: Income before income taxes and minority interests	**$4,175,500**	**1,010,975**	**5,186,475**
Income taxes:			
Current	**$1,462,670**	**347,085**	**1,809,755**
Deferred	**29,161**	**(35,653)**	**(6,492)**
	$1,491,831	**311,432**	**1,803,263**

The Company and its domestic subsidiaries are subject to a number of income taxes, which, in the aggregate, represent a statutory income tax rate of approximately 40% for the year ended December 31, 2005 and 42% for the years ended December 31, 2004 and 2003.

Amendments to the Japanese tax regulations were enacted on March 24, 2003. As a result of these amendments, the statutory income tax rate was reduced from approximately 42% to 40% effective from the year beginning January 1, 2005. Consequently, the statutory tax rate utilized for deferred tax assets and liabilities expected to be settled or realized subsequent to January 1, 2005 is approximately 40%. The adjustments of deferred tax assets and liabilities for this change in the tax rate amounted to ¥3,613 million and have been reflected in income taxes on the consolidated statements of income for the year ended December 31, 2003.

A reconciliation of the Japanese statutory income tax rate and the effective income tax rate as a percentage of income before income taxes and minority interests is as follows:

Year ended December 31	2005	2004	2003
Japanese statutory income tax rate	**40.0%**	42.0%	42.0%
Increase (reduction) in income taxes resulting from:			
Expenses not deductible for tax purposes	**0.3**	0.4	0.2
Tax benefits not recognized on operating losses of subsidiaries	**—**	0.1	0.1
Income of foreign subsidiaries taxed at lower than Japanese statutory tax rate	**(1.9)**	(2.1)	(2.5)
Tax credit for research and development expenses	**(3.9)**	(4.0)	(4.0)
Effect of enacted changes in tax laws and rates	**—**	—	0.8
Other	**0.3**	(1.3)	(0.3)
Effective income tax rate	**34.8%**	35.1%	36.3%

Net deferred income tax assets and liabilities are reflected on the accompanying consolidated balance sheets under the following captions:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Prepaid expenses and other current assets	**¥ 52,116**	47,679	**$ 441,661**
Other assets	**61,325**	84,686	**519,703**
Other current liabilities	**(3,500)**	(2,873)	**(29,661)**
Other noncurrent liabilities	**(36,329)**	(30,049)	**(307,872)**
	¥ 73,612	99,443	**$ 623,831**

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004 are presented below:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Deferred tax assets:			
Inventories	¥ 13,459	11,364	$ 114,059
Accrued business tax	8,599	10,149	72,873
Accrued pension and severance cost	28,665	34,680	242,924
Minimum pension liability adjustments	5,592	22,778	47,390
Research and development — costs capitalized for tax purposes	23,629	22,499	200,246
Property, plant and equipment	21,839	17,406	185,076
Accrued expenses	20,132	17,976	170,610
Net operating losses carried forward	1,388	1,799	11,763
Other	24,362	24,258	206,457
Total gross deferred tax assets	147,665	162,909	1,251,398
Less valuation allowance	(3,345)	(3,495)	(28,347)
Net deferred tax assets	144,320	159,414	1,223,051
Deferred tax liabilities:			
Undistributed earnings of foreign subsidiaries	(6,806)	(5,638)	(57,678)
Net unrealized gains on securities	(6,480)	(6,833)	(54,915)
Tax deductible reserve	(14,307)	(11,975)	(121,246)
Financing lease revenue	(35,395)	(30,196)	(299,958)
Other	(7,720)	(5,329)	(65,423)
Total gross deferred tax liabilities	(70,708)	(59,971)	(599,220)
Net deferred tax assets	¥ 73,612	99,443	$ 623,831

The net changes in the total valuation allowance for the years ended December 31, 2005, 2004 and 2003 were decreases of ¥150 million ($1,271 thousand), ¥4,906 million and ¥1,282 million, respectively.

Based upon the level of historical taxable income and projections for future taxable income over the periods which the net deductible temporary differences are expected to reverse, management believes it is more likely than not that Canon will realize the benefits of these deferred tax assets, net of the existing valuation allowance at December 31, 2005.

At December 31, 2005, Canon had net operating losses which can be carried forward for income tax purposes of ¥4,697 million ($39,805 thousand) to reduce future taxable income. Periods available to reduce future taxable income vary in each tax jurisdiction and generally range from one year to ten years as follows:

	Millions of yen	Thousands of U.S. dollars
Within one year	¥1,943	$ 16,466
After one year through five years	2,012	17,051
After five years through ten years	94	797
Indefinite period	648	5,491
Total	¥4,697	$ 39,805

Income taxes have not been accrued on undistributed earnings of domestic subsidiaries as the tax law provides a means by which the dividends from a domestic subsidiary can be received tax free.

Canon has not recognized deferred tax liabilities of ¥29,728 million ($251,932 thousand) for a portion of undistributed earnings of foreign subsidiaries that arose for the year ended December 31, 2005 and prior years because Canon currently does not expect to have such amounts distributed or paid as dividends to the Company in the foreseeable future. Deferred tax liabilities will be recognized when Canon expects that it will realize those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investments. At December 31, 2005, such undistributed earnings of these subsidiaries were ¥531,499 million ($4,504,229 thousand).

(15) Common Stock

For the years ended December 31, 2005, 2004 and 2003, the Company issued 765,528 shares, 6,638,606 shares and 2,202,401 shares of common stock, respectively, in connection with the conversion of convertible debt. In accordance with the Japanese Commercial Code, conversion into common stock of convertible debt is accounted for by crediting one-half or more of the conversion price to the common stock account and the remainder to the additional paid-in capital account.

(16) Legal Reserve and Retained Earnings

The Japanese Commercial Code provides that an amount equal to at least 10% of cash dividends and other distributions from retained earnings paid by the Company and its Japanese subsidiaries be appropriated as a legal reserve. No further appropriations are required when the total amount of the additional paid-in capital and the legal reserve equals 25% of their respective stated capital. The Japanese Commercial Code also provides that to the extent that the sum of the additional paid-in capital and the legal reserve exceeds 25% of the stated capital, the amount of the excess (if any) is available for appropriations by the resolution of the shareholders. Certain foreign subsidiaries are also required to appropriate their earnings to legal reserves under the laws of the respective countries.

Cash dividends and appropriations to the legal reserve charged to retained earnings for the years ended December 31, 2005, 2004 and 2003 represent dividends paid out during those years and the related appropriations to the legal reserve. Retained earnings at December 31, 2005 do not reflect current year-end dividends in the amount of ¥59,913 million ($507,737 thousand) which will be payable in March 2006 upon approval by the stockholders.

The amount available for dividends under the Japanese Commercial Code is based on the amount recorded in the Company's nonconsolidated books of account in accordance with financial accounting standards of Japan. Such amount was ¥1,366,355 million ($11,579,280 thousand) at December 31, 2005.

Retained earnings at December 31, 2005 included Canon's equity in undistributed earnings of affiliated companies accounted for by the equity method in the amount of ¥8,714 million ($73,847 thousand).

(17) Other Comprehensive Income (Loss)

Changes in accumulated other comprehensive income (loss) are as follows:

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2005	2004	2003	2005
Foreign currency translation adjustments:				
Balance at beginning of year	¥ (79,751)	(83,801)	(68,524)	$(675,856)
Adjustments for the year	53,979	4,050	(15,277)	457,449
Balance at end of year	(25,772)	(79,751)	(83,801)	(218,407)
Net unrealized gains and losses on securities:				
Balance at beginning of year	7,470	6,784	(1,168)	63,305
Adjustments for the year	(1,397)	686	7,952	(11,839)
Balance at end of year	6,073	7,470	6,784	51,466
Net gains and losses on derivative instruments:				
Balance at beginning of year	(693)	(297)	(334)	(5,873)
Adjustments for the year	(481)	(396)	37	(4,076)
Balance at end of year	(1,174)	(693)	(297)	(9,949)
Minimum pension liability adjustments:				
Balance at beginning of year	(28,338)	(65,961)	(96,441)	(240,152)
Adjustments for the year	20,999	37,623	30,480	177,957
Balance at end of year	(7,339)	(28,338)	(65,961)	(62,195)
Total accumulated other comprehensive income (loss):				
Balance at beginning of year	(101,312)	(143,275)	(166,467)	(858,576)
Adjustments for the year	73,100	41,963	23,192	619,491
Balance at end of year	¥ (28,212)	(101,312)	(143,275)	$(239,085)

Tax effects allocated to each component of other comprehensive income (loss) and reclassification adjustments are as follows:

Year ended December 31	Millions of yen		
	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
2005:			
Foreign currency translation adjustments	**¥ 55,345**	**(1,366)**	**53,979**
Net unrealized gains and losses on securities:			
Amount arising during the year	**9,005**	**(3,892)**	**5,113**
Reclassification adjustments for gains and losses realized in net income	**(10,793)**	**4,283**	**(6,510)**
Net change during the year	**(1,788)**	**391**	**(1,397)**
Net gains and losses on derivative instruments:			
Amount arising during the year	**(9,137)**	**3,658**	**(5,479)**
Reclassification adjustments for gains and losses realized in net income	**8,333**	**(3,335)**	**4,998**
Net change during the year	**(804)**	**323**	**(481)**
Minimum pension liability adjustments	**40,364**	**(19,365)**	**20,999**
Other comprehensive income (loss)	**¥ 93,117**	**(20,017)**	**73,100**
2004:			
Foreign currency translation adjustments	¥ 4,400	(350)	4,050
Net unrealized gains and losses on securities:			
Amount arising during the year	5,022	(2,202)	2,820
Reclassification adjustments for gains and losses realized in net income	(3,698)	1,564	(2,134)
Net change during the year	1,324	(638)	686
Net gains and losses on derivative instruments:			
Amount arising during the year	(1,673)	708	(965)
Reclassification adjustments for gains and losses realized in net income	929	(360)	569
Net change during the year	(744)	348	(396)
Minimum pension liability adjustments	78,179	(40,556)	37,623
Other comprehensive income (loss)	¥ 83,159	(41,196)	41,963

Year ended December 31	Millions of yen		
	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
2003:			
Foreign currency translation adjustments:			
Amount arising during the year	¥(19,115)	3,469	(15,646)
Reclassification adjustments for gains and losses realized in net income	369	—	369
Net change during the year	(18,746)	3,469	(15,277)
Net unrealized gains and losses on securities:			
Amount arising during the year	12,129	(4,477)	7,652
Reclassification adjustments for gains and losses realized in net income	515	(215)	300
Net change during the year	12,644	(4,692)	7,952
Net gains and losses on derivative instruments:			
Amount arising during the year	(726)	305	(421)
Reclassification adjustments for gains and losses realized in net income	790	(332)	458
Net change during the year	64	(27)	37
Minimum pension liability adjustments	70,218	(39,738)	30,480
Other comprehensive income (loss)	¥ 64,180	(40,988)	23,192

	Thousands of U.S. dollars		
	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
2005:			
Foreign currency translation adjustments	**$ 469,025**	**(11,576)**	**457,449**
Net unrealized gains and losses on securities:			
Amount arising during the year	**76,314**	**(32,984)**	**43,330**
Reclassification adjustments for gains and losses realized in net income	**(91,466)**	**36,297**	**(55,169)**
Net change during the year	**(15,152)**	**3,313**	**(11,839)**
Net gains and losses on derivative instruments:			
Amount arising during the year	**(77,432)**	**31,000**	**(46,432)**
Reclassification adjustments for gains and losses realized in net income	**70,619**	**(28,263)**	**42,356**
Net change during the year	**(6,813)**	**2,737**	**(4,076)**
Minimum pension liability adjustments	**342,068**	**(164,111)**	**177,957**
Other comprehensive income (loss)	**$ 789,128**	**(169,637)**	**619,491**

(18) Net Income per Share

A reconciliation of the numerators and denominators of basic and diluted net income per share computations is as follows:

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2005	2004	2003	2005
Net income	¥384,096	343,344	275,730	$3,255,051
Effect of dilutive securities:				
1.20% Japanese yen convertible debentures, due 2005	5	24	36	42
1.30% Japanese yen convertible debentures, due 2008	18	72	86	153
Diluted net income	¥384,119	343,440	275,852	$3,255,246

	Number of shares		
Average common shares outstanding	887,173,810	885,365,124	878,648,844
Effect of dilutive securities:			
1.20% Japanese yen convertible debentures, due 2005	123,837	462,823	2,664,354
1.30% Japanese yen convertible debentures, due 2008	745,954	2,125,278	6,382,560
Diluted common shares outstanding	888,043,601	887,953,225	887,695,758

	Yen			U.S. dollars
Net income per share:				
Basic	¥432.94	387.80	313.81	$3.67
Diluted	432.55	386.78	310.75	3.67

(19) Derivatives and Hedging Activities

Risk management policy

Canon operates internationally, exposing it to the risk of changes in foreign currency exchange rates and interest rates. Derivative financial instruments are comprised principally of foreign exchange contracts and interest rate swaps utilized by the Company and certain of its subsidiaries to reduce these risks. Canon assesses foreign currency exchange rate risk and interest rate risk by continually monitoring changes in these exposures and by evaluating hedging opportunities. Canon does not hold or issue derivative financial instruments for trading purposes. Canon is also exposed to credit-related losses in the event of non-performance by counterparties to derivative financial instruments, but it is not expected that any counterparties will fail to meet their obligations, because most of the counterparties are internationally recognized financial institutions and contracts are diversified across a number of major financial institutions.

Foreign currency exchange rate risk management

Canon's international operations expose Canon to the risk of changes in foreign currency exchange rates. Canon uses foreign exchange contracts to manage certain foreign currency exchange exposures principally from the exchange of U.S. dollar and euro into Japanese yen. These contracts are primarily used to hedge the foreign currency exposure of forecasted intercompany sales and intercompany trade receivables which are denominated in foreign currencies. In accordance with Canon's policy, a specific portion of foreign currency exposure resulting from forecasted intercompany sales are hedged using foreign exchange contracts which principally mature within three months.

Interest rate risk management

Canon's exposure to the risk of changes in interest rates relates primarily to its debt obligations. The variable-rate debt obligations expose Canon to variability in their cash flows due to change in interest rates. To manage the variability in cash flows caused by interest rate changes, Canon enters into interest rate swaps when it is determined to be appropriate based on market conditions. The interest rate swaps change variable-rate debt obligations to fixed-rate debt obligations by primarily entering into pay-fixed, receive-variable interest rate swaps.

Fair value hedge

Derivative financial instruments designated as fair value hedges principally relate to interest rate swaps associated with fixed rate debt obligations. Changes in fair values of the hedged debt obligations and derivative financial instruments designated as fair value hedges of these debt obligations are recognized in other income (deductions). There is no hedging ineffectiveness or net gains or losses excluded from the assessment of hedge effectiveness for the years ended December 31, 2004 and 2003 as the critical terms of the interest rate swaps match the terms of the hedged debt obligations.

Cash flow hedge

Changes in the fair value of derivative financial instruments designated as cash flow hedges, including foreign exchange contracts associated with forecasted intercompany sales and interest rate swaps associated with variable rate debt obligations, are reported in accumulated other comprehensive income (loss). These amounts are subsequently reclassified into earnings through other income (deductions) in the same period as the hedged items affect earnings. Substantially all amounts recorded in accumulated other comprehensive income (loss) at year-end are expected to be recognized in earnings over the next twelve months. Canon excludes the time value component from the assessment of hedge effectiveness.

The amount of the hedging ineffectiveness was not material for the years ended December 31, 2005, 2004 and 2003. The amount of net gains or losses excluded from the assessment of hedge effectiveness (time value component) which was recorded in other income (deductions) was net losses of ¥3,725 million ($31,568 thousand), ¥2,096 million and ¥490 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Derivatives not designated as hedges

Canon has entered into certain foreign exchange contracts to manage its foreign currency exposures. These foreign exchange contracts have not been designated as hedges. Accordingly, the changes in fair value of the contracts are recorded in earnings immediately.

Contract amounts of foreign exchange contracts at December 31, 2005 and 2004 are set forth below:

December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
To sell foreign currencies	¥645,188	584,208	$5,467,695
To buy foreign currencies	46,424	34,201	393,424

(20) Commitments and Contingent Liabilities

Commitments

At December 31, 2005, commitments outstanding for the purchase of property, plant and equipment approximated ¥87,244 million ($739,356 thousand), and commitments outstanding for the purchase of parts and raw materials approximated ¥67,831 million ($574,839 thousand).

Canon occupies sales offices and other facilities under lease arrangements accounted for as operating leases. Deposits made under such arrangements aggregated ¥13,790 million ($116,864 thousand) and ¥14,307 million at December 31, 2005 and 2004, respectively, and are reflected under noncurrent receivables on the accompanying consolidated balance sheets. Rental expenses under the operating lease arrangements amounted to ¥38,297 million ($324,551 thousand), ¥41,381 million and ¥42,131 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Future minimum lease payments required under noncancellable operating leases that have initial or remaining lease terms in excess of one year at December 31, 2005 are as follows:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2006	¥14,571	$123,483
2007	10,723	90,873
2008	7,970	67,542
2009	5,684	48,169
2010	4,139	35,076
Thereafter	9,502	80,526
Total future minimum lease payments	¥52,589	$445,669

Guarantees

Canon provides guarantees for bank loans of its employees, affiliates and other companies. The guarantees for the employees are principally made for their housing loans. The guarantees of loans of its affiliates and other companies are made to ensure that those companies operate with less financial risk.

For each guarantee provided, Canon would have to perform under a guarantee if the borrower defaults on a payment within the contract periods of 1 year to 30 years, in the case of employees with housing loans, and of 1 year to 10 years, in the case of affiliates and other companies. The maximum amount of undiscounted payments Canon would have had to make in the event of default is ¥38,550 million ($326,695 thousand) at December 31, 2005. The carrying amounts of the liabilities recognized for Canon's obligations as a guarantor under those guarantees at December 31, 2005 were not significant.

Canon also issues contractual product warranties under which it generally guarantees the performance of products delivered and services rendered for a certain period or term. Changes in accrued product warranty cost for the year ended December 31, 2005 and 2004 are summarized as follows:

Year ended December 31	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Balance at beginning of year	**¥ 14,264**	10,512	**$ 120,881**
Addition	**18,510**	13,319	**156,864**
Utilization	**(15,580)**	(9,400)	**(132,034)**
Other	**(448)**	(167)	**(3,796)**
Balance at end of year	**¥ 16,746**	14,264	**$ 141,915**

Legal proceedings

In February 2003, a lawsuit was filed by St. Clair Intellectual Property Consultants, Inc. ("St. Clair") against the Company and one of its subsidiaries in the United States District Court of Delaware, which accused the Company of infringement of patents related to certain technology. In connection with this case, in October 2004, a jury preliminarily found damages against the Company of approximately ¥4,000 million ($33,898 thousand) based on a percentage of certain product sales in the United States through 2003. Subsequent to this jury finding, St. Clair also made a motion to the court for damages relating to certain 2004 sales, using the same royalty rate awarded by the jury which could result in additional in damages. There are additional defenses that are yet to be litigated in a follow-up non-jury trial solely before a judge; thus, a final decision by the court, as to both infringement and the total amount of damages, has not yet been reached.

In November 2003, a law suit was filed by a former employee against the Company at the Tokyo District Court in Japan. The lawsuit alleges that the former employee is entitled to ¥45,872 million ($388,746 thousand) as compensation for an invention related to certain technology used by the Company, and the former employee has sued for a partial payment of ¥1,000 million ($8,475 thousand) and interest thereon. The case is still pending and the final outcome is not yet determinable.

In Germany, Verwertungsgesellschaft Wort ("VG Wort"), a collecting agency representing certain copyright holders, has filed a series of lawsuits seeking to impose copyright levies upon digital products such as PCs and printers, that allegedly enable the reproduction of copyrighted materials, against the companies importing and distributing these digital products. In May 2004, VG Wort filed a civil lawsuit against Hewlett-Packard GmbH seeking for levies on multi-function printers. This is an industry test case under which Hewlett-Packard GmbH represents other companies sharing common interests, and Canon has undertaken to be bound by the final decision of this court case. The court of first instance and the court of appeals held that the multi-function printers were subject to a levy. In particular, the court of appeals ordered Hewlett-Packard GmbH to pay the amount equivalent to the levies imposed on photocopiers (EUR 38.35 to EUR 613.56 per unit, depending on printing speed and color printing capability). This lawsuit is currently under appeal before the German Federal Supreme Court. With regard to single-function printers, VG Wort filed a separate lawsuit on January 3, 2006 against Canon seeking for payment of copyright levies. Canon, other companies and the industry associations have expressed opposition to such extension of the levy scope and the final conclusion of these court cases including the amount of levies to be imposed, remains uncertain.

Canon is involved in various claims and legal actions, including those noted above, arising in the ordinary course of business. In accordance with SFAS No. 5, "Accounting for Contingencies," Canon has recorded provisions for liabilities when it is probable that liabilities have been incurred and the amount of loss can be reasonably estimated. Canon reviews these provisions at least quarterly and adjusts these provisions to reflect the impact of the negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case. Based on its experience, Canon believes that any damage amounts claimed in the specific matters discussed above are not a meaningful indicator of Canon's potential liability. In the opinion of management, the ultimate disposition of the above mentioned matters will not have a material adverse effect on Canon's consolidated financial position, results of operations, or cash flows. However, litigation is inherently unpredictable. While Canon believes that it has valid defenses with respect to legal matters pending against it, it is possible that Canon's consolidated financial position, results of operations, or cash flows could be materially affected in any particular period by the unfavorable resolution of one or more of these matters.

(21) Disclosures about the Fair Value of Financial Instruments and Concentrations of Credit Risk

Fair value of financial instruments

The estimated fair values of Canon's financial instruments at December 31, 2005 and 2004 are set forth below. The following summary excludes cash and cash equivalents, trade receivables, finance receivables, noncurrent receivables, short-term loans, trade payables, accrued expenses for which fair value approximate their carrying amounts. The summary also excludes marketable securities and investments which are disclosed in Note 4.

December 31	Millions of yen				Thousand of U.S. dollars	
	2005		2004		2005	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt, including current installments	**¥(32,074)**	**(35,194)**	(38,530)	(44,620)	**$(271,813)**	**(298,254)**
Foreign exchange contracts:						
Assets	**2,250**	**2,250**	4,875	4,875	**19,068**	**19,068**
Liabilities	**(10,062)**	**(10,062)**	(11,020)	(11,020)	**(85,271)**	**(85,271)**

The following methods and assumptions are used to estimate the fair value in the above table.

Long-term debt

The fair values of Canon's long-term debt instruments are based on the quoted price in the most active market or the present value of future cash flows associated with each instrument discounted using Canon's current borrowing rate for similar debt instruments of comparable maturity.

Foreign exchange contracts

The fair values of foreign exchange contracts, all of which are used for purposes other than trading, are estimated by obtaining quotes from brokers.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instruments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Concentrations of credit risk

At December 31, 2005 and 2004, one customer accounted for approximately 12% and 13% of consolidated trade receivables, respectively. Although Canon does not expect that the customer will fail to meet its obligations, Canon is potentially exposed to concentrations of credit risk if the customer failed to perform according to the terms of the contracts.

(22) Supplemental Cash Flow Information

For the years ended December 31, 2005, 2004 and 2003, aggregate common stock and additional paid-in capital arising from conversion of convertible debt amounted to ¥1,147 million ($9,720 thousand), ¥9,938 million and ¥3,297 million, respectively.

ERNST & YOUNG

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The Board of Directors and Stockholders of
Canon Inc.

We have audited the accompanying consolidated balance sheets of Canon Inc. and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2005, all expressed in Japanese yen. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The consolidated statements of income, stockholders' equity, and cash flows of Canon Inc. and subsidiaries for the year ended December 31, 2003 were audited by other auditors whose report dated January 28, 2004 expressed a qualified opinion on those statements with respect to the omission of segment information required by U.S. generally accepted accounting principles.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company's consolidated financial statements do not disclose segment information required by Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information." In our opinion, disclosure of segment information is required by U.S. generally accepted accounting principles.

In our opinion, except for the omission of segment information as discussed in the preceding paragraph, the 2005 and 2004 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Canon Inc. and subsidiaries at December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2005 in conformity with U.S. generally accepted accounting principles.

We have also recomputed the translation of the consolidated financial statements as of and for the year ended December 31, 2005 into United States dollars. In our opinion, the consolidated financial statements expressed in Japanese yen have been translated into United States dollars on the basis described in Note 2.

January 26, 2006

Ernst & Young ShinNihon

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STOCKHOLDERS' INFORMATION

Stock Exchange Listings:
Tokyo, Osaka, Nagoya, Fukuoka, Sapporo, New York and Frankfurt am Main stock exchanges

American Depositary Receipts are traded on the New York Stock Exchange (CAJ).

Stockholders' Annual General Meeting:
March 30, 2006, in Tokyo

Further Information:
For publications or information, please contact the Corporate Communications Center, Canon Inc., Tokyo, or access Canon's Website at
www.canon.com/

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