CANON ANNUAL REPORT 2004

Fiscal Year Ended December 31, 2004

CORPORATE PROFILE

Canon Inc. (NYSE: CAJ) and the Canon Group develop, produce, and market a wide range of products used in the home, the office, and industry, including business machines, cameras, and optical products. The Canon Group provides employment for over 108,000 people worldwide.

Under its corporate philosophy of *kyosei*, or living and working together for the common good, the Group as a whole aims to create new technologies and entire new genres of products, and, through their commercialization, make new contributions to people and communications around the world. The Canon Group pursues a variety of environmental and philanthropic activities and focuses on fulfilling its duties to investors and society by stressing good corporate governance throughout its activities.

In fiscal 2004, under our management strategy, Phase II of the Excellent Global Corporation Plan, we reported the highest level of sales and net income in our history, the fifth consecutive year of gains in both sales and income.

CORPORATE PHILOSOPHY: *Kyosei*

The corporate philosophy of Canon is *kyosei*. A concise definition of this word would be "Living and working together for the common good," but our definition is broader: "All people, regardless of race, religion, or culture, harmoniously living and working together into the future." Unfortunately, the presence of imbalance in our world—in areas such as trade, income levels, and the environment—hinders the achievement of *kyosei*. Addressing these imbalances is an ongoing mission, and Canon is doing its part by actively pursuing *kyosei*. True global companies must foster good relations, not only with their customers and the communities in which they operate, but also with nations and the environment. They must also bear the responsibility for the impact of their activities on society. For this reason, Canon's goal is to contribute to the prosperity of the world and the happiness of humanity, which will lead to continuing growth and bring the world closer to achieving *kyosei*.

CORPORATE GOAL

Fiscal 2005 is the concluding year for Phase II of the Excellent Global Corporation Plan, which the Company began to implement in fiscal 2001. The theme of the next medium-term plan, Phase III, which will begin in fiscal 2006, will be "Toward Healthy Growth," maintaining a high margin structure.

CONTENTS

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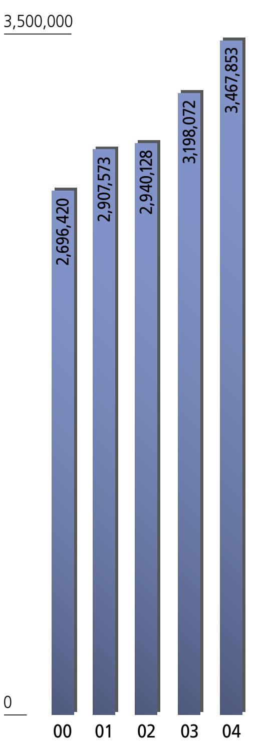
Cover Photo:
Equipped with our original image-processing engine, iR Controller, the imageRUNNER C3220(iR C3220 in some areas) actively manages printing, copying, scanning, and e-mail efficiently, while processing color as well as monochrome images with equal ease. The Multifunctional Embedded Application Platform (MEAP) also allows users to customize their own applications.

FINANCIAL HIGHLIGHTS

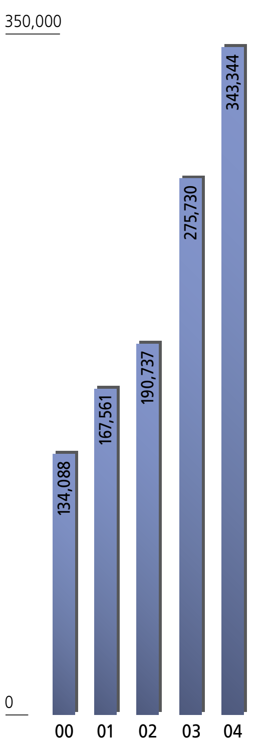
	Millions of yen (except per share amounts)			Thousands of U.S. dollars (except per share amounts)
	2004	2003	Change (%)	**2004**
Net sales	**¥ 3,467,853**	3,198,072	+ 8.4	**$ 33,344,740**
Operating profit	**543,793**	454,424	+ 19.7	**5,228,779**
Income before income taxes and minority interests	**552,116**	448,170	+ 23.2	**5,308,808**
Net income	**343,344**	275,730	+ 24.5	**3,301,385**
Net income per share:				
-Basic	**¥ 387.80**	313.81	+ 23.6	**$ 3.73**
-Diluted	**386.78**	310.75	+ 24.5	**3.72**
Total assets	**¥ 3,587,021**	3,182,148	+ 12.7	**$ 34,490,587**
Stockholders' equity	**¥ 2,209,896**	1,865,545	+ 18.5	**$ 21,249,000**

Notes:
1. Canon's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
2. U.S. dollar amounts are translated from yen at the rate of JPY104=U.S.$1, the approximate exchange rate on the Tokyo Foreign Exchange Market as of December 30, 2004, solely for the convenience of the reader.

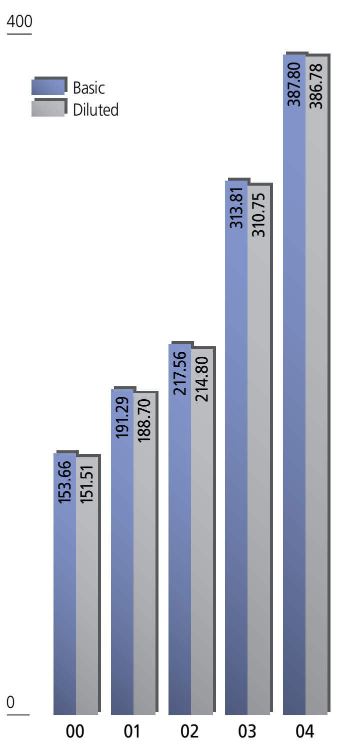
Net Sales
(Millions of yen)



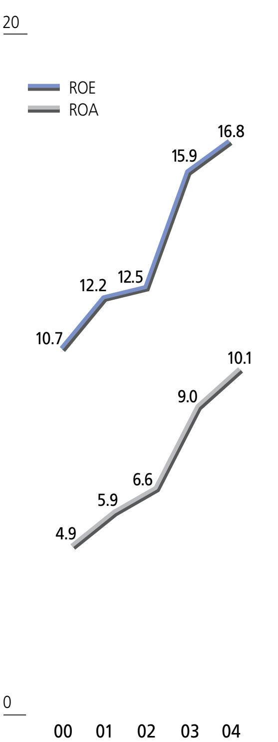
Net Income
(Millions of yen)



Net Income per Share
(yen)



ROE/ROA
(%)



TO OUR SHAREHOLDERS

The global economy was strong in the first half of 2004, driven by ongoing growth in the United States and China. While Asian countries generally reported economic expansion, European nations, for the most part, experienced only moderate growth. The world economy experienced a temporary slowdown in the second half, however, indicated by signs of decelerating growth. The average value of the yen for the year was ¥108.12 to the U.S. dollar and ¥134.57 to the euro, representing a year-on-year increase of 7% against the U.S. dollar, and a decrease of 3% against the euro.

Canon adeptly navigated these conditions to post record earnings and marked its fifth consecutive year of higher sales and profits. Net sales grew 8.4% from the previous year, to ¥3,467.9 billion (US$33,345 million), while net income climbed 24.5%, to ¥343.3 billion (US$3,301 million). We also met our consolidated financial targets for Phase II of our Excellent Global Corporation Plan, covering fiscal 2001 through 2005, ahead of schedule, achieving a shareholders' equity ratio of 61.6% and an debt to total assets ratio of 1.1%.

In addition, we were recognized by the investment community for firmly rooting the objective of further increasing corporate value in all aspects of our business operations, as called for in Phase II. In fiscal 2005, we will work to see Phase II to a successful conclusion while laying a firm foundation for the implementation of Phase III, Toward Healthy Growth, which will get under way in 2006.

Overview of Fiscal 2004

Revenue growth in fiscal 2004 was underpinned by continued sharp growth in sales of digital cameras and color network digital multifunction devices (MFDs) as well as significantly higher demand for semiconductor production equipment. By product segment, sales of business machines advanced 4.1%, to ¥2,388.0 billion (US$22,961 million), sales of cameras climbed 16.8%, to ¥763.1 billion (US$7,337 million), and sales of optical and other products jumped 26.9%, to ¥316.8 billion (US$3,046 million).

During the year, despite ongoing production-reform efforts and the timely launch of competitive, new products, the gross profit ratio declined 0.9% from the previous year, to 49.4%, hurt by the yen's appreciation against the U.S. dollar and heightened price competition.

R&D expenditures grew by ¥16.2 billion and SG&A expenses increased by just 1.3% year on year. As the rate of increase in these expenses was slower than that of net sales, operating profit rose ¥89.4 billion, or 19.7%, to ¥543.8 billion (US$5,229 million). While the appreciation of the yen and more intense price competition were negative factors, we overcame the effects of these through increases in unit volume and other efforts, including production reform and the timely launch of competitive new products. As a result, income before income taxes and minority interests advanced 23.2%, to ¥552.1 billion (US$5,309 million), aided by a ¥14.6 billion improvement in other income. The effective tax rate declined 1.2 percentage points, to 35.1%. Consequently, net income was ¥343.3 billion (US$3,301 million), exceeding the ¥300 billion mark for the first time in the Company's history.

Basic net income per share was ¥387.80 (US$3.73), up ¥73.99 from the previous year. Reflecting its strong financial position, Canon increased the annual dividend by ¥15, to ¥65 (US$0.63).

Aiming to be No. 1 in All Our Main Businesses

To realize the management objectives set for Phase II of our Excellent Global Corporation Plan, we aim to capture the No. 1 position in each of our main business fields worldwide. We have already claimed the top position in the markets for copying machines, laser beam printers, digital cameras, and mask aligners for large LCD panels. In inkjet printers, the PIXMA brand (PIXUS brand in Japan) was successful globally and returned Canon to the No. 1 position in the Japanese market for the first time in eight years. We plan to further strengthen our lineups of photo-quality color printers and MFDs. In semiconductor production equipment, our early launch of new, industry-leading products will strengthen our competitive position in this field.

We are upgrading our R&D capabilities to make our main businesses No. 1 in their respective categories and to create new businesses. We will endeavor to strengthen our concurrent product development structure, and shorten the time required to create and bring new products to the market, while reducing costs. The use of our 3D-CAD infrastructure will allow us to strengthen our capability for simulation, inspection, and measuring technologies significantly and enable us to introduce "prototype-less" development that eliminates the need for building physical prototypes.

Preparing for Future, Sustainable Growth

To cultivate future growth businesses, in October 2004, we established a joint venture with Toshiba Corporation to develop and manufacture surface-conduction electron-emitter display (SED) panels with an eye on gaining a strong foothold in this promising area. The joint venture is now preparing to begin full-scale operations. Moreover, we will work to bolster our infrastructure for the future through the establishment of new facilities, such as a new state-of-the-art technology research center, and a production engineering technology center, whose activities will include plastic injection molds technology development.

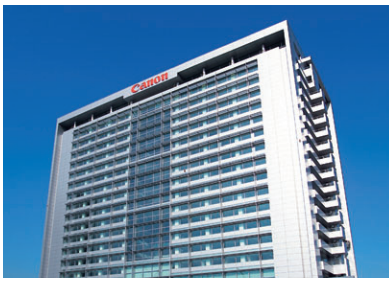
Canon has made concern for the environment one of its top management priorities. One way we do this is to develop products that are environment-friendly throughout their life cycles, from development, production, sales, use, to collection and recycling. Moreover, we readily disclose our environmental information and actively participate in environmental preservation activities.

We will continue to work to improve profitability through implementing a wide range of policies. These will include pursuing further improvements in our innovative production systems, developing and introducing a cutting-edge automated assembly system, and shortening lead times for production as well as optimizing inventories through improvements in our supply chain management systems. We will also promote the manufacturing of key components in-house and reform our procurement processes.

Through these activities, we will strive for further growth and aim to increase Canon's corporate value.

Fujio Mitarai
President and CEO
Canon Inc.

The most important value of a business is the pursuit of profit. It includes profit for the customer who benefits from using our products and profit for local communities that benefit from our job creation, economic vitality, and payment of taxes.



Canon Inc. Headquarters

Fiscal 2005 is the concluding year for Phase II of the Excellent Global Corporation Plan, which the Company began to implement in fiscal 2001. The theme of the next five-year plan, Phase III, which will begin in 2006, will be "Toward Healthy Growth," while maintaining a high margin structure.

Canon's Approach to Management: Our Management Strategy

Canon aims to create new technologies and entire new genres of products, and through their commercialization, make new contributions to people and communities around the world. Moreover, our management stance emphasizes fair and sincere business operations conducted in full respect of all laws.

The most important value of a business is the pursuit of profit. This does not mean, however, simply pursuit of financial profits for the company. It includes profit for the customer who benefits from using our products, and profit for local communities that benefit from job creation, economic vitality, and payment of taxes. Of course, generating sufficient financial profit to return a portion to our shareholders and to the community is essential. This is the meaning of our corporate philosophy, *kyosei*.

Based on this fundamental management strategy, Canon has taken initiatives under the Excellent Global Corporate Plan Phase I, launched in 1996, to implement management innovation. The objective of this plan has been to become a corporation worthy of admiration and respect worldwide. The plan addressed such key issues as focusing on profitability and overall optimization, leading us to embark on innovation in production and other areas. We believe this innovation will lead to sustainable corporate growth, which is essential for enhancing corporate value.

In 2001, we began to put Phase II into action. Canon already has 184 consolidated subsidiaries around the world and employs more than 108,000 people. But, to become a "Truly Excellent Global Corporation," we believe it is essential "to secure the No. 1 position worldwide in all core business areas," "build up R&D strength capable of continually creating new business," "achieve a strong financial position" and "foster a corporate culture wherein all employees work

Excellent Global Corporation Plan

Vision

In accordance with the *kyosei* philosophy, Canon will continue contributing to society through technological innovation, aiming to be a corporation worthy of admiration and respect worldwide.

Goals

1. Becoming No. 1 in the world in all of Canon's major areas of business
2. Maintaining the R&D capability to continually create new business
3. Keeping a strong financial structure for the Group as a whole that can operate and handle long-term investment without borrowed capital
4. Having all employees enthusiastically commited to achieving their ideals and taking pride in their work

Change in Thinking
- Pursuit of overall optimum results
- Shift to profit focus

Advancement of Consolidated Management
- Implementation of the Consolidation Planning and Measurement System (1997)
- Consolidated financial results by Product Group Operation
- Performance evaluations for each Product Group Operation

Four Purposes of Companies
- Stability of livelihoods of employees
- Returns to shareholders
- Contributions to society
- Investment for continued existence

Pursuit of Company Innovation
- Cash-flow management
- Withdrawal from unprofitable business

Production Reform
- Upgrade to cell production from belt conveyor system
- Foster multi-skilled production employees
- *Chie*-tech (wisdom-tech): Customize tools yourself
- Implementation of the just-in-time concept

Development Innovation
- 100% implementation of 3D-CAD
- Establish Color Technical Center and Color Stadium
- Undertake "no-prototype production"

Sales Innovations
- Restructure and consolidate marketing subsidiaries
- Emphasize solution business
- Construct Pan-European business system
- Strengthen business in China and other parts of Asia

New Diversification
- Development of new business at headquarters
  Enhancement of basic research
- Group diversification
  Individual Group companies strengthen their own business
- Global diversification
  Establish a three-regional-headquarters global management system

Canon began the development of SED technology in 1986. To accelerate its commercialization, we formed a joint venture with Toshiba Corporation in 2004.

ardently to acheive the company's goals." These four goals are the heart of Phase II and enable us to maintain and further develop a corporate culture that encourages us to pursue new challenges.

Under Phase II, we invested aggressively in platform technologies, including simulation, analysis and measurement technologies, and brought in-house the manufacture of key devices, such as CMOS sensors. Along with this, we invested in our corporate infrastructure. As a result of such measures, all of Canon's products are highly competitive, enabling us to stay ahead of the trend toward digital products. We also accelerated business diversification. To commercialize the surface-conduction electron-emitter display (SED), we formed a joint venture with Toshiba Corporation in 2004. Canon is now making preparations for mass production of SED products.

Canon's digital SLRs and lenses can be seen in action at many sports events, including the UEFA EURO 2004™.

Our most important policies in 2005 will be the following:

1. Further reduction in costs through the integration of development and production
2. Completion of a global sales system suited to the new era
3. Creation and strengthening of next-generation businesses
4. Further improvement in technological development capabilities, which is the source of profitability
5. Improvement of Canon's corporate infrastructure
6. Development of human resources and strengthening of compliance systems

Our Brand Management Strategy

For us at Canon, our brand is evidence of the trust that we have won over the years, and brand management is equivalent in meaning and scope to management itself. In other words, the Canon brand is the crystallization of the trust—our most valuable asset—that we have earned over the more than 60 years since the Company was established. We believe the brand should be a source of pride for Canon employees and an integral part of our corporate culture. Since its establishment, Canon has focused on technologies and worked to nurture new technologies while creating innovative and diverse products. This innovativeness is the core support of Canon's corporate culture. In our brand management basics, we encourage our customers to feel pride in Canon products because of their excellent features, performance, reliability, and design.

Along with product excellence, we emphasize winning and maintaining the trust of society as another major aspect of our activities to build an ever-stronger brand. We are convinced that such important initiatives as environmental preservation, compliance with laws and regulations, corporate governance, and social responsibility all contribute to the value of the Canon brand. We believe that implementing management policies based on innovation and *kyosei* will contribute to creating an even stronger brand.

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Canon has been implementing various measures to improve its corporate governance. In addition to our board of directors and board of corporate auditors, Canon Inc. has also upgrated its system for internal auditing to promote the further development of its corporate governance.

Canon's Management Systems: Our Corporate Governance Structure

Canon, recognizing the extreme importance of bolstering management supervision functions aimed at increasing management transparency and achieving management objectives, has been implementing various measures to improve its corporate governance. In this manner, we are striving to continuously elevate the Company's corporate value.

In creating our corporate governance structure, we have not adopted the approach of appointing independent, external directors for a number of reasons. Chief among these is that since its founding, Canon has relied on Guiding Principles focusing on the "Three Selfs" concept, known as the "Three Js" in Japanese: *Ji-hatsu*, or self-motivation to do every job right; *Ji-chi*, or self-management; and *Ji-kaku*, or self-awareness of one's working environment and responsibilities. Group employees understand these forward-looking concepts and put them into practice daily in their work. We therefore believe that appointing directors from among Canon personnel, who have followed the same codes of behavior and have been subject to close scrutiny within the Company over many years, allows these carefully chosen members of management to implement corporate governance effectively. Also, to assure the functions commonly associated with outside directors, we require all directors to undergo a thorough program of compliance education.

Implementation of Corporate Governance Measures

In addition to our board of directors and board of corporate auditors, Canon Inc. has also created an original system of internal audit for the further development of its corporate governance.

Corporate Directors and Cross-Company Management Strategy Advisory Committee

There are 27 directors on the Company's board, as of the end of December 2004. In order to realize a more streamlined and efficient management decision-making process, Canon has not adopted an outside director system. Under the current system, as a general rule, all matters of importance are decided at board and management meetings attended by all directors. Moreover, various cross-company management strategy advisory committees have been established to address important management themes. Each committee serves to accelerate and rationalize the decision-making process while supplementing and checking the business-operations system.

How Canon Is Evaluated

Canon is evaluated highly around the world. For example, Canon placed 30th in the *Fortune* magazine ranking of the world's most respected companies, issued in February 2005. This was the second consecutive time for Canon to be included among the top 50 companies in the *Fortune* ranking, having ranked 34th in 2004.

Canon also placed among the world's top 100 companies in the *Business Week* magazine ranking of the world's top 1,000 companies, which was issued in July 2004. *Business Week* listed Canon's corporate value at $36.6 billion and ranked Canon as number 89. Among Japanese companies in this ranking, we have moved from 16th in 2002 to 9th in 2003, and then to 4th in the most recent ranking for 2004. In the ranking of the world's most respected companies and top managers issued by the *Financial Times* in November 2004, Fujio Mitarai, President and CEO of Canon, placed 10th and Canon received a ranking of 25th.

Canon has also received high evaluations from international and domestic financial rating agencies. Standard and Poor's has upgraded its rating of Canon's long-term debt to AA, as shown at right, and Moody's Investors Services reviewed and increased its long-term rating from Aa3 to Aa2 in 2004.

Current ratings are as follows:

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

Board of Directors *(as of December 31, 2004)*

President & CEO

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

Kinya Uchida
President & CEO, Canon U.S.A., Inc.

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; Senior General Manager, 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

Kunio Watanabe
Group Executive, Corporate Planning Development Headquarters

Ikuo Soma
Chief Executive, Office Imaging Products Operations

Hironori Yamamoto
Group Executive, Core Technology Development Headquarters

Directors

Yoroku Adachi
President & CEO, Canon (China) Co., Ltd.

Yasuo Mitsuhashi
Chief Executive, Peripheral Products Operations

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
Group Executive, Global Manufacturing Headquarters

Masahiro Osawa
Group Executive, Global Procurement Headquarters

Keijiro Yamazaki
Group Executive, Information & Communication Systems Headquarters

Shunichi Uzawa
Group Executive, SED Development Headquarters; President, SED Inc.

Masaki Nakaoka
Deputy Chief Executive, Office Imaging Products Operations

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

In January 2004, we established new standing committees, namely the Corporate Ethics and Compliance Committee and Internal Control Committee, with the president appointed as chairman of both groups. Accordingly, the purpose of the Corporate Ethics and Compliance Committee is to examine, from various viewpoints, Canon's social responsibilities and to convey the findings to the Company with the intention of raising compliance and ethical awareness.

The Internal Control Committee not only serves to ensure the reliability of the Company's financial reporting in accordance with the Sarbanes-Oxley Act, but also aims to ensure the effectiveness and efficiency of our business operations, as well as compliance with related laws, regulations and internal controls. The committee performs reviews of control systems for the entire Canon Group and has documented control activities related to the Company's operations. Subsequently, the committee will evaluate and bolster documented internal-control processes and, at the same time, intensify efforts targeting more efficient operation processes.

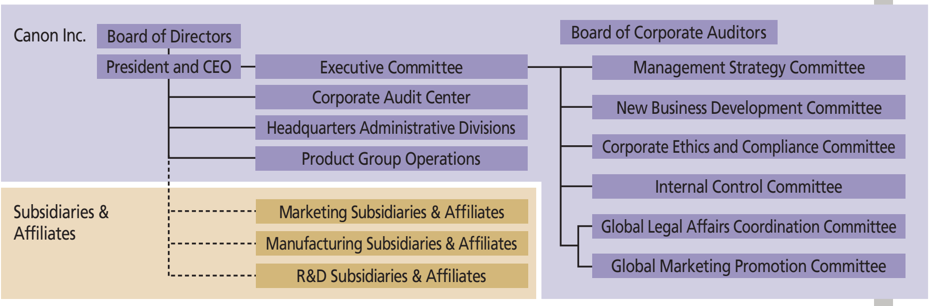
Corporate Auditors and Internal Auditing

Canon's Board of Corporate Auditors consists of four members, two of whom are outside corporate auditors. In accordance with the Board of Corporate Auditors' auditing policies and their assigned duties, the auditors attend board, management, and various committee meetings, listen to business reports from the directors and others, carefully examine documents related to important decisions, and conduct strict audits of the Company's business and assets.

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 reinforce 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 accounting firms and the company before they are entered into.

Furthermore, 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. The various relevant administrative divisions also work very closely with the Corporate Audit Center to inspect such areas as quality, environmental issues, information security, and physical security.

Canon Governance Structure *(as of December 31, 2004)*



Information Disclosure

Disclosing accurate, fair, and timely information on management, business strategy, and financial results to capital markets is a top priority at Canon. The objective of these IR activities is to gain the trust of capital markets and improve the corporate value of Canon. IR functions are carried out based on Disclosure Guidelines, which are rules for information disclosure to capital markets intended to help the Group achieve these goals.

Some of the regularly conducted IR tasks of the Group include briefings to securities analysts and institutional investors on quarterly financial results, briefings on management policies given by the President and CEO and updates on business strategies. IR operations have also been established in Europe and the United States to respond quickly to the needs of foreign investors (51.7% of all shareholders at the end of 2004) in all regions. On the Canon website, corporate information is made available not only in Japanese, but also in English to the extent possible, including audio and video information as needed.

We carefully observe rules relating to information disclosure, strictly controlling undisclosed information and preventing the possibility of insider trading. Further, outside evaluations of Canon from the capital markets are reported within the Group whenever useful to management and operations. The Security Analysts Association of Japan selected Canon as the top company in the Japanese electric and precision machinery industry category in its 2004 ranking of company disclosure.

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

Section 303A of the NYSE listed Company Manual (the "Manual") provides that companies listed on the New York Stock Exchange (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 *Kabushiki-Kaisya* (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. However, unlike the NYSE Corporate Governance Rules, 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 a 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 the Company to have specified committees, including those that are responsible for director nomination, corporate governance

and executive compensation.
The Company's board of directors nominates the candidate for directorship and submits a proposal at the shareholders' meeting for shareholder approval. Pursuant to the Code, the shareholders then vote to elect directors at a general shareholders 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 shareholders meeting respectively, unless the amount or calculation method is provided under the Articles of Incorporation. As the Articles of Incorporation of the Company stipulates 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 plans to avail itself of paragraph (c)(3) of Rule 10A-3 of the 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 (4) corporate auditors, although the minimum number of corporate auditors required pursuant to the Code and the Special Exception Law is three (3).

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 the 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, at least one of the corporate auditors of the Company must be an "outside" corporate auditor. This is an individual who has not been a director, executive officer, manager, or employee of the Company or its subsidiaries for five-years prior to the date of appointment as an outside corporate auditor. There are four (4) members on the Company's board of auditors, two (2) of whom are outside corporate auditors. As of the date of the general shareholders meeting of the Company relating to the fiscal year ending December 31, 2005, in accordance with the amendment of the Special Exception Law, more than half of the members of the board of auditors of the Company must be outside corporate auditors. From the same date, the five year period referred to above will also be amended so that it will be prohibited for an outside corporate auditor to have ever been a director, executive officer, manager, or employee of the Company or its subsidiaries. The Company's current corporate auditor system meets these new 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, the Company is only required to obtain shareholder approval if the Company 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, the Company is required to obtain approval by special resolution (as defined in the Code) at the general meeting of shareholders. The Company currently has not adopted any stock option compensation plans.

We at Canon view technology as the origin of our profit. Looking to Canon's development from 2010 through 2020, we are working to identify fields for further growth.

Fujio Mitarai

Our Approach to R&D

Phase II of our Excellent Global Corporation Plan, a blueprint of long-term management objectives to be met in 2005, contains four goals, one of which is "building up R&D strength to enable Canon to continually create new business opportunities." We at Canon view technology as the origin of our profit.

In fiscal 2004, research and development expenses totaled ¥275.3 billion, an increase of ¥16.2 billion from the previous fiscal year, corresponding to 7.9% of consolidated net sales. Because the sales growth rate exceeded growth in research and development expenses, the ratio of such expenses to net sales declined compared with fiscal 2003. Looking at figures for individual business segments in fiscal 2004, investment in business machines was ¥120.9 billion, or 43.9% of total research and development expenses, while investment in cameras was ¥35.5 billion, or 12.9%.

Investment in optical and other products was ¥29.4 billion, or 10.7%, and basic R&D that cannot be allocated by business segment was ¥89.5 billion, or 32.5%.

Our emphasis on research and development has yielded significant benefits.

Architect's drawing of a new state-of-the-art technology research center

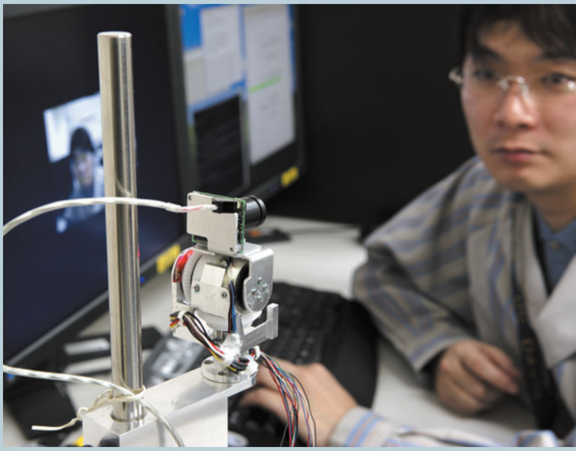
One of these benefits is a wealth of intellectual property, as attested to by the number of patent registrations held. Canon typically pursues 140-150 development themes at any one time.

In 2004, the Company's research and development efforts resulted in the registration of 1,805 patents in the United States (according to figures announced by the U.S. Department of Commerce), thus ranking Canon third, and the Company continued its 13-year winning streak of finishing among the top three patent registrants.

Canon has designated the following five fields as its imaging engines:

1. Image-capturing engines, such as those in cameras
2. Electrophotographic engines, such as those in copying machines and laser beam printers
3. Inkjet printing engines, such as those in inkjet printers
4. Photolithographic engines, encompassing optical and precision technologies
5. Display engines, which will mark out entry into a new field

In the fifth area of display engines, Canon has developed an SED (surface-conduction electronic emitter display) and is now concentrating its efforts on commercializing SED panels. SEDs will make it possible to meet the growing market demand for even larger, high image quality display screens that offer brightness and high image resolution comparable with cathode ray tubes but with a thin profile.



The Robotics Eye, now under development at Canon is a cutting-edge sensor that can recognize and track human faces.

Our R&D Structure

Canon carries out research and development at worldwide R&D centers, with bases in each region possessing their own particular core technologies. Canon promotes cooperation among its global network of research and development centers in all areas, from basic research to product development. In Japan, the centers carry out basic R&D in such areas as nanotechnology and biotechnology and, moreover, each business unit has research and development centers that engage in product development.

Another important feature of Canon's research and development is its emphasis on environmental issues.

In 2004, Canon positioned its Leading-Edge Technology Development Headquarters with the aim of creating core technologies that will give birth to next-generation, major businesses. As the next step in this process, we will complete a new state-of-the-art technology research center at the Canon

Headquarters in Shimomaruko, Tokyo in 2005. In 2004, we built a new inkjet printer development laboratory in Japan. We plan to open a production engineering technology research center with the aim of accelerating the development of production engineering technologies and moving toward even higher levels of automation and fully unmanned facilities.

In Europe, building on its advanced technology development, Canon has achieved solid results in developing solutions, including the creation of sophisticated customized tools for digital MFDs. In the United States, in addition to advanced development using Extensible Markup Language (XML) in the area of basic research, we have worked to develop solutions that facilitate the linkage of XML digital products with networks. In Australia, we have established a strong track record in the development of digital image processing technologies, while in Asia we have focused on developing technologies and software that address user needs in each country and region in terms of language, ethnicity, and culture. Canon also engages in cooperative research worldwide with industry, academia, and government.

Top 10 Corporations Receiving U.S. Patents in 2004
(Preliminary count)

Rank	Organization	Number of Patents
1	IBM	3,248
2	Matsushita Electric	1,934
3	Canon	1,805
4	Hewlett-Packard	1,775
5	Micron Technology	1,760
6	Samsung Electronics	1,604
7	Intel	1,601
8	Hitachi	1,514
9	Toshiba	1,310
10	Sony	1,305

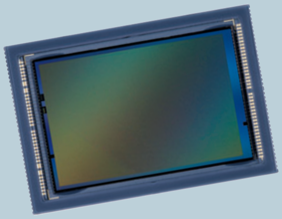
(Source:United States Patent and Trademark Office)


Our prototype-less design is made possible by our 3D-CAD infrastructure.

Research and Development Focal Points and Future Steps

Canon is centering its production and development reforms on prototype-less designs and common platforms. In our prototype-less design, which is based on a cutting-edge 3D-CAD infrastructure, we are drawing fully on simulation, analysis, and measurement technologies to shorten product development lead times and reduce costs. All the process improvements we develop in this area will then be employed throughout Canon's business domains.

Another of our activities to speed up development is concurrent engineering. Our Toride Plant in Japan, which is due for completion in 2005, will house our top-of-the-line copying machine manufacturing operations. All aspects of these operations, from design through prototypes, full production, quality assurance, and delivery functions are scheduled to be located in the same new building at the Toride Plant.


CMOS sensors sustain Canon's strong competitive position in digital SLR cameras.

In addition, Canon takes a proactive stance toward cooperating with other companies rather than relying exclusively on internal development to boost research and development efficiency.

Canon's Worldwide R&D Centers

Canon is driving forward with efforts to reduce its ratio of costs to sales. To attain this goal, Canon is closely coordinating product development, production engineering technology, and manufacturing technology.

Fujio Mitarai

First Step in Production Reform: Cell Production System

Canon attained a consolidated gross profit ratio of 49.4% in 2004 as a result of production reforms inaugurated in 1998 aimed at cost reductions.

Canon's production reforms started with the introduction of the cell production system, thus eliminating the inefficiency of conveying goods in process on a conveyor belt, and allowing each worker to make adjustments and perform tasks flexibly according to his or her own ability.

By autumn 2002, an aggregate 12-plus miles of conveyor belts had been removed from 54 operations, and the cell method is now in place in all plants. In addition to reducing inventories, its introduction has cut annual carbon dioxide emissions by about 75,000 tons.

This system makes it possible to lower costs and increase efficiency while also responding flexibly and quickly to the market needs of specific regions. Through the adoption of the cell production system, Canon has been able to move forward even more aggressively with its ongoing policy of selecting optimal locations for its manufacturing activities.

Optimum Worldwide Production

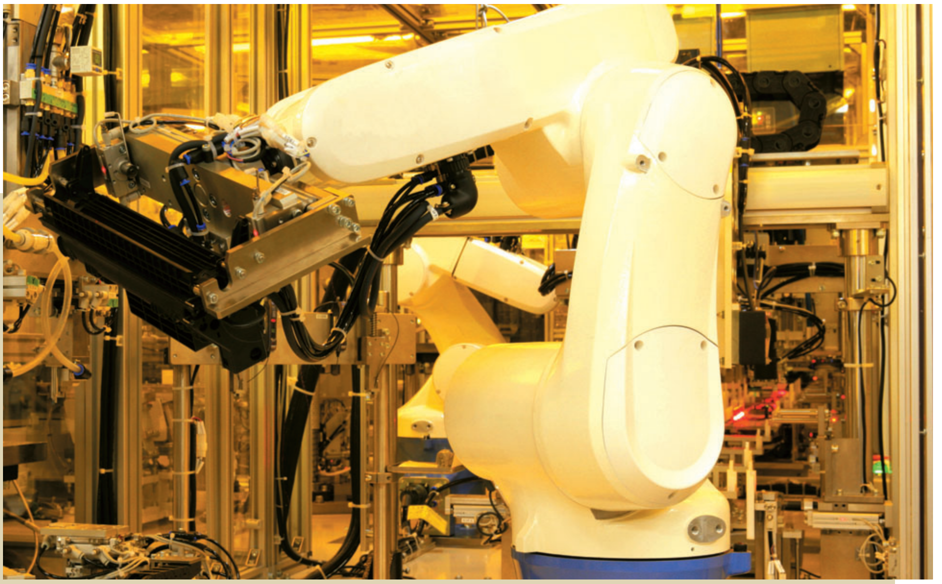
In 2004, production outside Japan accounted for about 42% of total production. Going forward, Canon plans to maintain this level, even as production continues to expand. To this end, Canon will emphasize expanding its production in Japan and apply its own original manufacturing know-how. Specifically, this means that even though Japan's labor costs are high, it is possible to achieve close coordination of development and production in Japan, facilitating the easy, timely, and fast procurement of key, high-valued components because they are produced in Japan, and that it is possible to lower costs through further automation.

To expand output of high-value-added products in Japan, in November 2004, we began production at the new plant at Oita Canon, Inc. Because this new plant was designed without internal pillar supports, it is possible to change cell production system layouts flexibly and respond to changes in market demand. The new Oita plant will have an annual combined production capacity of 6.8 million digital camera and video camera units. In 2005, we are scheduled to bring on line a new copying machine production facility at our Toride Plant. These activities will conclude our drive to upgrade our production infrastructure as quickly as possible for the time being.

At present, Canon's production facilities in China and other countries in Asia are positioned as bases for exporting products. However, in the near future, these countries may experience rising labor costs and thus may lose their comparative cost advantages. On the other hand, looking ahead, these countries may well become even more attractive as major markets. Amid these fast-changing global business conditions,

Canon's cell production system is now around the world, including this facility of Canon Bretagne S.A.S. in France.

The absence of internal pillar supports makes flexible cell production system layouts possible at the new plant at Oita Canon, Inc.



An automated assembly system for toner cartridge production

we believe we must relentlessly improve quality and reduce costs by closely coordinating product development, production engineering technology, and manufacturing technology to continue to grow our operations.

One of the ways we are going about doing this is by shifting the production of parts and devices in-house. In addition to CMOS sensors and other key parts and key devices, we are moving to bring in-house the production of manufacturing equipment and molds. In 2004, through the acquisition of Igari Mold Co., Ltd., which has state-of-the-art plastic injection molding technology, we were able to strengthen the Canon Group's technological capabilities in this area.

Cost Reduction through Coordination of Development and Production

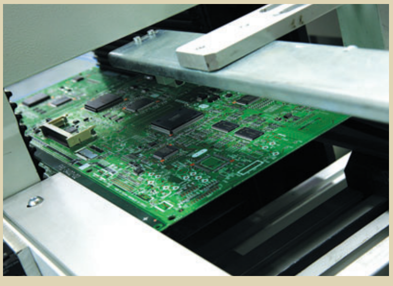
The first initiative directed at further cost reduction is to introduce "prototype-less design." This will have a major positive impact on costs. The prototype-less design infrastructure will accelerate sophisticated information sharing between development and production, thus advancing Canon's drive toward concurrent engineering. Through these activities, we will be able not only to eliminate the costs of building prototypes and losses incurred in production start-up, but also to reduce the lead times required for introducing new products.

Reforms in Procurement

Canon's second initiative is to reform its procurement activities. Accordingly, we are promoting such measures as processes to reduce costs from the development stage and consolidating purchasing by means of unified guidelines. Through the fair assessment of suppliers and parts based on EQCD (Environment, Quality, Cost, Delivery) considerations and competition, we aim to increase the number of outstanding suppliers with high technological capabilities. This will contribute to improved quality, enabling us to move closer to realizing our goal of an inspection-free procurement process.

Automation of Assembly Operations

Canon's third initiative is to reform its production activities by working toward full automation of assembly operations. We have already begun specific initiatives in this area. Canon operated automated assembly systems at some plants, including Oita Canon Materials, Inc., which manufactures toner cartridges. For further improvement in this area, Canon intends to shift to fully automated and unmanned assembly systems. We will be able to minimize costs and prevent the outflow of Canon technology by manufacturing equipment for these fully automated assembly systems internally. For the development of next-generation production engineering technology, Canon will concentrate its production engineering technology- related divisions in a center in Kawasaki.



Canon manufactures circuit boards.

Canon's Worldwide Production Sites

Canon is nearing the completion of structural reforms in its sales companies around the world. Going forward, we believe we will reap the full benefits of these reforms through enhanced sales power and efficiency. —— *Fujio Mitarai*

Canon's Global Sales Structure for the New Era

In 1955, Canon's international deployment began with the establishment of a branch in New York, which was followed in 1957 with a sales branch in Europe.

We now have 98 consolidated marketing subsidiaries worldwide. Canon sells its products mainly through these subsidiaries, each of which takes responsibility for serving a defined geographic territory. Each also undertakes its own market research, and determines its sales channels and advertising and promotional activities.

Canon is presently implementing a global sales headquarters system divided into five regions. Under this system, the head office provides general supervision to reinforce the operations of marketing companies in the Americas, Europe, Asia outside Japan, Oceania and Japan.

The Americas

Consolidated sales in the Americas amounted to ¥1,059 billion (US$10,187 million).

Headquartered in New York, Canon U.S.A., Inc. markets an extensive product line and digital solutions that enable businesses and consumers in the Americas to capture, store, and distribute information. In 2004, initiatives to strengthen marketing capabilities included further enhancing relationships with leading dealers and retailers.

In the office imaging products field, sales of color machines doubled over the previous year, and monochrome copying machines maintained the No. 1 brand position in all subsegments for the third consecutive year. Among consumer products, sales of digital cameras continued to record rapid growth. Looking forward, in 2005 and subsequent years, we expect to draw on our human and capital resources to acquire promising technologies and products in the region.

Canon is actively developing business activities in Russia.

Europe

Canon Europe's 2004 consolidated net sales were ¥1,093 billion (US$10,512 million). By geographic area, sales in Europe exceeded those in the Americas and became our largest market. At present, Canon Europe employs more than 12,000 people across 19 countries.

In 2004, 10 countries were newly admitted to the EU, bringing the total membership to 25. The market growth in Eastern Europe and Russia contributed to the European market's expansion. In November 2004, following approximately two years of development work, we began the operation of our pan-European integrated information system. The capabilities of this system are extensive and include not only accounting and personnel matters, but also logistics, sales, and our copying machine service business. We anticipate this system will contribute to consistency, uniformity, and transparency as well as faster decision making. Over the next two years, we plan to introduce this system in all our sales companies in Europe.

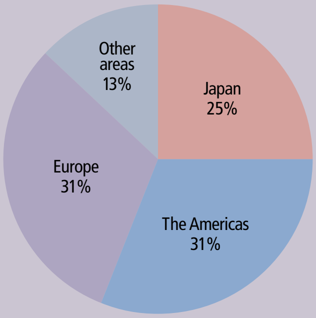
A *Canon Corner* at a Staples office supply store in the United States

Moreover, we moved forward with the consolidation of our logistics activities with the goal of implementing a pan-European distribution structure.

Japan and Asia, Oceania

By geographic segment, sales in Japan amounted to ¥850 billion (US$8,171 million) and Other areas reported sales of ¥465 billion (US$4,475 million).

Sales by Region (2004)



Deleted due to portrait rights.

Canon's solution offerings successfully won ING as a customer, and Canon has supplied more than 3,000 MFDs to ING in Europe.

The reorganization of the Group's sales companies in Japan, with Canon Sales Co., Inc. as the core company, is going forward with a view to the overall optimization and reinforcement of each Group company's competitiveness. Canon Sales has increased its sales and profit to record highs and has also significantly improved its financial position.

Boosted by market expansion, our operations in China have also seen higher sales. Ahead of the lifting of prohibitions on domestic sales in China in 2005, preparations in 2004 included the expansion of sales operations to 15 branches to strengthen the Canon (China) Co., Ltd. marketing network, as well as the installation of a distribution network. We can now make deliveries anywhere in China within two business days. Other Asian operations, excluding those in Japan, also marked high growth.

A camera sales store in Shanghai

Canon has opened sales branches in China, including fast-growing Shenzhen.

In Australia, sales and profits rose as the country continued to enjoy stable economic growth. We have been successful in expanding sales of inkjet printers, and sales of printer supplies have increased markedly.

Globally Responding to the Voice of Our Customers

To support our customers for consumer products around the world, we are proceeding with the introduction of our Web Self-Service System (WSSS). WSSS, created by Canon Inc., contains all the information needed for service support and is linked to the websites of our sales companies in all parts of the world. As of December 2004, this system was being accessed about four million times a month in the United States, Canada, Latin America, Singapore, Australia, China, and Japan. Links to the European region will begin in 2005.

In addition, as one method of gathering information from our customers, we developed and initiated use of our Call Analysis Tracking System (CATS), which globally collects information from each of our call centers, allows sharing of information among Canon and its sales companies, and efficiently provides feedback to our R&D and production departments, and sales companies.

Sales Network of Canon (China) Co., Ltd.

Canon's Worldwide Sales & Marketing Sites

The various activities that constitute the exercise of corporate social responsibility (CSR) are exactly what we at Canon mean by *kyosei*. By conducting activities based on the philosophy of *kyosei*, Canon is actively fulfilling its social responsibilities. —— *Fujio Mitarai*

Canon's Approach to CSR

Canon formally introduced its corporate philosophy of *kyosei*—"living and working together for the common good"—in 1988. The concept, partially embodied in the beliefs of Canon's founders, is that the Company should thrive in conjunction with the many communities where it operates and through contributions to society at large. *Kyosei* is the concept of working for the common good together with all races, religions, and cultures with an eye toward harmonious living both now and into the future. In other words, the overriding objective of *kyosei* is to create a sustainable society.

In 1996, Canon embarked on its "Excellent Global Corporation Plan," based on the philosophy of *kyosei*. The aim of this plan is not simply to increase sales and expand business operations, but to improve corporate value to the level necessary to ensure sustainable growth.

The foundation for our sustainable growth consisted of maintaining excellent relations with stakeholders, such as shareholders and investors, customers, employees, suppliers worldwide, and the local communities where we operate. At the same time, we are committed to fulfilling our social responsibility and fully understand the importance of improving the transparency of management and strengthening our systems for legal compliance. Continuing efforts in the area of governance help to ensure that Canon achieves its management goals.

Corporate enterprises, particularly manufacturers such as Canon, play a vital role in furnishing the products and services that enrich lives, promote happiness, and enhance convenience for consumers worldwide. At the same time, Canon is firmly committed to building a sustainable world that alleviates the burden on the global environment, and to balancing economic and environmental needs in the manufacturing and marketing of its products.

Encouraging Employee Initiatives

To realize its aim of becoming a truly excellent global corporation, Canon requires each and every employee to be a truly excellent person. At the same time, in its role as an employer, Canon is in full compliance with local laws, cultural norms, and standards for the workplace environment.

The Canon of today grew out of broad-minded and expansive thinking, and an enterprising temperament. To keep this corporate climate fully alive and well, the Company is careful to respect the individuality and foster the capabilities of all its employees. All are encouraged to realize their ambitions, and Canon fairly compensates personnel who have striven to improve their skills and achieve their goals. Building an excellent company requires providing the opportunities for each employee to make the most of his or her true capabilities. Amid an environment where a just and fair evaluation of each employee's work is guaranteed, Canon makes available a vast array of training programs to support the development of employees with special skills. Also, at Canon Inc. training programs are provided for managerial personnel to help them improve their personnel development skills.

©WWF-Canon/Martin HARVEY

Canon is assisting the WWF in digitalizing its priceless collection of photographs.

Canon and all of its managers and employees recognize the importance of abiding by the law and adhering to corporate ethical principles. Canon fosters a corporate culture that takes the law and corporate ethics fully into account in all of its activities and focuses on enhancing visibility and soundness in all of its endeavors.

Canon places importance on enhancing the role of women in the workplace and fostering the career goals of its female employees. For example, Canon Inc. has established a reemployment system for working mothers and a part-time employment system for employees who must care for their children and/or senior family members.

Moreover, Canon makes concerted efforts to create mutually supportive environments for the physically challenged. The Company raised the percentage of people with physical disabilities among its employees to 1.8% in 2004.

Contributing to Society

In every corner of the globe, Canon is responding to the needs of society with social contribution activities based on the philosophy of *kyosei*.

One of the prize-winning entries in the UNEP International Photographic Competition on the Environment 2004-2005

Canon technology is used for educational purposes, including providing expanded access to the wonders of Yellowstone National Park.

Policy on Social Contribution Activities

With the corporate philosophy of *kyosei* ever in mind, Canon makes social contributions a natural part of its business activities, while striving to fulfill its responsibilities in various areas as well. In addition to making social contributions through business, we are striving to help people around the world enjoy richer lives by acting as a good corporate citizen in the following six areas: conservation of the environment, social welfare, local communities, education and science, art, culture and sports, and humanitarian aid and disaster relief.

Goals

- Provide ongoing support to people and organizations in need
- Carry out a range of support activities in cooperation with partner organizations that have diverse values and expertise
- Effectively apply Canon's internal resources accumulated over many years, including employee skills, funds, facilities, and technical know-how

One of our latest activities on a global scale in 2004 has been a joint sponsor of the fourth United Nations Environmental Programme (UNEP) photographic competition, "Focus on Your World." Canon has acted as sponsor of this event since 1991. The awards for the 2004 competition were presented at the EXPO 2005, Aichi, Japan.

Eyes on Yellowstone Is Made Possible by Canon

Eyes on Yellowstone is a collaborative ecological research and teaching initiative between Canon U.S.A., Inc., a subsidiary of Canon Inc., the Yellowstone Park Foundation, and Yellowstone National Park. The program was established to fund important scientific research and break new ground in conservation, endangered species protection, and the application of cutting-edge science and technology essential for the management of park wildlife and ecosystems. Another element of the program is increased public access via the Internet to the wonders of Yellowstone. *Windows into Wonderland* (URL: http://www.windowsintowonderland.org/) showcases electronic field trips, with images shot with Canon digital camcorders and digital cameras.

The fundamental concept that aims to maximize resource efficiency has been defined by the Factor 2 concept. By 2010, Canon plans to double the efficiency of all its activities in comparison with 2000, while cutting the environmental burdens associated with its businesses. —— *Fujio Mitarai*

Environment-Conscious Management and the Canon Environmental Charter

The Canon Environmental Charter was enacted in 1993 to enunciate basic concepts and policies for protecting the environment under Canon's corporate philosophy, *kyosei*, and the EQCD concept*1, which stands for environment, quality, cost, and delivery. In 2001, the charter was revised to incorporate concepts for "maximization of resource efficiency"*2 based on the conviction that the environment and the economy are mutually sustainable through new technologies and healthy social mechanisms in the community.

In 2003, having further honed its ideas, Canon devised Factor 2, an overriding indicator for achieving environmental targets. This indicator also provides a visionary goal for the year 2010. One aim of Factor 2 is to more than double resource efficiency throughout the life cycles of products within 10 years, from 2000 to 2010.

Canon fully recognizes its responsibility as a manufacturer to focus on the product life cycle and alleviate the environmental burden. This concept is embodied in Factor 2 as the ultimate means for counteracting environmental degradation. Based on these ideas, Canon has set a goal of achieving a 25% reduction in CO_2 emissions related to sales from the 2000 level.

*1 EQCD concept
Environment (environmental assurance): Companies are not qualified to manufacture goods if they are incapable of environmental assurance.
Quality: Companies are not qualified to market goods if they are incapable of producing quality goods.
Cost, Delivery: Companies are not qualified to compete if they are incapable of meeting cost and delivery requirements.

*2 Maximization of resource efficiency
"Achieving maximum efficiency in the use of resources—in other words, offering the highest quality standards for products and services, while minimizing resource consumption and practicing reuse and recycling. The key objective is to add as much value as possible, using as few resources and as little energy as possible.

Canon's Environmental Burden

Canon's business activities commence with the receipt of raw materials and components from its suppliers. The Company assembles these materials and components into products that it then ships to sales subsidiaries and other firms. Following customer use, products are recycled to the extent possible, and parts are reused. The following paragraphs describe Canon's concern for the environment in regard to the life cycles of its products.

Procurement of Materials and Components

Canon instituted its "Green Procurement" program in 1997. Moreover, Canon took the initiative in establishing the Japan Green Procurement Survey Standardization Initiative (JGPSSI), which prepares material declaration guidelines. With major electronics industry associations in the United States (the EIA) and Europe (the EICTA), JGPSSI is setting global standards for material declarations.

At most of its plants worldwide, Canon has installed equipment to analyze the materials it procures, and, in anticipation of the implementation of the European Directive Restriction of the use of certain Hazardous Substances in electrical and electronic equipment (RoHS), has conducted on-site confirmations of the facilities of its suppliers.

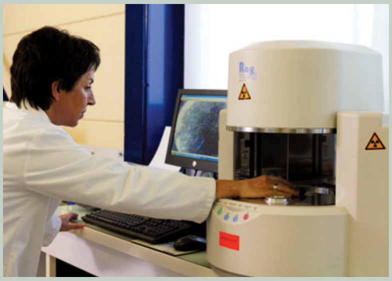
Canon personnel conducted on-site verifications at the plants of its suppliers to confirm lead-free operations in Suzhou, China.

Research and Development

As a regular part of the "prototype-less" product development process, the design information in Canon's 3D-CAD systems is checked automatically for environmental attributes. This includes suitability for recycling, environmental impact (LCA/LCC), and the environmental qualities of its parts. In addition, the elimination of the need for prototypes saves resources.

Production

In production activities, Canon has introduced the cell production method as a



Environment analysis equipment is used at the company's production facilities throughout the world.

core element in its reforms. This method helps to save resources and energy, reduces carbon dioxide gas emissions and waste, and lowers costs. The end result is a contribution to profitability.

Looking at waste measures first, the pursuit of company-wide reductions in costs and the introduction of technologies to sort collected items, and to disassemble and recycle them into valuable goods all contribute to reducing waste output. At present, 39 of Canon's production sites in Japan and nine sites outside Japan have achieved the goal of zero landfill waste. Even greater efforts are being made to reduce waste at the other plants and at marketing subsidiaries and affiliates.

Canon is moving forward with water conservation and recycling measures.

In 2004, Canon recycled 930,000 m³ of water. When we established Oita Canon Materials Inc. in 1999, we made its plant a zero wastewater facility by installing a completely closed recycling system that uses no outside water sources other than rain. Canon also introduced new closed wastewater processing systems at the Utsunomiya Plant (Japan) and Canon Zhuhai, Inc. (China), and the use of Ultra-Pure Water Recycling Systems at our semiconductor plants.

Canon developed a new closed recycling system for processing, purifying, and reusing water and introduced it in Zhuhai, China.

Sales and Logistics

Canon has been reducing carbon dioxide emissions in its logistics operations and, by developing a highly efficient system for distribution and delivery, is working to reduce the burden on the environment. Canon is also working in other areas to preserve the environment; for example, through the introduction of low-emission vehicles and by paying close attention to product packaging. Moreover, Canon is aggressively implementing a modal shift, or a switch from truck transport to ship or rail transport. In 2004, Canon Inc. teamed up with a transport firm and a railway company in Japan to jointly design a new railcar container that is similar in measurement to an ocean container, with high storage capacity. In the United States and Europe also, Canon is implementing a modal shift to use of rail transportation.

New railcar container designed jointly with a transport firm and a railway company.

Products in Use

Canon has improved the energy efficiency of its products even further with the introduction of on-demand, energy-efficient technology and other proprietary technologies. As copying machines and laser beam printers use the most energy when they are in standby mode, Canon has adopted two types of on-demand, energy-efficient technologies to reduce their energy consumption while in this mode.

In on-demand, energy-efficient technology, a ceramic heater localizes the heating to a specific area through a fixing film during printing. Surplus energy consumption is avoided and energy efficiency realized. IH fixing technology, which employs an electromagnetic induction heater,

Vision for 2010

Overriding Indicator: Factor 2

(Increase by at least a factor of 2.0 the ratio of net sales*1 to life cycle CO_2 emissions*2, using 2000 as the reference year)

*1 Annual consolidated sales of the Canon Group.

*2 The environmental burden from the business activity life cycle —the flow of business activities from production of raw materials, to production and marketing by the Canon Group, use by the customer, and recycling/disposal after use—is converted into total direct CO_2 emissions.

achieves greater efficiency in the high-speed machines.

Recycling

Canon is aggressively pursuing Inverse Manufacturing (IM) in line with our dedication to being a global corporation supporting a recycling-oriented society.

Canon's IM has been implemented through a global recycling structure, with centers in the Americas, Europe, and Asia. The sharing of information and resources among these regions makes it possible to realize global recycling. Specific activities include:

Remanufacture of Copying Machines

The Canon Group has expanded its copying machine remanufacturing program globally since 1992. Remanufacturing begins with the collection of used products and the selection of parts according to rigorous criteria. Selected parts are thoroughly cleaned and worn parts replaced to ensure that the reused materials meet the same high quality standards as new parts. We guarantee that each reused part is as good as a new one.

Parts Reuse

We initiated the TREE recycling program in 1999 as a way to effectively reuse machine parts. Short for "Technology of Reusing for Environment with Economy," the TREE program does not simply involve the recycling of used products. Rather, parts removed from used products are reused in other machines, promoting an effective use of resources.

Recycling of Cartridges

Since 1990, Canon has led other companies around the world in introducing and operating a Toner Cartridge Collection and Recycling Program on a global scale. Collected cartridges are separated by machine

Toner cartridge recycling

type, and parts that can be used again are reused or 100% recycled. By the end of 2004, the accumulated volume of cartridges collected had risen to 127,000 tons.

Moreover, we believe that development and utilization of new environmental technologies are key to our goal of reducing the burden on the environment. Moving forward, we plan to establish and to widen the application of this technology to the greatest extent possible.

Canon's Latest Response to Environmental Concerns: imageRUNNER 4570 (iR 4570 in Europe)

Equipped with our original image-processing engine, the iR Controller, Canon's iR 4570 monochrome multifunction device provides leading-edge functions for creating and sharing office documents.

The iR 4570 is on the leading edge, not only in terms of function, but also for its responsiveness to environmental concerns. For example, while it offers high-performance with an output of 45 pages per minute, its compact size of only 565mm in width, contributes to resource conservation. Thanks to energy-efficient on-demand fixing technology, the power requirement of the iR 4570 in "sleep mode" has been drastically cut to 1W. Also, Canon has implemented "green procurement" and selected alternative materials in advance of the implementation of the EU's new RoHS Directive. Moreover, the external case adopted for the iR 4570 is made from plastic recovered through a closed recycling system.

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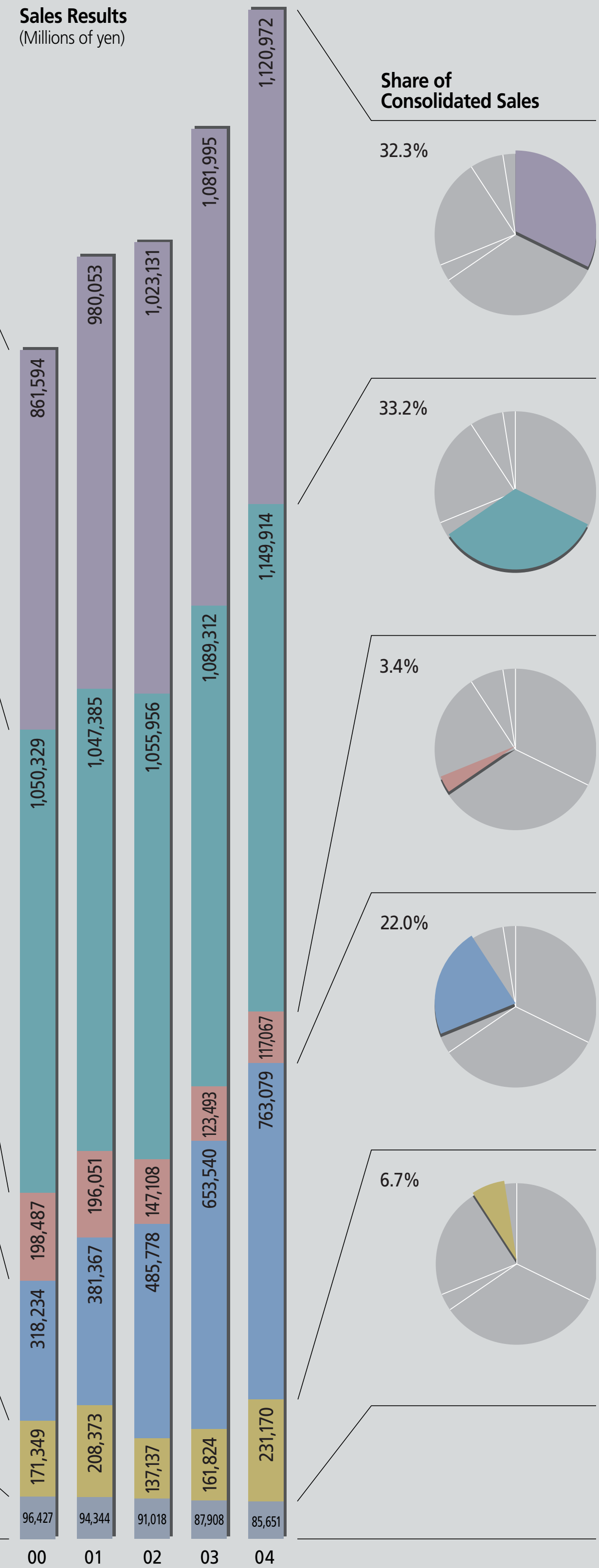
PRODUCT GROUP SUMMARY



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Business Machines
OFFICE IMAGING PRODUCTS

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

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Business Machines
COMPUTER PERIPHERALS

Laser beam printers
Inkjet printers
Inkjet multifunction peripherals
Image scanners, etc.

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Business Machines
BUSINESS INFORMATION PRODUCTS

Computer information systems
Micrographic equipment
Personal information products, etc.

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CAMERAS

SLR cameras
Compact cameras
Digital cameras
Digital video camcorders, etc.

OPTICAL PRODUCTS

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

OTHER PRODUCTS

OFFICE IMAGING PRODUCTS

Although the office equipment market is regarded as mature, Canon has achieved steady growth by introducing new products, improving its marketing channel policies, and adopting effective strategies. These activities made it possible for Canon to report the highest level of profits to date in the Office Imaging Products segment.

Ikuo Soma
Chief Executive*
Office Imaging Products Operations

Canon is the world's largest manufacturer of office copying machines and multifunction machines. Even though the business machine market has matured, during 2004, we focused on attaining steady growth. We aim to create new business domains while setting market trends. One way we plan to do this is to accelerate the shift to color printing in the office market by aggressively launching advanced color equipment. At the same time, we are paying close attention to strategies for maintaining price stability and profitability.

In parallel with these marketing strategies, we are working to upgrade our global supply chain management (SCM) strategy. We are working to make a complete shift to a weekly production/sales system that matches actual demand from our sales companies and meets schedules for delivery to customers.

In the United States, Canon retained its No. 1 positions in both the monochrome and color equipment markets in terms of brand share. In Canada, mid-range color equipment is taking off as well. Moreover, in Latin America, demand for low-speed equipment was strong, lifting sales to a record high in this area.

In Europe, sales were strong across the board, with sales volume in the monochrome market showing double-digit growth compared with 2003. Eastern Europe, including Russia, showed particularly strong demand, with growth exceeding 20%. Under these conditions, Canon increased its market share and strengthened its No. 1 position.

In Japan, building on the trend from the previous year, the shift to color equipment accelerated, with the proportion of the market accounted for by color models rising from less than 30% in 2003 to attain 40% at the end of 2004.

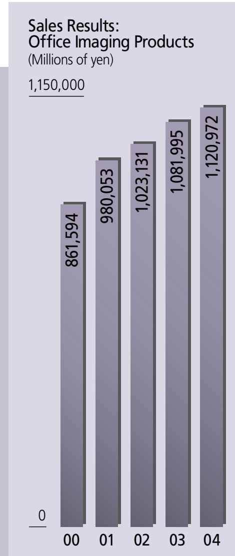
The Asia/Oceania market remained strong, registering double-digit growth. In the key Chinese market, amid falling prices for low-speed copying machines, we increased our market share through sophisticated marketing activities.

Going forward, we plan to cultivate the print-on-demand market by offering high-speed machines. In addition, we plan to expand sales of our multifunction machines, that is, Java-based MEAP (Multifunctional Embedded Application Platform) products, in the small-office/home office (SOHO) market and grow our solutions business. Our solutions business comprises mainly components from three fields: MEAP in the devices field, the imageWARE series in the software field, and e-Service in the Internet field.

Color imageRUNNER C3200N

*Group Chief Executive in FY 2004.

Fiscal 2004 Review



Demand for network digital MFDs indicated a shift from monochrome to color models, as well as a trend toward higher-end features.

The Color imageRUNNER C3200/iR C3200N, which offers intelligent color sending to multiple destinations and combines scanning, printing, copying, and distributing functions working together concurrently, continued to sell well in markets all around the world, thus sustaining the momentum from 2003, when these models were launched. The iR C3100 and the high-end model iR C6800, introduced in Japan in 2003, were also launched in Europe and the United States in the first half of 2004 and have been well received in these markets. The iR C3220/iR C3220N, which succeeds the iR C3200, was launched in autumn 2004 and has similarly been well received. In the United States, to counter mounting competition in the steadily expanding color equipment market, we simultaneously launched 14 new models, including color and monochrome machines, in October 2004.

imageRUNNER C6800N

In the monochrome equipment market, where prices have finally stopped falling, we provided models with enhanced functionality, lower energy consumption, and smaller footprints. In addition to extending the Multifunctional Embedded Application Platform (MEAP), enabling customers to develop unique functions on the imageRUNNER platform, we launched new MEAP machines with output capabilities of between 72 to 105 pages per minute in the promising high-speed machine segment in November 2004. Supplies, including toner and drums, posted steady growth.

Overall, sales of office imaging products in 2004 saw a year-on-year increase of 3.6%, to ¥1,121 billion (US$10,779 million).

Our Future Growth Engine: High-Compression PDF Conversion Technology

Full-color document data typically contain 30 to 40 times more digital information than monochrome data. Files become extremely large when users employ JPEG and other conventional compression methods to store or transmit files in their original, high-resolution condition. This creates problems because it takes considerable time to send them over a network and places a heavy burden on servers. Canon's high-compression PDF conversion technology makes it possible to compress image files to a fraction of the size that would normally be required. For example, using JPEG compression, scanning an A4-size color document filled with text and photos at 150-dpi resolution would create a file of about 2 MB in size. However, using Canon's groundbreaking technology, the file is compressed to about one-tenth this size without deterioration in image quality. The secret is that Canon's technology can successfully separate the text from the background and compress them separately. Using this technology, photographs remain clear and alphanumeric characters are reproduced crisply. Therefore, this technology maintains high image quality even as it significantly reduces the volume of data. This breakthrough is differentiating Canon's network MFDs from those of competitors.

High-compression PDF

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imageRUNNER C3220

In the inkjet printer business, Canon is seeking to achieve balanced growth throughout the "triangle" constituting operating cash flow, profits, and market share. Canon is continuing to sustain profitability in this consumer product business even under highly competitive conditions by building on the power of its brand and its technological capabilities for product development and production.

Katsuichi Shimizu
Chief Executive
Inkjet Products Operations

Canon is one of the few companies in the world boasting world-class technologies for both cameras and photo-quality color printers. Leveraging this outstanding competitive technological advantage in cameras and its strong brand name, Canon aims to be No. 1 in the home printing market. Today's market is moving toward digital photos, and customers need photographic quality prints for a wide range of applications. Canon is therefore exceptionally well positioned to take advantage of emerging business opportunities.

In managing its activities, the inkjet printer business draws a triangle with profits as the base and operating cash flow and market share forming the other two sides. The business generates profits, which are indispensable for expanding and renewing its activities, and seeks to maintain high growth. The biggest difference between Canon and its competitors is its drive to manufacture its products internally. By leveraging its in-house production capabilities, Canon aims to improve its cost-competitiveness and further strengthen its systems to generate profits.

In 2004, primarily as a result of the introduction in the latter half of the year of the PIXMA brand (PIXUS brand in Japan), unit sales expanded nearly 20% from the previous year. As a result, Canon showed excellent performance for the year, returning to the No. 1 position in the Japanese market for the first time in eight years.

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MP-780

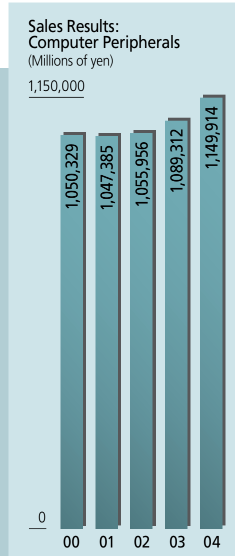
These inkjet printers incorporate Canon's original FINE technology, which that gives them the strengths that Canon printers have become known for, namely photo-quality imaging together with high printing speed. Reflecting these strengths, the number of machines installed in the field is growing, and this promises to lead to increases in the consumption of printing supplies.

PIXMA iP8600

In the field of supplies, we also introduced a new technology in Japan. This technology offers photographic prints with greatly enhanced durability through the use of genuine Canon paper and ink. Our new products in Japan, which include our new print head and original Canon ink and paper, is capable of printing images that can be preserved in an album for 100 years without fading. We plan to introduce this technology to the global market and leverage our technology in printing supplies to expand sales.

In the field of flatbed scanners, in 2005, we introduced a new, advanced design that can scan from either a vertical or horizontal orientation. Going forward, Canon will draw on its original FARE (Film Automatic Retouching and Enhancement) and LiDE (LED Indirect Exposure) technologies to offer scanners that meet the growing need for high-resolution, high-speed processing.

Fiscal 2004 Review



In fiscal 2004, the spread of digital cameras and heightened print quality fueled the steady spread of a "home-printing" culture, where people enjoy making digital photographs using their own peripherals. Although the inkjet printer market on the whole has recently shown only modest growth, Canon is further developing its lineup of single function and multifunction models with FINE printing heads and PictBridge direct-printing compatibility. Canon's PIXMA series of advanced-design, box-type printers, which were introduced in fall 2004, won praise for their exceptional functionality, including dual-path paper feeding and built-in automatic duplexing for double-sided printing.

In the laser beam printer (LBP) area, we experienced explosive sales growth in low-priced monochrome units that led to a temporary shortage of units. Along with increases in demand in growing markets, we reported major expansion overall in our monochrome units because of their superior energy-saving properties, fast printing speeds, and reliability. In the color LBP area, our printers are well received because of our original energy-saving technologies.


LBP-5200

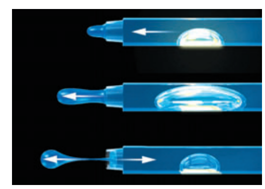
In 2004, to expand demand, we added new models to provide a full lineup and introduced low-priced machines. As a result, unit sales doubled from the previous year. In addition, sales of cartridges for both monochrome and color printers showed steady growth.

The market for flatbed scanners is contracting because of the shift in demand in major countries toward multifunction printers. In response to this shift, we have introduced a high-speed, high-resolution scanner and a slim-type scanner incorporating Canon's original contact image sensor. We are expanding our market share in countries around the world, especially in Europe.


CanonScan 9950F

Our Future Growth Engine: FINE

Canon has created "FINE: Full-photolithography Inkjet Nozzle Engineering," which offers a rich repertoire of capabilities for picture-perfect results. Achieving this level of quality required each individual dot to be printed at a smaller size and with greater accuracy. However, as the ink droplets become smaller, variations in droplet size and dot placement have an adverse effect on overall image quality. FINE is based on new concepts for the ink ejection mechanism and an innovative manufacturing technology for the nozzles. Born of advanced semiconductor manufacturing technology, FINE print heads have an array of 6,144 nozzles, or 23 per millimeter in our iP8500. Each of the nozzles in this unit can eject a maximum of 24,000 ink droplets of only two picoliters each per second. Moreover, our PIXMA iP5000 is capable of ejecting ink droplets of only one picoliter. Using these advanced Canon inkjet printers, the droplets hit the paper with a high degree of accuracy and achieve both high levels of image quality and speed.


Conventional Bubble Jet printing technology


"FINE" technology

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PIXMA iP4000

As unit sales of digital cameras have expanded nearly 60% annually, Canon has moved forward with aggressive innovations in all phases of its activities, from development through production and other aspects of its digital camera business.

Tsuneji Uchida
Chief Executive
Image Communication Products Operations

The digital SLR camera market has expanded since the introduction of our EOS Digital Rebel (EOS 300D in some areas) in 2003. In 2004, the worldwide market size was estimated to be about 2.4 million units, or three times the market size of the previous year. Amid these market conditions, Canon moved well ahead of its competitors by introducing a strong lineup. These included the EOS-1D Mark II and EOS-1Ds Mark II for the professional market, as well as the EOS 20D for the advanced amateur market. As a result, we succeeded in capturing a more than 50% market share.

Our success was largely thanks to our large-size CMOS sensors, which we produce internally, including a full-size 35mm CMOS sensor with 16.7 million pixels. Another important accomplishment was further improvements to the DIGIC, our most advanced image processing engine. The DIGIC II has enhanced capabilities for high-quality image reproduction and high-speed data processing. The superior performance resulting from these improvements enabled Canon to establish a dominant presence at major sporting events in 2004.

Turning next to the compact digital camera field, where market competition has become increasingly aggressive, Canon is working to accurately identify market trends while achieving competitive production costs. In 2005, we will expand our lineup of models incorporating DIGIC II. Our aim is to sustain product quality while maintaining appropriate levels of profitability.

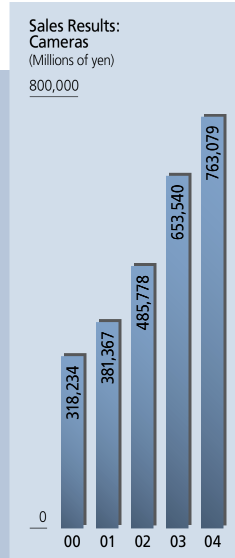
In product development improvements, we are shortening the time to market by taking advantage of simulation, analysis, and measurement technologies that move us closer to "prototype-less design." These improvements allow us to pursue concurrent development from the trial production stage all the way to mass production. With the opening of our new, cutting-edge manufacturing plant in Oita, Kyushu (Japan), our production capacity has been expanded substantially, and we believe we can strengthen our No. 1 position in digital cameras. At the same time, we are now much better positioned to respond flexibly to changes in the market.

PowerShot SD500
(Digital IXUS 700 in some areas)

In the video camcorder world market, where more than 80% of units sold are now digital, Canon is aiming to expand its market share by continuing to introduce new products that feature high image quality in a compact body at competitive prices. In the U.S. market, we further strengthened our position in the professional and advanced amateur market segments by introducing the XL2, a new model to follow our long-term, best-selling XL1.

Furthermore, in 2005 and beyond, we are taking steps to expand into new areas, including the compact photo printer and LCD projector fields. We developed a new projector that uses reflective liquid crystal on silicon, or LCOS, that we introduced near the end of 2004. We have also developed a new optical engine, "AISYS" (Aspectual Illumination System), for LCOS that features ultrafine image quality and responds to SXGA+ (1400 x 1050 pixels) requirements.

Fiscal 2004 Review



Products in the Cameras segment include compact digital cameras, digital SLR cameras, digital video camcorders (DVCs), film cameras, lenses, visual communication products, and LCD projectors.

Sales of digital cameras are expanding throughout the world. In 2004, we introduced three digital SLR models and 16 compact types in rapid succession. The number of units shipped rose nearly 60% from the prior year. To maintain our position as the leading company in compact digital cameras, we are implementing initiatives to expand our presence in rapidly growing markets, such as Europe and China.

At the same time, with compact photo printers that can print images directly from all PictBridge-compatible digital cameras, we are exercising strong leadership to accelerate sales in those fast growing markets.

Reflecting continued strong sales of digital SLR cameras during the period under review, sales of interchangeable lenses also increased. Amid these market conditions, Canon reported strong sales results. Although demand for film cameras is declining, we still retain the No. 1 market position in SLR cameras and a high position in the market for compact cameras.

Optura 500 (MVX35i in some areas)

Throughout all categories of video camcorders, including analog models, the global market grew a marginal 2%, but the DVC market posted significant growth of nearly 20%. In 2004, we introduced 11 new DVC models and substantially increased our global market share.

In the LCD projector field, although the world market expanded more than 30% in unit terms, prices continued to decline, and market growth in monetary terms remained in the single-digit range. Canon is expanding unit sales with a strong momentum that exceeds growth in the market as a whole.

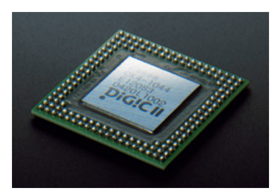
SX-50

Our Future Growth Engine: DIGIC

High image quality is the pride of Canon's digital cameras, and DIGIC is the image processing "brain" that provides it. The role of the image processor is to process the visual information from the light that enters the lens and is captured by the light sensors, and develop the image, preserving its original beauty without alteration.

Canon developed its DIGIC image processor by concentrating all its photographic know-how, gained over more than 60 years, in a single microchip, making it possible to process a vast amount of complex image information instantly. For example, in the case of white balance, which is the basis for color, DIGIC divides the relevant information into several hundred thousand images and makes judgments based on an abundance of expertise that only a leading camera manufacturer could realize. In 2004, we introduced DIGIC II, which is faster and has even more sophisticated functions and capabilities, first in our EOS-1D Mark II, digital SLR camera, and then in our other SLR and compact models. DIGIC II will ensure that our customers continue to equate Canon digital cameras with top image quality.

EOS-1Ds Mark II



DIGIC II

Equipped with DIGIC II, Canon's digital SLR cameras and lenses offered unmatched strengths for sporting event photography in 2004.

Canon implemented major structural reforms in its Optical Products Operations and these activities got off to a new start in April 2004. In our Medical Equipment business, we focused on shortening product development time through various reforms and introduced products that meet market needs in a timely fashion.

Junji Ichikawa
Chief Executive
Optical Products Operations

We implemented major structural reforms in our semiconductor-production equipment business in April 2004 and these operations made a new start. These reforms included a review of product development, the accelerated introduction of next-generation platforms, lead-time compression, and reductions in production costs.

The market for semiconductor-production equipment, which has been expanding, is forecast to enter an adjustment phase in 2005. We are aiming to expand the volume of unit sales and develop new, cutting-edge models.

In the semiconductor-production industry, circuit patterns continue to shrink at an accelerating pace, and responding to this trend is becoming increasingly urgent. As the core technology in the semiconductor design process, photolithography is the driver of faster and more highly integrated semiconductors as well as cost reductions. Currently, the design rules for a circuit's width call for 90 nanometers (one nanometer is equivalent to a millionth of a millimeter).

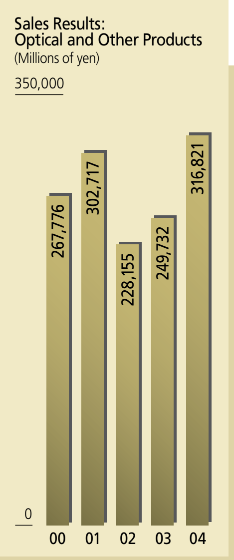
Among next-generation technologies, somewhere in the 2006 to 2007 period, the market is expected to move toward the full-scale use of products incorporating liquid immersion technologies that employ argon fluoride (ArF) lasers. At Canon, we plan to introduce products based on this next-generation platform in 2007. In view of this trend, we have reviewed our product development processes and introduced a product manager system with the aim of exerting strong leadership to speed up our development. Moreover, we plan to strengthen our position vis-a-vis competitors by substantially shortening the interval between the receipt of orders and the installation of equipment. As an up and coming technology, we are developing equipment that makes use of EUV (extreme ultra violet) light sources.

FPA-6000 AS4

In the LCD mask aligner business, demand for large-scale units is very strong, and we have won the No. 1 market share for high-end mask aligners. Canon will continue to develop and introduce new equipment and units capable of processing low-temperature polysilicon, while working to maintain its No. 1 position.

In the medical equipment field, we have begun to market an all-digital fundus camera for retinal imaging. We have also begun the full-scale development of systems products for ophthalmic applications and have introduced support systems for ophthalmic imaging diagnosis. In the field of digital radiography systems, we are promoting market expansion by taking full advantage of handheld sensors in applications that require mobile photography. Moreover, Canon is proceeding with the development of high-performance sensors seeking to adapt to a wider range of applications in the digital X-ray imaging field.

Fiscal 2004 Review



In fiscal 2004, conditions in the semiconductor market improved and, along with recovery in capital investment by semiconductor manufacturers, demand in the stepper market was strong, especially in Japan and other Asian countries. The number of units sold rose approximately 50% over the number for 2003. To take full advantage of strong market demand, Canon introduced new products, including the FPA-5000ES4b and FPA-6000ES6, and captured high market shares in Japan and other Asian countries, where semiconductor manufacturers are making major investments.

Along with the expansion in the use of LCD panels for PC monitors and growth in the market for LCD TVs, sales of mask aligners for LCD production are also increasing. We now occupy the No. 1 position in LCD mask aligners for making seventh-generation large panels (1,870mm x 2,200mm). Expansion in this area will be sustained by our technology for full-screen exposure of large substrates, which is based on our capabilities for manufacturing large-scale, ultrahigh-performance concave mirrors and our technology for processing and measuring large-scale stages.

Canon also reported major progress in mainstay products in the medical equipment segment. In ophthalmic equipment, Canon is vying for the top share of the market for non-mydriatic fundus cameras. In the digital-radiography system area, Canon continues to hold the top market share with its wide-ranging product offerings.

In other product areas, lenses for TV broadcast cameras staged a gradual recovery in 2004 as a result of the movement toward use of digital equipment and other factors. Especially strong increases in demand were recorded for HDTV camera lenses used for broadcasting sporting events. Canon continues to hold the leading market share in this product area.

Sales in 2004 amounted to ¥316.8 billion (US$3,046 million), 26.9% higher than for the previous year.

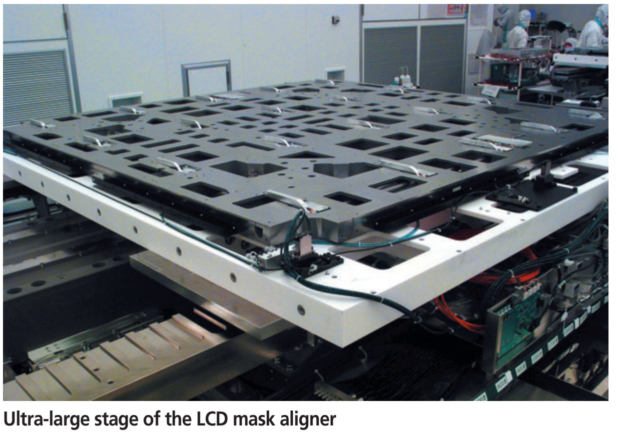
Our Future Growth Engine: Large-Scale Concave Mirror Technology

Demand for LCD displays is expanding globally. The key to manufacturing LCD display panels is the photolithographic technology that enables microscopic pixel patterns to be printed on glass substrates. There are several photolithographic methods for this, but from the point of view of productivity, the best method is the "mirror projection" method. This involves creating an optical mask of the desired microscopic pattern, which is then used in conjunction with a concave mirror to expose the pattern on glass substrate.


Large-scale concave mirror

To manufacture increasingly large LCD panels that have large areas to be exposed requires large-scale, ultrahigh-performance concave mirrors. Canon has been a pioneer in applying optical technology and has been successful in manufacturing the world's largest concave mirrors with a diameter of approximately 1.5 meters and with the highest levels of surface precision. This has made it possible to manufacture 48-inch wide-screen LCD TV panels with a single exposure.


MPA-8500


Ultra-large stage of the LCD mask aligner

MAJOR CONSOLIDATED SUBSIDIARIES

As of December 31, 2004

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 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.
Guang-Dong United Optical Instrument Co., Ltd.
Tianjin Canon Co., Ltd.
Canon (Suzhou) Inc.
Canon Opto (Malaysia) Sdn. Bhd.
Canon Hi-Tech (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 Research Centre 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 (Singapore) Pte. Ltd.
Canon Marketing (Malaysia) Sdn. Bhd.
Canon Marketing (Philippines), Inc.
Canon Marketing (Thailand) Co., Ltd.
Canon Semiconductor Engineering Korea Inc.
Canon Semiconductor Equipment Taiwan Inc.

FINANCIAL SECTION

TABLE OF CONTENTS

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 2004, although the U.S. economy experienced a temporary slowdown in the second half of the year due to the diminishing effectiveness of tax cuts, the high price of crude oil, and rising interest rates, economic growth was realized as consumer spending increased modestly, and an upturn in corporate earnings fueled continued growth in private-sector capital spending. Economic growth in Europe remained moderate through 2004, held back somewhat in the second half by a sluggish world economy combined with high crude oil prices and the negative impact of the appreciation in value of the euro. In Asia, China's economy continued to achieve steady growth, driven by strong consumer spending and increased capital investment, while other Asian economies were also in recovery mode. In Japan, while the economy slowed down somewhat in the second half due to the global downward economic trend, the economy continued to recover gradually, supported by stable consumer spending and an increase in capital investment.

Market environment

With respect to the markets in which Canon operates, although sales of digital cameras slowed in Japan due to a rising household penetration rate, demand overseas, especially in Europe, continued to grow significantly during fiscal 2004. Demand for network digital multifunction devices (MFDs) remained strong, especially in the office market, fueled by the shift toward multifunctionality and color. Although the market for computer peripherals, including printers, grew overall, mainly among color models, the segment experienced severe price competition and a shift in demand for lower priced models offering improved functionality. In the field of optical equipment, capital spending for semiconductor-production equipment recovered strongly owing to such factors as the sustained high demand for memory devices resulting from replacement demand for personal computers, and a growing digital consumer electronics market, along with the high rate of capacity utilization by semiconductor manufacturers. Moreover, increased demand for liquid crystal display (LCD) televisions fueled growth in the market for projection aligners, which are used in the production of LCDs.

Summary of operations

Canon achieved record highs in both consolidated net sales and net income, and a fifth 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 a substantial increase in sales of semiconductor-production equipment. In fiscal 2004, Canon achieved 8.4% growth in net sales, to ¥3,467,853 million (U.S.$33,345 million), and a 24.5% increase in net income, to ¥343,344 million (U.S.$3,301 million). Canon's gross profit increased by 6.5%, to ¥1,713,343 million (U.S.$16,474 million).

Key performance indicators

Following are the key performance indicators ("KPI") that Canon uses in managing its business. The changes from year to year in these KPI are set forth in the table shown on page 33.

Revenues

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

Net sales is one of the KPI. Canon derives net sales primarily from the sale of products, and 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 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 KPI. Canon is focusing on two areas for improvement. On one hand, Canon strives to control and reduce its selling, general and administrative expenses. On the other hand, Canon's R&D policy is designed to maintain a high level of spending in core technology in order to sustain Canon's leading position in its current fields of business, and to explore possibilities in other markets. Canon believes such investments will be the basis for future success in its business and operations.

Cash Flow Management

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

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

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

KEY PERFORMANCE INDICATORS	2004	2003	2002	2001
Net sales (Millions of yen)	¥ 3,467,853	¥ 3,198,072	¥ 2,940,128	¥ 2,907,573
Gross profit to net sales ratio	49.4%	50.3%	47.6%	44.0%
R&D expense to net sales ratio	7.9%	8.1%	7.9%	7.5%
Operating profit to net sales ratio	15.7%	14.2%	11.8%	9.7%
Inventory turnover within days	49 days	49 days	51 days	57 days
Debt to total assets ratio	1.1%	3.1%	5.0%	10.4%

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 accounting principles generally accepted in the United States of America, and based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. Canon believes that the following are some of the more critical judgment areas in the application of its accounting policies that currently affect its financial condition and results of operations.

Revenue recognition

Canon 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 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 are recognized as services are provided.

Revenues from the sale of equipment under sales-type leases are 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 lease or direct-financing lease 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.

A liability for estimated product warranty cost is recorded at the time revenue is recognized and is included in accrued expenses. Estimates for accrued product warranty cost 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.

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 2004, Canon estimated a discount rate of 2.7% and an expected long-term rate of return on plan assets of 3.6%. In estimating the discount rate, Canon 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 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 income (expense) in the following years, and vice versa. For fiscal 2005, 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 ¥2,090 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 asset gains (losses) affects the value of plan assets in fiscal years and, ultimately, future pension income (expense).

The Company and certain of its domestic subsidiaries realized a net gain ¥17,141 million (U.S.$165 million) for fiscal 2004 due to the return to the Japanese Government of the substitutional portion of the Employee's Pension Funds. "Accrued pension and severance cost" decreased in fiscal 2004 compared to fiscal 2003, as a result of the return.

CONSOLIDATED RESULT OF OPERATIONS

SUMMARY OF OPERATIONS

	(Millions of yen) 2004	change	2003	change	2002	(Thousands of U.S. dollars) 2004
Net sales	**¥ 3,467,853**	**+8.4%**	3,198,072	+8.8%	2,940,128	**$ 33,344,740**
Operating profit	**543,793**	**+19.7**	454,424	+31.2	346,359	**5,228,779**
Income before income taxes and minority interest	**552,116**	**+23.2**	448,170	+35.8	330,017	**5,308,808**
Net income	**343,344**	**+24.5**	275,730	+44.6	190,737	**3,301,385**

Sales

Canon's consolidated net sales in fiscal 2004 totaled ¥3,467,853 million (U.S.$33,345 million). This represents an 8.4% increase from the previous fiscal year, reflecting significant growth in sales of digital cameras, color network digital MFDs and semiconductor-production equipment.

Overseas operations are significant to Canon's operating results and generated approximately 73% of total net sales in fiscal 2004. 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 2004 was ¥108.12 to the U.S. dollar, and ¥134.57 to the euro, representing an appreciation of 7% against the U.S. dollar, and a depreciation of 3% against the euro, compared with the previous year. These effects of foreign exchange rate fluctuations unfavorably impacted net sales by approximately ¥57,000 million. Net sales denominated in foreign currency decreased by approximately ¥77,700 million in U.S. dollars, increased by ¥20,300 million in euro, and increased by ¥400 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 2004, 2003 and 2002 was 50.6%, 49.7% and 52.4%, respectively.

Gross profit

Canon's gross profit in fiscal 2004 increased by 6.5% to ¥1,713,343 million (U.S.$16,474 million) from fiscal 2003. Despite ongoing efficiency enhancements in production during fiscal 2004 and the timely launch of competitive new products, the gross profit ratio decreased 0.9% from the previous year to 49.4%, mainly due to severe price competition and the appreciation of the yen against the U.S. dollar.

Selling, general and administrative expenses

The major components of selling, general and administrative expenses are payroll, R&D, advertising expenses and other marketing expenses. Although R&D expenditures grew 6.2% from the previous year to ¥275,300 million (U.S.$2,647 million) along with increased advertising and sales-promotion spending, selling, general and administrative expenses for the year increased by just 1.3% year on year, mainly due to other selling, general and administrative expenses remaining at a lower level than the year-ago period, coupled with a ¥17,141 million (U.S.$165 million) gain realized from the return to the Japanese Government of the substitutional portion of the Employees' Pension Funds (EPF) that the company and certain of its subsidiaries in Japan had operated. In general, Canon maintains a high level of R&D expenditure to strengthen its R&D capabilities. R&D expenditures grew in fiscal 2004 from the previous year, resulting from increased R&D activities. Advertising and other marketing expenses increased by 11.5% from the previous year to ¥111,770 million (U.S.$1,075 million), reflecting management's policy to strengthen Canon's corporate and brand image.

Operating profit

Operating profit in fiscal 2004 increased by 19.7% to ¥543,793 million (U.S.$5,229 million) from fiscal 2003. Operating profit in fiscal 2004 was 15.7% of net sales, compared with 14.2% in fiscal 2003.

Other income (deductions)

Other income (deductions) improved by ¥14,577 million (U.S.$140 million), attributable to gains from sales of subsidiary companies' shares which totaled ¥9,082 million (U.S.$87 million), along with a decrease in currency exchange losses and improved equity gains (losses) of affiliated companies.

Income before income taxes and minority interests

Income before income taxes and minority interests in fiscal 2004 was ¥552,116 million (U.S.$5,309 million), a 23.2% increase from fiscal 2003, and constituted 15.9% of net sales.

Income taxes

Provision for income taxes increased by ¥31,361 million (U.S.$302 million) from fiscal 2003, primarily as a result of the increase in income before income taxes and minority interests. The effective tax rate during fiscal 2004 declined by 1.2% compared with fiscal 2003.

Net income

Net income in fiscal 2004 increased by 24.5% to ¥343,344 million (U.S.$3,301 million), which exceeds the growth rate of income before income taxes and minority interests. This represents a 9.9% 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 single lens reflex ("SLR") cameras, compact cameras, digital cameras and digital video camcorders.
- **The optical and other products product group** includes steppers for semiconductor chip production, mirror projection mask aligners used in the production of LCDs, television broadcasting lenses and medical equipment.

Effective January 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 current relation with those products. Accordingly, information for previous fiscal years has been reclassified to conform with the current classification.

Sales by product

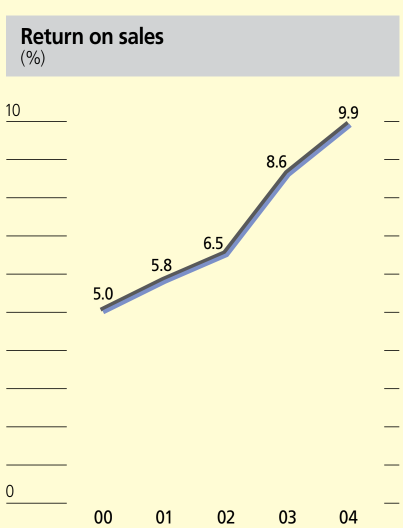
Canon's sales by product group are summarized as follows:

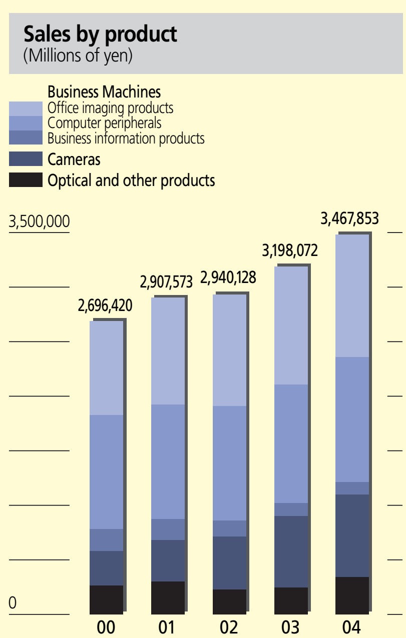
SALES BY PRODUCT

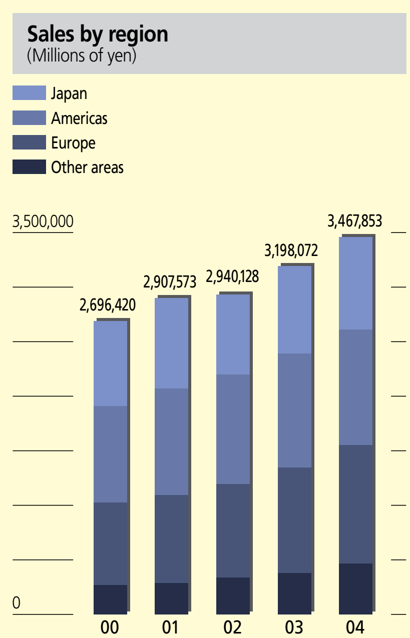
	(Millions of yen) 2004	change	2003	change	2002	(Thousands of U.S. dollars) 2004
Business machines:						
Office imaging products	¥ 1,120,972	+3.6%	1,081,995	+5.8%	1,023,131	$ 10,778,577
Computer peripherals	1,149,914	+5.6	1,089,312	+3.2	1,055,956	11,056,865
Business information products	117,067	–5.2	123,493	–16.1	147,108	1,125,644
	2,387,953	+4.1	2,294,800	+3.1	2,226,195	22,961,086
Cameras	763,079	+16.8	653,540	+34.5	485,778	7,337,298
Optical and other products	316,821	+26.9	249,732	+9.5	228,155	3,046,356
Total	¥ 3,467,853	+8.4	3,198,072	+8.8	2,940,128	$ 33,344,740

Sales of business machines, constituting 69% of consolidated net sales, increased 4.1%, to ¥2,387,953 million (U.S.$22,961 million) in fiscal 2004.

Sales of office imaging products increased 3.6%, to ¥1,120,972 million (U.S.$10,779 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) C3200/iRC3200N recorded strong sales in both the domestic Japanese and overseas markets. The iRC3100 and the high end model iRC6800, introduced in Japan in the second half of fiscal 2003, were also launched in Europe and the United States in the first half of fiscal 2004 and have also recorded strong sales. The iRC3220/iRC3220N, which succeeds the iRC3200, and the iRC2620/iRC2620N were launched in September 2004 and have also recorded strong sales. Among monochrome network digital MFDs, such low-end models as the iR1600/2000 series recorded considerable sales increases, while mid-level models, such as the iR2200 series, and high-end models, such as the iR5000 series, also achieved strong sales. Color office imaging products accounted for 24% and 20% and monochrome office imaging products accounted for 62% and 67% of office imaging products sales in fiscal 2004 and 2003, respectively. Sales of facsimiles and information system business accounted for 14% and 13% of sales of office imaging products in both fiscal 2004 and 2003.







Sales of computer peripherals increased 5.6% to ¥1,149,914 million (U.S.$11,057 million). Despite the effects of the yen's appreciation against the U.S. dollar and a shift in demand toward lower priced models in the monochrome and color segment, laser beam printer sales substantially increased due to an increase in sales of color models. Inkjet printers recorded an approximately 20% increase in unit sales with the PIXMA iP3100 and iP4100 models, especially in Japan and Europe, along with the PIXMA MP700 and MultiPASS MP370 high-speed multifunction systems, as the adverse effect of severe price competition on sales of computer peripherals was more than offset by a rise in unit sales.

Sales of business information products decreased 5.2%, to ¥117,067 million (U.S.$1,126 million) in fiscal 2004, mainly due to the intentional curtailing of personal computer sales in the domestic market.

Sales of cameras continued to achieve significant sales growth of 16.8%, totaling ¥763,079 million (U.S.$7,337 million). Amid the continued strong demand for digital models worldwide, sales of compact digital cameras showed significant growth, boosted by the launch of eight new PowerShot-series models for fiscal 2004, including the PowerShot S500 Digital ELPH and PowerShot A75. Canon's digital SLR cameras also continued to enjoy robust growth, bolstered by strong sales of the EOS Digital Rebel, and the EOS 20D which is successor of the EOS 10D. As a result, unit sales of digital cameras grew by nearly 60% compared with the previous year. Digital cameras accounted for 69% and 61% and conventional film cameras accounted for 16% and 21% of camera sales in fiscal 2004 and 2003, respectively. Video camcorders accounted for the remaining 15% and 18% of camera sales in fiscal 2004 and 2003, respectively. In the field of digital video camcorders, new models such as the Optura 500/400, Elura 70/65/60 and Optura 40/30 achieved favorable sales during fiscal 2004. Sales of cameras constituted 22% of consolidated net sales in fiscal 2004, an increase of 2% from fiscal 2003, primarily due to increased sales of digital cameras.

Sales of optical and other products increased 26.9%, to ¥316,821 million (U.S.$3,046 million). Sales of aligners for the production of LCDs realized notable growth as the PC monitor industry continued to shift from CRT to LCD computer displays, and the LCD television market continued to expand. Sales of steppers, used for the production of semiconductors, also increased as investment in semiconductor-production equipment showed a recovery owing to the improved conditions in the semiconductor-device market. Sales of optical and other products constituted 9% of consolidated net sales in fiscal 2004, an increase of 1 % from fiscal 2003, primarily due to increased sales of aligners for LCDs and steppers.

Sales by region

A geographical analysis indicates that net sales in fiscal 2004 increased in every region.

In Japan, net sales increased by 6.0% in fiscal 2004 from fiscal 2003. The results were mainly attributable to increased sales of office imaging products and digital cameras. Color network digital MFDs, which include the Color imageRUNNER(iR) C3200/iRC3200N, Canon's first color offering in the powerful imageRUNNER-series lineup, have contributed to increased sales of office imaging products.

In the Americas, net sales increased by 8.3% 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 1.4%.

In Europe, net sales increased by 11.6% on a local currency basis mainly due to increased sales of digital cameras, Color network digital MFDs and laser beam printers. On a yen basis, after accounting for the depreciation of the yen against the euro, net sales in Europe grew 12.8% in fiscal 2004.

Sales in other areas increased by 21.7% on a yen basis in fiscal 2004, 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) 2004	change	2003	change	2002	(Thousands of U.S. dollars) 2004
Japan	¥ 849,734	+6.0%	801,400	+9.4%	732,551	$ 8,170,519
Americas	1,059,425	+1.4	1,045,166	+3.5	1,010,166	10,186,779
Europe	1,093,295	+12.8	969,042	+13.1	857,167	10,512,452
Other areas	465,399	+21.7	382,464	+12.4	340,244	4,474,990
Total	¥ 3,467,853	+8.4	3,198,072	+8.8	2,940,128	$ 33,344,740

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
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
2002:	Net sales:					
	Unaffiliated customers	¥ 2,226,195	485,778	228,155	—	2,940,128
	Intersegment	—	—	139,608	(139,608)	—
	Total	2,226,195	485,778	367,763	(139,608)	2,940,128
	Operating cost and expenses	1,815,179	415,488	379,415	(16,313)	2,593,769
	Operating profit	¥ 411,016	70,290	(11,652)	(123,295)	346,359
	Assets	¥ 1,296,829	263,532	338,377	1,043,968	2,942,706
	Depreciation and amortization	106,865	14,118	19,817	24,460	165,260
	Capital expenditure	104,877	15,627	23,767	54,431	198,702
(Thousands of U.S. dollars)		Business machines	Cameras	Optical and other products	Corporate and Eliminations	Consolidated
2004:	**Net sales:**					
	Unaffiliated customers	**$22,961,086**	**7,337,298**	**3,046,356**	**—**	**33,344,740**
	Intersegment	**—**	**—**	**1,330,952**	**(1,330,952)**	**—**
	Total	**22,961,086**	**7,337,298**	**4,377,308**	**(1,330,952)**	**33,344,740**
	Operating cost and expenses	**17,950,663**	**6,079,625**	**4,100,077**	**(14,404)**	**28,115,961**
	Operating profit	**$ 5,010,423**	**1,257,673**	**277,231**	**(1,316,548)**	**5,228,779**
	Assets	**$12,873,240**	**3,838,529**	**4,023,250**	**13,755,568**	**34,490,587**
	Depreciation and amortization	**1,113,750**	**210,385**	**239,375**	**289,298**	**1,852,808**
	Capital expenditure	**1,289,692**	**382,529**	**502,539**	**889,952**	**3,064,712**

Notes:

1 Beginning first quarter of 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 current relation with those products. Accordingly, information for previous fiscal years has been reclassified to conform with the current classification.

2 General corporate expenses of ¥136,929 million (U.S.$1,317 million) and ¥147,616 million for fiscal 2004 and 2003, respectively, are included in "Corporate and Eliminations." For fiscal 2004, a gain of ¥17,141 miillion (U.S.$165 million) is also included, which relates to the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities.

3 Corporate assets of ¥1,430,599 million (U.S.$13,756 million) and ¥1,185,506 million as of December 31, 2004 and 2003, respectively, which mainly consist of cash and cash equivalents, marketable securities, investments and corporate properties, are included in "Corporate and Eliminations."

4 The segments are defined under Japanese GAAP.

SEGMENT INFORMATION BY GEOGRAPHIC AREA

(Millions of yen)	Japan	Americas	Europe	Others	Corporate and Eliminations	Consolidated
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
2002: Net sales:						
Unaffiliated customers	¥ 789,066	1,007,572	852,931	290,559	—	2,940,128
Intersegment	1,475,091	9,791	4,639	426,914	(1,916,435)	—
Total	2,264,157	1,017,363	857,570	717,473	(1,916,435)	2,940,128
Operating cost and expenses	1,867,817	969,542	836,341	699,420	(1,779,351)	2,593,769
Operating profit	¥ 396,340	47,821	21,229	18,053	(137,084)	346,359
Assets	¥ 1,485,238	346,021	460,521	202,388	448,538	2,942,706

(Thousands of U.S. dollars)	Japan	Americas	Europe	Others	Corporate and Eliminations	Consolidated
2004: Net sales:						
Unaffiliated customers	**$ 8,838,010**	**10,164,096**	**10,487,615**	**3,855,019**	**—**	**33,344,740**
Intersegment	**18,105,509**	**85,221**	**40,010**	**5,689,202**	**(23,919,942)**	**—**
Total	**26,943,519**	**10,249,317**	**10,527,625**	**9,544,221**	**(23,919,942)**	**33,344,740**
Operating cost and expenses	**21,212,894**	**9,861,807**	**10,303,385**	**9,279,615**	**(22,541,740)**	**28,115,961**
Operating profit	**$ 5,730,625**	**387,510**	**224,240**	**264,606**	**(1,378,202)**	**5,228,779**
Assets	**$ 17,246,913**	**3,284,769**	**5,133,318**	**2,611,212**	**6,214,375**	**34,490,587**

Notes:
1 General corporate expenses of ¥136,929 million (U.S.$1,317 million) and ¥147,616 million for fiscal 2004 and 2003, respectively, are included in "Corporate and Eliminations." For fiscal 2004, a gain of ¥17,141 miillion (U.S.$165 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 ¥1,430,599 million (U.S.$13,756 million) and ¥1,185,506 million as of December 31, 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.

Operating profit by product

Operating profit for business machines in fiscal 2004 increased ¥35,519 million (U.S.$342 million) to ¥521,084 million (U.S.$5,010 million). Despite the effects of the stronger yen, the gross profit ratio remained at prior year levels, due to cost reduction efforts, and the sales-to-expense ratio declined, contributing to an increase in operating profit.

Operating profit for cameras increased ¥4,480 million (U.S.$43 million) to ¥130,798 million (U.S.$1,258 million). Despite the negative effects of the stronger yen and price competition, along with the impact of increased advertising and sales-promotion spending, a increase in unit sales of digital cameras contributed to improved profitability.

Optical and other products generated operating profits of ¥28,832 million (U.S.$277 million) in fiscal 2004, as compared to losses of ¥9,883 million in fiscal 2003, due to a significant increase in sales of aligners and steppers.

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 a consolidation adjustment between foreign subsidiaries, by net sales of foreign subsidiaries. Marketing activities are generally less profitable than production activities, which are mainly conducted by the Company and its domestic subsidiaries. The returns on foreign operation sales in fiscal 2004, 2003 and 2002 were 2.8%, 3.2% and 2.7%, respectively. This compares with returns of 9.9%, 8.6% and 6.5% on total operations for the respective years.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents in fiscal 2004 increased ¥197,476 million (U.S.$1,899 million) to ¥887,774 million (U.S.$8,536 million), compared with ¥690,298 million in fiscal 2003 and ¥521,271 million in fiscal 2002. 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 2004 increased by ¥95,880 million (U.S.$922 million) from the previous year to ¥561,529 million (U.S.$5,399 million). 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 2004, 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, due to the increase in advertising and marketing expenses, reflecting management's policy to strengthen Canon's corporate brand image. Cash outflow for payments of income taxes increased, due to the increase in taxable income.

Net cash used in investing activities in fiscal 2004 was ¥252,967 million (U.S.$2,432 million), compared with ¥199,948 million in fiscal 2003 and ¥230,220 million in fiscal 2002, consisting primarily of capital expenditures. Capital expenditures in fiscal 2004 totaled ¥318,730 million (U.S.$3,065 million), mainly due to expanding production capabilities in Japan and overseas, as well as to bolster Canon's R&D-related infrastructure. In November 2004, Canon also entered into an agreement whereby certain assets were deposited into an irrevocable trust to meet the debt service requirements of 1.88% Japanese yen notes, 2.95% Japanese yen notes, and 2.27% Japanese yen notes in the aggregate amount of ¥25,000 million (U.S.$240 million). Upon this agreement, Canon used cash aggregating to ¥26,637 million (U.S.$256 million).

As a result, free cash flow, or cash flow from operating activities minus cash flow from investing activities, totaled ¥308,562 million (U.S.$2,967 million) for fiscal 2004 as compared to ¥265,701 million for fiscal 2003.

Net cash used in financing activities totaled ¥102,268 million (U.S.$983 million) in fiscal 2004, mainly resulting from Canon's active efforts to repay loans toward the goal of improving Canon's financial position. The company also paid dividends in fiscal 2004 of 65 yen (U.S.$ 0.63) per share, which was an increase of 15 yen (U.S.$ 0.14) per share over the prior year.

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

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

Short-term loans (including current portion of long-term debt) amounted to ¥9,879 million (U.S.$95 million) at December 31, 2004 compared to ¥39,136 million at December 31, 2003. Long-term debt (excluding their current portions) amounted to ¥28,651 million (U.S.$275 million) at December 31, 2004 compared to ¥59,260 million at December 31, 2003.

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

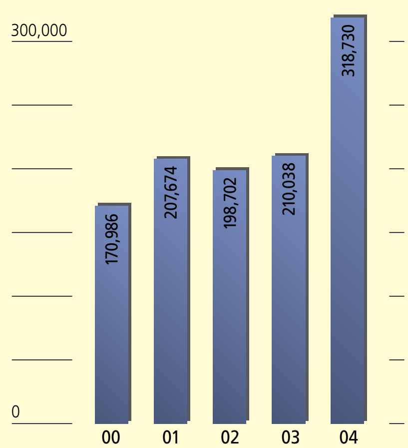
In order to facilitate access to global capital markets, Canon obtains credit ratings from two rating agencies, Moody's Investors Services, Inc. ("Moody's") and Standard and Poor's Rating Services ("S&P"). In addition, Canon maintains a rating from Rating and Investment Information, Inc. ("R&I"), a rating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

As of January 14, 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 2004 amounted to ¥318,730 million (U.S.$3,065 million) compared with ¥210,038 million in fiscal 2003 and ¥198,702 million in fiscal 2002. In fiscal 2004, 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 2005, Canon projects its capital expenditures will be approximately ¥375,000 million (U.S.$3,606 million). The capital expenditures include an investment in new production plants and new facilities of Canon.

Employer contributions to Canon's worldwide defined benefit pension plans were ¥31,018 million (U.S.$298 million) in fiscal 2004, ¥29,944 million in fiscal 2003, ¥33,661 million in fiscal 2002. During fiscal 2005, Canon expects to make cash contributions of approximately ¥36,183 million (U.S.$348 million) to its defined benefit pension plans.

Capital expenditure
(Millions of yen)



Working capital in fiscal 2004 increased ¥145,513 million (U.S.$1,399 million), to ¥1,248,987 million (U.S.$12,009 million), compared with ¥1,103,474 million in fiscal 2003 and ¥903,134 million in fiscal 2002. This increase was primarily a result of an increase in cash and cash equivalents and a decrease in short-term loans. Canon believes its working capital will be sufficient for its requirements for the foreseeable future. Canon's capital requirements are primarily dependent on management's business plans regarding the levels and timing of capital expenditures and investments. The working capital ratio (ratio of current assets to current liabilities) for fiscal 2004 was 2.27, compared to 2.33 for fiscal 2003 and 2.13 for fiscal 2002.

Return on assets (Net income divided by the average of total assets as of December 31, 2004, 2003 and 2002) increased to 10.1% in fiscal 2004, compared to 9.0% in fiscal 2003 and 6.6% in fiscal 2002. This increase was due mainly to an increase in net income.
Return on stockholders' equity increased to 16.8% in fiscal 2004, compared with 15.9% in fiscal 2003 and 12.5% in fiscal 2002.

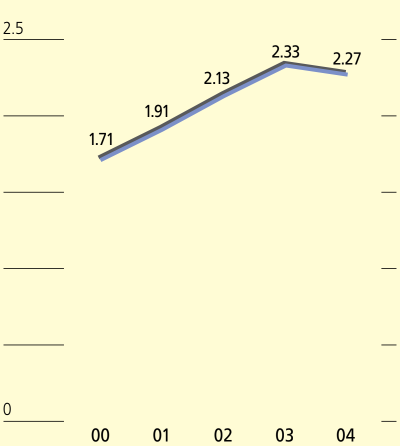
Debt to total assets ratio was 1.1%, 3.1% and 5.0% as of December 31, 2004, 2003 and 2002, respectively. Canon had short-term loans and long-term debt of ¥38,530 million as of December 31, 2004, ¥98,396 million as of December 31, 2003 and ¥148,103 million as of December 31, 2002.

OFF-BALANCE SHEET ARRANGEMENTS

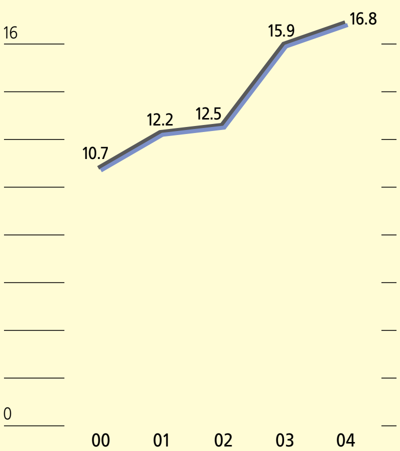
As part of its ongoing business, Canon does not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating 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 ¥43,634 million (U.S.$420 million) at December 31, 2004. The carrying amounts of the liabilities recognized for Canon's obligations as a guarantor under those guarantees are insignificant.

Working capital ratio



Return on stochholder's equity
(%)



CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following summarizes Canon's contractual obligations at December 31, 2004.

(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	¥	**8,585**	4,144	3,782	635	24
Other Long-Term Debt		**29,945**	5,735	12,665	11,544	1
Operating Leases Obligations		**49,532**	12,714	15,858	10,671	10,289
Purchase Commitments for						
Property Plant and Equipment		**39,286**	39,286	—	—	—
Parts and Raw Materials		**55,666**	55,666	—	—	—
Total	¥	**183,014**	117,545	32,305	22,850	10,314

(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	$	**82,548**	39,846	36,366	6,106	230
Other Long-Term Debt		**287,932**	55,144	121,779	110,999	10
Operating Leases Obligations		**476,269**	122,250	152,481	102,605	98,933
Purchase Commitments for						
Property Plant and Equipment		**377,750**	377,750	—	—	—
Parts and Raw Materials		**535,250**	535,250	—	—	—
Total	$	**1,759,749**	1,130,240	310,626	219,710	99,173

Canon provides warranties generally less than one year against defects in materials and workmanship on most of its consumer products. A liability for estimated product warranty related cost is established at the time revenue is recognized and is included in accrued expenses. Estimates for accrued product warranty cost are primarily based on historical experience, and are affected by ongoing product failure rates, specific product class failures outside of the baseline experience, material usage and service delivery costs incurred in correcting a product failure. As of December 31, 2004, the accrued product warranty cost amounted to ¥14,264 million (U.S.$137 million).

At December 31, 2004, commitments outstanding for the purchase of property, plant and equipment approximated ¥39,286 million ($378 million), and commitments outstanding for the purchase of parts and raw materials approximated ¥55,666 million ($535 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.

On September 14, 2004, the Company and Toshiba Corporation ("Toshiba") entered into an agreement to jointly establish SED Inc. for the development, production and marketing of next-generation flat-screen SED (Surface-conduction Electron-emitter Display) panels. The Company and Toshiba initially contributed approximately ¥500 million ($5 million) in cash, each. Under the agreement, the Company is further committed to contribute 50% of the financing requirements for SED Inc. through the establishment of a prototype production line.

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

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

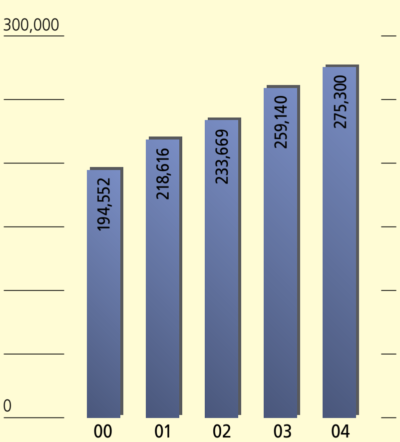
With respect to its R&D goals, Canon formulated as part of its management plan the "Canon Over IP" concept, through which Canon intends to connect its digital products to the Internet and lay the foundations for Internet-businesses for the future. Canon envisions Canon products and systems interconnected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

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

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)

R&D expenditure
(Millions of yen)



Canon had R&D expenditures of ¥275,300 million (U.S.$2,647 million) in fiscal 2004, ¥259,140 million in fiscal 2003 and ¥233,669 million in fiscal 2002. The ratio of R&D expenditure to total net sales for fiscal 2004, 2003 and 2002 was 7.9%, 8.1% and 7.9%, respectively.

Canon seeks to produce new products that are protected by patents and to set market product standards in order to enhance its market position. The United States Patent and Trademark Office (USPTO) announced that Canon obtained the third-greatest number of private sector patents in 2004. This achievement marks Canon's thirteenth consecutive year as one of the top three patent-receiving private-sector organizations.

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

RECENT DEVELOPMENTS

On October 15, 2004, the Company entered into an agreement with Canon Sales Co., Inc. and Canotec Co., Inc. ("Canotec"), joint equity shareholders of Niigata Canotec Co., Inc. ("Niigata Canotec"), to acquire all outstanding shares of Niigata Canotec. Therefore, on January 1, 2005, Niigata Canotec became a wholly owned subsidiary of the Company and changed its name to Canon Imaging System Technologies' Inc. By making Canon Imaging System Technologies Inc. a wholly owned subsidiary of the Company, Canon aims to raise the level of its technical capacity and improve development efficiency by enabling closer coordination each other.

On January 1, 2005, Canotec and FastNet, Inc. merged, and changed its name to Canon Network Communications, Inc. The purpose of the merger was to increase management efficiency by consolidating the Canon Group's network and Internet service operations. Canon Network Communications, Inc. aims to strengthen Information Technology Management Services, dealing with all stages from the establishment of comprehensive network systems to their operation and management.

MARKET RISK EXPOSURE

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

Equity price risk

Canon holds marketable securities included in current assets for short-term investments, which consists 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, 2004.

Foreign 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 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	¥ 301	341	$ 2,895	3,279
Due after one year through five years	1,607	2,191	15,452	21,068
Due after five years	1,049	1,047	10,086	10,067
Equity securities	10,302	26,950	99,058	259,134
	¥ 13,259	30,529	$ 127,491	293,548

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	¥ 21,460	21,460	$ 206,346	206,346

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

	Millions of yen			
Forwards to sell foreign currencies:	U.S.$	euro	Others	Total
Contract amounts	¥ 315,117	237,851	31,240	584,208
Estimated fair value	3,526	(8,147)	(93)	(4,714)
Forwards to buy foreign currencies:				
Contract amounts	¥ 19,149	5,290	9,762	34,201
Estimated fair value	(136)	(220)	(1,075)	(1,431)

	Thousands of U.S. dollars			
Forwards to sell foreign currencies:	U.S.$	euro	Others	Total
Contract amounts	$ 3,029,971	2,287,029	300,385	5,617,385
Estimated fair value	33,904	(78,337)	(894)	(45,327)
Forwards to buy foreign currencies:				
Contract amounts	$ 184,125	50,865	93,866	328,856
Estimated fair value	(1,308)	(2,115)	(10,337)	(13,760)

currency exchange transactions existing at December 31, 2004. All of the foreign exchange contracts described in the following table have a contractual maturity date in 2005.

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 the fixed-rate debt obligations by primarily entering into pay-fixed, receive-variable interest rate swaps.

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, 2003 and 2002 as the critical terms of the interest rate swaps match the terms of the hedged debt obligations.

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, 2004, 2003 and 2002. 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 ¥2,096 million ($20 million), ¥490 million and ¥668 million for the years ended December 31, 2004, 2003 and 2002, 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

For Canon, 2005 marks the fifth and the final year of Phase II of its Excellent Global Corporation Plan (2001-2005). Canon will continue to move forward with several initiatives designed to ensure that it meets its goals, including enhancements of efficiencies in all areas of Canon's operation, from R&D and production processes to head-office administrative operations, by simultaneously targeting improved productivity and the elimination of waste. In the area of development, Canon will target the further shortening of product development periods and improvements in design quality. Canon will also continue to strive to substantially reduce product development costs by implementing digital trial production procedures that make it unnecessary to create prototypes. As for production, Canon will focus its energies on the in-house production of key components and development of innovative high-efficiency factory automation equipment to realize even greater cost

LONG-TERM DEBT (including due within one year) (Millions of yen)

	Weighted average interest rates		Total	Expected maturity date 2005	2006	2007	2008	2009	Thereafter	Estimated Fair Value
Japanese yen notes	2.46%	¥	25,200	5,200	—	10,000	10,000	—	—	26,559
Japanese yen convertible debentures	1.28%		1,796	309	—	—	1,487	—	—	6,634
Other long-term debt	2.38%		11,534	4,370	5,046	1,401	587	105	25	11,427
Total		¥	38,530	9,879	5,046	11,401	12,074	105	25	44,620

LONG-TERM DEBT (including due within one year) (Thousands of U.S. dollars)

	Weighted average interest rates		Total	Expected maturity date 2005	2006	2007	2008	2009	Thereafter	Estimated Fair Value
Japanese yen notes	2.46%	$	242,308	50,000	—	96,154	96,154	—	—	255,375
Japanese yen convertible debentures	1.28%		17,269	2,971	—	—	14,298	—	—	63,788
Other long-term debt	2.38%		110,903	42,019	48,520	13,471	5,643	1,010	240	109,875
Total		$	370,480	94,990	48,520	109,625	116,095	1,010	240	429,038

Note: All long-term debt is fixed rate except loans, principally from banks which include both fixed and floating rate debt.

reductions. With regard to marketing activities, in addition to promoting marketing reforms through structural reorganization and strengthening marketing channels, Canon is also working to expand and strengthen its solutions business and improve its hardware solutions offerings through greater customization to better meet customer needs. Canon also views the protection of the environment as an essential part of its management activities and will continue to develop environmentally-conscious products and introduce resource-recycling systems while actively expanding its green procurement and purchasing programs.

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 high-speed models. Also, in addition to the mid-level models for office market which enjoys steady growth, Canon expects that the market will expand into higher-end models and low-end multi-function models. The market for color digital devices continued to grow rapidly, and sales of monochrome digital multifunction devices were stable, reflecting the market trend shifting from single-function to multifunction.

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. 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.

Manufacturing in the new Canon Suzhou facility in China has been progressing satisfactorily. While competitors seek to transfer manufacturing facilities to China, Canon regards its manufacturing bases in Japan important as well, in order to pursue total cost reduction by strengthening and reinforcing of technology, through the collaboration of R&D division, manufacturing division and quality management division.

Computer peripheral products

In the inkjet printer market, Canon expects a continuation of declines in market prices, a shift from single-function printers to multi-function printers, and an expanding size of the digital photo market. To manage these trends, Canon has newly established the PIXMA, brand name for its inkjet single-function printers/multi-function printers worldwide (other than Japan in which already introduced as PIXUS brand) with new functions and technologies.

Canon's laser beam printer business has 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 consumer 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.

Canon expects that the size of the scanner market will continue to contract, but Canon has increased its share in the market with the new CanonScanLiDE series introduced in fiscal 2003.

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 multi-function printers with facsimile function, prices are also declining for stand-alone machines.

Business information products

With regard to personal computers, demand from corporate clients on the Japanese market held steady, but a decline in sales was caused by our 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 2005.

Cameras segment

The entire digital camera market continues to expand. Although in Japan and USA, it has started showing slow growing curve, the emerging market, especially China and Eastern Europe, have shown steep growth. In addition, the emergence of new photo imaging systems, such as PC free direct printing system, expands the digital imaging possibilities through networking connectivity, along with the improvement of the user-friendly image processing interface and software.

Canon expects the market for compact digital cameras will expand in the intermediate term. In general, declines in prices and intense competition are causing decrease in profitability in the industry.

The compact photo printer market is developing rapidly. Canon expects that the ratio of Compact Photo printers that is attached to digital cameras will reach around 30% within a few years, and Canon will take an initiative to lead the expansion of the market.

Canon played a major role in the rapid expansion of the digital single lens reflex(SLR) market in fiscal 2004. The market size almost tripled from fiscal 2003, easily taking over the majority of the SLR market from the film cameras. With the introduction of the new models, Canon is determined to stay atop of the expanding market in fiscal 2005.

While industry enjoy many positive impact to motivate the industry's growth, as a nature of the Digital Consumer Goods, the market will face with price competition as well as technological competition focused on image quality and high performance. Though profit levels in the industry have recently declined, Canon has succeeded in maintaining profitability by carrying out production and procurement reforms.

Film camera market is suffering from this rapid digital shift of the camera market. Canon anticipates the trend to continue, both in the film SLR, and in the film compact category.

Canon expects to see growth in the interchangeable lens market as a result of the rapid market penetration of digital single lens reflex cameras. In response to the rapid shift of the single lens reflex camera market from film to digital, Canon began to introduce interchangeable lenses exclusively for digital single lens reflex cameras in the last half of fiscal 2003, and so far has introduced four models in this market. Canon seeks to expand its sales and share by introducing products especially made for popular class digital single lens reflex cameras.

For video camcorders, analog camcorder sales has been further replaced by digital sales in the fiscal 2004 worldwide market, including the most significant transition occurring in United States, where the speed of transition used to be moderate. At the same time, while Mini DV (Mini Digital Video) is currently the main recording media, camcorders with new media such as DVD (Digital Versatile Drive), SD (Secure Digital) memory card, HDD (Hard Disk Drive), and new recording format such as HDV are starting to emerge. Canon expects that Mini DV (Mini Digital Video) will remain the mainstream of format while the emerging new media will drive new expansion of the entire camcorder market. Canon will seek to continue sales growth with a stronger product lineup for the Mini DV market, while keeping investment on R&D to follow this trend in the market.

Canon expects that the market for liquid crystal business will continue to grow by about 30% per year on a unit basis, while market prices will continue to decline, resulting in a moderate growth in monetary basis. Canon introduced to the market in fiscal 2004 the reflective liquid crystals (LCOS (Liquid Crystal on Silicon)) type projector, the SX50 that was developed independently by Canon. Canon will expand its business with products that will be distinguished by high brightness, high resolution, and high picture quality and that will be easy to use (stress-free); all achieved using its advanced optical technologies.

Optical and other products segment

Within the semiconductor-production equipment market, Canon expects that the pace of new orders will likely slow somewhat in fiscal 2005, as semiconductor manufacturers grow more cautious in their capital investment spending. In general, the trend toward high resolution and higher speed equipment will likely to continue in the semiconductor industry. In order to manage theses trends, Canon introduced FPA-6000AS4 Stepper, the fastest ArF Stepper which also has the highest NA (0.85) and an ultra-low aberration lens system. With recommended illumination, the FPA-6000AS4 Stepper will be used for the most advanced IC mass-production.

For fiscal 2004, sales of aligners for the production of LCDs realized notable growth as the PC monitor industry continued to shift from CRT to LCD displays, and the LCD television market continued to expand. In the LCD production mask aligner market, demand is expected to decline gradually as the trend toward increased capital investment tapers off.

Canon expects the overall market size for TV broadcasting lenses to remain relatively stable in the long run. Since fiscal 2002, the market has expanded slightly, recovering from a slump after 9/11 and benefiting from a trend digitalization of broadcast equipment. The gradual increase in the TV lens market in part reflected studio equipment replacement by major TV stations in Japan, and outside broadcast vehicle equipment replacement in the United States. In coming years, Canon anticipates local station equipment replacement in Japan and studio equipment replacement in the United States. Equipment replacement in Europe, China and other Asian nations will likely follow. China, with the 2008 Olympics in Beijing, is an attractive market for Canon's 100x television broadcasting zoom lens. Though Canon already has a major market share worldwide for this class of lens, Canon will continue to strengthen its position in this market.

Forward looking statements

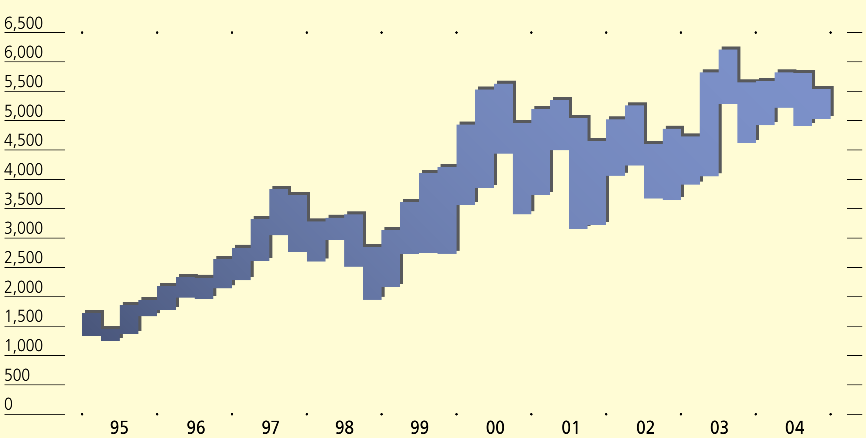
The foregoing discussion and other disclosure in this report contains forward-looking statements that reflect management's current views with respect to certain future events and financial performance. Actual results may differ materially from those projected or implied in the forward-looking statements. 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: exchange rate fluctuations; the uncertainty of Canon's ability to implement its plans to localize production and other measures to reduce the impact of exchange rate fluctuations; uncertainty as to economic 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 exchange rates; and inventory risk due to shifts in market demand.

TEN-YEAR FINANCIAL SUMMARY

(Millions of yen except per share amounts)

	2004	2003	2002	2001
Net sales:				
Domestic	¥ **849,734**	801,400	732,551	827,288
Overseas	**2,618,119**	2,396,672	2,207,577	2,080,285
Total	**3,467,853**	3,198,072	2,940,128	2,907,573
Percentage of previous year	**108.4%**	108.8	101.1	107.8
Net income	**343,344**	275,730	190,737	167,561
Percentage of sales	**9.9%**	8.6	6.5	5.8
Advertising	**111,770**	100,278	71,725	66,837
Research and development	**275,300**	259,140	233,669	218,616
Depreciation of property, plant and equipment	**174,397**	168,636	158,469	147,286
Capital expenditure	**318,730**	210,038	198,702	207,674
Long-term debt, excluding current installments	**28,651**	59,260	81,349	95,526
Stockholders' equity	**2,209,896**	1,865,545	1,591,950	1,458,476
Total assets	**3,587,021**	3,182,148	2,942,706	2,844,756
Per share data:				
Income before cumulative effect of change in accounting principle:				
Basic	**387.80**	313.81	217.56	187.07
Diluted	**386.78**	310.75	214.80	184.55
Net income:				
Basic	**387.80**	313.81	217.56	191.29
Diluted	**386.78**	310.75	214.80	188.70
Cash dividends declared	**65.00**	50.00	30.00	25.00
Stock price:				
High	**5,820**	6,210	5,250	5,330
Low	**4,910**	3,910	3,620	3,150
Average number of common shares in thousands	**885,365**	878,649	876,716	875,960
Number of employees	**108,257**	102,567	97,802	93,620

Common stock price range (Tokyo stock exchange)
(Yen)



2000	1999	1998	1997	1996	1995	(Thousands of U.S. dollars except per share amounts) 2004
779,366	718,513	725,063	811,455	784,917	677,692	**$ 8,170,519**
1,917,054	1,812,383	2,011,021	1,858,079	1,687,920	1,408,186	**25,174,221**
2,696,420	2,530,896	2,736,084	2,669,534	2,472,837	2,085,878	**33,344,740**
106.5	92.5	102.5	108.0	118.6	112.0	**108.4**
134,088	70,234	109,569	118,813	94,177	55,036	**3,301,385**
5.0	2.8	4.0	4.5	3.8	2.6	**9.9**
67,840	67,544	76,911	75,800	68,354	53,033	**1,074,712**
194,552	177,922	176,967	170,793	150,085	125,253	**2,647,115**
144,043	155,682	159,888	137,777	117,263	104,474	**1,676,894**
170,986	200,386	221,401	219,779	176,357	123,560	**3,064,712**
142,925	165,277	180,320	226,889	192,254	298,055	**275,490**
1,298,914	1,202,003	1,155,520	1,109,511	1,007,434	880,150	**21,249,000**
2,832,125	2,587,532	2,728,329	2,872,779	2,644,452	2,506,152	**34,490,587**
153.66	80.66	126.10	137.73	111.29	65.96	**3.73**
151.51	79.50	123.93	134.60	106.96	62.73	**3.72**
153.66	80.66	126.10	137.73	111.29	65.96	**3.73**
151.51	79.50	123.93	134.60	106.96	62.73	**3.72**
21.00	17.00	17.00	17.00	15.00	13.00	**0.63**
5,620	4,200	3,400	3,820	2,630	1,940	**55.96**
3,400	2,170	1,930	2,280	1,780	1,230	**47.21**
872,606	870,699	868,916	862,664	846,224	834,329	
86,673	81,009	79,799	78,767	75,628	72,280	

Notes: U.S. dollar amounts are translated from yen at the rate of U.S.$1 = ¥104, the approximate exchange rate on the Tokyo Foreign Exchange Market as of December 30, 2004.

CONSOLIDATED BALANCE SHEETS

December 31, 2004 and 2003

ASSETS	Millions of yen 2004	Millions of yen 2003	Thousands of U.S. dollars (note 2) 2004
Current assets:			
Cash and cash equivalents	¥ 887,774	690,298	$ 8,536,288
Marketable securities (note 4)	1,554	1,324	14,942
Trade receivables, net (note 5)	602,790	539,006	5,796,058
Inventories (note 6)	489,128	444,244	4,703,154
Prepaid expenses and other current assets (notes 8, 10 and 13)	250,906	255,905	2,412,558
Total current assets	2,232,152	1,930,777	21,463,000
Noncurrent receivables (note 19)	14,567	16,543	140,067
Investments (notes 4 and 10)	97,461	78,912	937,125
Property, plant and equipment, net (notes 7, 8 and 10)	961,714	846,433	9,247,250
Other assets (notes 8, 9, 12 and 13)	281,127	309,483	2,703,145
Total assets	¥ 3,587,021	3,182,148	$ 34,490,587

LIABILITIES AND STOCKHOLDERS' EQUITY	Millions of yen 2004	Millions of yen 2003	Thousands of U.S. dollars (note 2) 2004
Current liabilities:			
Short-term loans and current portion of long-term debt (note 10)	¥ 9,879	39,136	$ 94,990
Trade payables (note 11)	465,396	391,181	4,474,962
Income taxes (note 13)	105,565	83,064	1,015,048
Accrued expenses (note 19)	205,296	193,657	1,974,000
Other current liabilities (note 13)	197,029	120,265	1,894,510
Total current liabilities	983,165	827,303	9,453,510
Long-term debt, excluding current installments (note 10)	28,651	59,260	275,490
Accrued pension and severance cost (note 12)	132,522	238,001	1,274,250
Other noncurrent liabilities (note 13)	45,993	30,843	442,240
Total liabilities	1,190,331	1,155,407	11,445,490
Minority interests	186,794	161,196	1,796,097
Commitments and contingent liabilities (note 19)			
Stockholders' equity:			
Common stock			
Authorized 2,000,000,000 shares; issued 887,977,251 shares in 2004 and 881,338,645 shares in 2003 (note 14)	173,864	168,892	1,671,769
Additional paid-in capital (note 14)	401,773	396,939	3,863,202
Legal reserve (note 15)	41,200	39,998	396,154
Retained earnings (note 15)	1,699,634	1,410,442	16,342,634
Accumulated other comprehensive income (loss) (note 16)	(101,312)	(143,275)	(974,154)
Treasury stock, at cost 1,120,867 shares in 2004 and 1,606,513 shares in 2003	(5,263)	(7,451)	(50,605)
Total stockholders' equity	2,209,896	1,865,545	21,249,000
Total liabilities and stockholders' equity	¥ 3,587,021	3,182,148	$ 34,490,587

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

Year ended December 31, 2004, 2003 and 2002

	Millions of yen			Thousands of U.S. dollars (note 2)
	2004	2003	2002	2004
Net sales	¥ 3,467,853	3,198,072	2,940,128	$ 33,344,740
Cost of sales (notes 9, 12 and 19)	1,754,510	1,589,172	1,540,097	16,870,288
Gross profit	1,713,343	1,608,900	1,400,031	16,474,452
Selling, general and administrative expenses (notes 1, 9, 12 and 19)	1,169,550	1,154,476	1,053,672	11,245,673
Operating profit	543,793	454,424	346,359	5,228,779
Other income (deductions):				
Interest and dividend income	7,118	9,284	9,198	68,442
Interest expense	(2,756)	(4,627)	(6,788)	(26,500)
Other, net (notes 1, 4 and 18)	3,961	(10,911)	(18,752)	38,087
	8,323	(6,254)	(16,342)	80,029
Income before income taxes and minority interests	552,116	448,170	330,017	5,308,808
Income taxes (note 13)	194,014	162,653	134,703	1,865,520
Income before minority interests	358,102	285,517	195,314	3,443,288
Minority interests	14,758	9,787	4,577	141,903
Net income	¥ 343,344	275,730	190,737	$ 3,301,385

	Yen			U.S. dollars (note 2)
Net income per share (note 17)				
Basic	¥ 387.80	313.81	217.56	$ 3.73
Diluted	386.78	310.75	214.80	3.72
Cash dividends per share	65.00	50.00	30.00	0.63

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Year ended December 31, 2004, 2003 and 2002

	Millions of yen			Thousands of U.S. dollars (note 2)
	2004	2003	2002	2004
Common stock:				
Balance at beginning of year	¥ 168,892	167,242	165,287	$ 1,623,962
Conversion of convertible debt	4,972	1,650	1,955	47,807
Balance at end of year	173,864	168,892	167,242	1,671,769
Additional paid-in capital:				
Balance at beginning of year	396,939	394,088	392,456	3,816,721
Conversion of convertible debt and other	4,966	1,649	1,953	47,750
Stock exchanged under exchange offering	114	—	1,052	1,096
Capital transactions by consolidated subsidiaries	(246)	1,202	(1,373)	(2,365)
Balance at end of year	401,773	396,939	394,088	3,863,202
Legal reserve:				
Balance at beginning of year	39,998	38,803	38,330	384,596
Transfers from retained earnings	1,202	1,195	477	11,558
Other	—	—	(4)	—
Balance at end of year	41,200	39,998	38,803	396,154
Retained earnings:				
Balance at beginning of year	1,410,442	1,164,445	997,848	13,561,942
Net income for the year	343,344	275,730	190,737	3,301,385
Cash dividends	(52,950)	(28,538)	(23,663)	(509,135)
Transfers to legal reserve	(1,202)	(1,195)	(477)	(11,558)
Balance at end of year	1,699,634	1,410,442	1,164,445	16,342,634
Accumulated other comprehensive income (loss):				
Balance at beginning of year	(143,275)	(166,467)	(135,168)	(1,377,644)
Other comprehensive income (loss) for the year, net of tax	41,963	23,192	(31,299)	403,490
Balance at end of year	(101,312)	(143,275)	(166,467)	(974,154)
Treasury stock:				
Balance at beginning of year	(7,451)	(6,161)	(277)	(71,643)
Repurchase, net	(503)	(1,290)	(5,884)	(4,837)
Stock exchanged under exchange offering	2,691	—	—	25,875
Balance at end of year	(5,263)	(7,451)	(6,161)	(50,605)
Total stockholders' equity	¥ 2,209,896	1,865,545	1,591,950	$ 21,249,000
Disclosure of comprehensive income:				
Net income for the year	¥ 343,344	275,730	190,737	$ 3,301,385
Other comprehensive income (loss) for the year, net of tax (note 16)				
Foreign currency translation adjustments	4,050	(15,277)	(15,864)	38,942
Net unrealized gains and losses on securities	686	7,952	(1,732)	6,596
Net gains and losses on derivative instruments	(396)	37	2,089	(3,808)
Minimum pension liability adjustments	37,623	30,480	(15,792)	361,760
Other comprehensive income (loss)	41,963	23,192	(31,299)	403,490
Total comprehensive income for the year	¥ 385,307	298,922	159,438	$ 3,704,875

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended December 31, 2004, 2003 and 2002

	Millions of yen			Thousands of U.S. dollars (note 2)
	2004	2003	2002	2004
Cash flows from operating activities:				
Net income	¥ 343,344	275,730	190,737	$ 3,301,385
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	192,692	183,604	165,260	1,852,808
Loss on disposal of property, plant and equipment	24,597	12,639	13,137	236,510
Deferred income taxes	9,060	(3,035)	(1,788)	87,115
Increase in trade receivables	(53,595)	(36,638)	(47,077)	(515,337)
(Increase) decrease in inventories	(40,050)	(15,823)	14,029	(385,096)
Increase in trade payables	65,873	1,129	64,040	633,394
Increase in income taxes	21,689	3,441	14,935	208,548
Increase in accrued expenses	8,196	37,131	12,901	78,808
Increase (decrease) in accrued pension and severance cost	(16,924)	29,445	20,993	(162,731)
Other, net	6,647	(21,974)	1,783	63,913
Net cash provided by operating activities	561,529	465,649	448,950	5,399,317
Cash flows from investing activities:				
Purchases of property, plant and equipment	(256,714)	(199,720)	(205,139)	(2,468,404)
Proceeds from sale of property, plant and equipment	7,431	9,354	11,971	71,452
Purchases of available-for-sale securities	(388)	(249)	(2,751)	(3,731)
Purchases of held-to-maturity securities	(21,544)	—	—	(207,154)
Proceeds from sale of available-for-sale securities	9,735	6,544	1,099	93,606
Proceeds from sale of subsidiary common stock	9,731	—	—	93,567
Purchases of other investments	(8,628)	(24,341)	(30,331)	(82,962)
Other, net	7,410	8,464	(5,069)	71,251
Net cash used in investing activities	(252,967)	(199,948)	(230,220)	(2,432,375)
Cash flows from financing activities:				
Proceeds from issuance of long-term debt	2,115	4,132	10,609	20,337
Repayments of long-term debt	(43,175)	(25,301)	(60,690)	(415,144)
Decrease in short-term loans	(3,046)	(49,224)	(101,125)	(29,288)
Dividends paid	(52,950)	(28,538)	(23,663)	(509,135)
Purchases of treasury stock, net	(494)	(1,071)	(5,884)	(4,750)
Other, net	(4,718)	(2,037)	(2,961)	(45,366)
Net cash used in financing activities	(102,268)	(102,039)	(183,714)	(983,346)
Effect of exchange rate changes on cash and cash equivalents	(8,818)	5,365	(19,979)	(84,789)
Net increase in cash and cash equivalents	197,476	169,027	15,037	1,898,807
Cash and cash equivalents at beginning of year	690,298	521,271	506,234	6,637,481
Cash and cash equivalents at end of year	¥ 887,774	690,298	521,271	$ 8,536,288
Supplemental disclosure for cash flow information (note 21):				
Cash paid during the year for:				
Interest	¥ 2,981	4,570	6,890	$ 28,663
Income taxes	164,450	162,247	121,556	1,581,250

See accompanying notes to consolidated financial statements.

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, 2004, 2003 and 2002 were distributed as follows: office imaging products 33%, 34% and 35%, computer peripherals 33%, 34% and 36%, business information products 3%, 4% and 5%, cameras 22%, 20% and 16%, and optical and other products 9%, 8% 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 73% of consolidated net sales for each of the years ended December 31, 2004, 2003 and 2002 were generated outside Japan, with 30%, 33% and 34% in the Americas, 31%, 30% and 29% in Europe, and 12%, 10% and 10% in other areas, respectively.

Canon sells laser beam printers on an OEM basis to Hewlett-Packard Company; such sales constituted approximately 21%, 20% and 21% of consolidated net sales for the years ended December 31, 2004, 2003 and 2002, respectively.

Canon's manufacturing operations are conducted primarily at 18 plants in Japan and 14 overseas plants which are located in 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 accounting principles generally accepted in the United States of America. 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 accounting principles generally accepted in the United States of America 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, 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 were ¥17,800 million ($171,154 thousand), ¥20,311 million and ¥23,468 million for the years ended December 31, 2004, 2003 and 2002, 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 gain 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 20% to 50% owned affiliates in which Canon has the ability to exercise significant influence over their operating and financial policies 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 by 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 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 instead tested for impairment at least annually. 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 are recognized as services are provided.

Revenues from the sale of equipment under sales-type leases are 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 lease or direct-financing lease 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.

A liability for the estimated product warranty cost is recorded at the time revenue is recognized and is included in accrued expenses. Estimates for accrued product warranty cost 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. Research and development expenses were ¥275,300 million ($2,647,115 thousand), ¥259,140 million and ¥233,669 million for the years ended December 31, 2004, 2003 and 2002, respectively.

(t) Advertising Costs

Advertising costs are expensed as incurred. Advertising expenses were ¥111,770 million ($1,074,712 thousand), ¥100,278 million and ¥71,725 million for the years ended December 31, 2004, 2003 and 2002, respectively.

(u) Shipping and Handling Costs

Shipping and handling costs totaled ¥46,953 million ($451,471 thousand), ¥40,660 million and ¥39,170 million for the years ended December 31, 2004, 2003 and 2002, 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 March 2004, the Emerging Issues Task Force reached a consensus on Issue No. 03-1 ("EITF 03-1"), "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." EITF 03-1 provides guidance on other-than-temporary impairment models for marketable debt and equity securities accounted for under Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"), and non-marketable equity securities accounted for under the cost method. The EITF developed a basic three-step model to evaluate whether an investment is other-than-temporarily impaired. The Financial Accounting Standards Board ("FASB") issued FASB Staff Position EITF 03-1-1 in September 2004 which delayed the effective date of the recognition and measurement provisions of EITF 03-1. The adoption of EITF 03-1 is not expected to have a material effect on Canon's consolidated results of operations and financial position.

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 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 153 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

(y) Reclassification

Certain reclassifications have been made to the prior years' consolidated financial statements to conform with the presentation used for the year ended December 31, 2004.

(2) Basis of Financial Statement Translation

The consolidated financial statements presented herein are expressed in yen and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ¥104 = U.S.$1, the approximate exchange rate prevailing on the Tokyo Foreign Exchange Market on December 30, 2004. 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
	2004	2003	2002	2004
Total assets	¥ 1,500,197	1,339,854	1,238,800	$ 14,424,971
Net assets	632,657	564,041	518,927	6,083,240
Net sales	2,548,700	2,341,221	2,151,062	24,506,731
Net income	70,227	74,274	58,883	675,260

(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, 2004 and 2003 were as follows:

December 31 (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:				
Governmental bond securities	¥ 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

(Millions of yen)	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2003: Current:				
Available-for-sale:				
Governmental bond securities	¥ 65	—	4	61
Corporate debt securities	7	—	—	7
Bank debt securities	71	—	—	71
Fund trusts	51	12	—	63
Equity securities	1,044	78	—	1,122
	¥ 1,238	90	4	1,324
Noncurrent:				
Available-for-sale:				
Governmental bond securities	¥ 243	—	5	238
Corporate debt securities	5,141	53	—	5,194
Fund trusts	2,047	455	—	2,502
Equity securities	6,525	15,534	204	21,855
	¥ 13,956	16,042	209	29,789

(Thousands of U.S. dollars)	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2004: Current:				
Available-for-sale:				
Corporate debt securities	**$ 1,327**	**—**	**—**	**1,327**
Bank debt securities	**683**	**—**	**—**	**683**
Fund trusts	**885**	**384**	**—**	**1,269**
Equity securities	**10,740**	**961**	**38**	**11,663**
	$ 13,635	**1,345**	**38**	**14,942**
Noncurrent:				
Available-for-sale:				
Governmental bond securities	**$ 5,154**	**250**	**241**	**5,163**
Corporate debt securities	**538**	**184**	**—**	**722**
Fund trusts	**19,846**	**5,519**	**115**	**25,250**
Equity securities	**88,318**	**159,884**	**731**	**247,471**
	113,856	**165,837**	**1,087**	**278,606**
Held-to-maturity:				
Corporate debt securities	**206,346**	**—**	**—**	**206,346**
	$ 320,202	**165,837**	**1,087**	**484,952**

Maturities of debt securities and fund trust classified as available-for-sale and held-to-maturity were as follows at December 31, 2004:

Available-for-sale securities

	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥ 301	341	$ 2,895	3,279
Due after one year through five years	1,607	2,191	15,452	21,068
Due after five years	1,049	1,047	10,086	10,067
	¥ 2,957	3,579	$ 28,433	34,414

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	¥ 21,460	21,460	$ 206,346	206,346

The gross realized gains for the year ended December 31, 2004 were ¥3,867 million ($37,183 thousand). The gross realized gains for the years ended December 31, 2003 and 2002 and the gross realized losses for the years ended December 31, 2004, 2003 and 2002 were not significant.

At December 31, 2004, 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 ¥14,635 million ($140,721 thousand) and ¥18,253 million at December 31, 2004 and 2003, respectively. Investments with an aggregate cost of ¥14,607 million ($140,452 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 investment and (b) Canon did not identify any events or changes in circumstances that might have had significant adverse effect on the fair value of those investments.

Investments in affiliated companies accounted for by the equity method amounted to ¥26,546 million ($255,250 thousand) and ¥24,806 million at December 31, 2004 and 2003, 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 ¥1,921 million ($18,471 thousand) for the year ended December 31, 2004 and losses of ¥1,124 million and ¥3,521 million for the years ended December 31, 2003 and 2002, respectively.

(5) Trade Receivables

Trade receivables are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	**2004**
Notes	**¥ 30,261**	28,880	**$ 290,971**
Accounts	**584,186**	524,549	**5,617,174**
	614,447	553,429	**5,908,145**
Less allowance for doubtful receivables	**(11,657)**	(14,423)	**(112,087)**
	¥ 602,790	539,006	**$ 5,796,058**

(6) Inventories

Inventories comprised the following:

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Finished goods	¥ 352,656	305,414	$ 3,390,923
Work in process	121,613	124,410	1,169,356
Raw materials	14,859	14,420	142,875
	¥ 489,128	444,244	$ 4,703,154

(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
	2004	2003	2004
Land	¥ 182,330	177,953	$ 1,753,173
Buildings	824,969	766,398	7,932,394
Machinery and equipment	1,053,121	990,638	10,126,164
Construction in progress	74,599	29,627	717,298
	2,135,019	1,964,616	20,529,029
Less accumulated depreciation	(1,173,305)	(1,118,183)	(11,281,779)
	¥ 961,714	846,433	$ 9,247,250

(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
	2004	2003	2004
Total minimum lease payments receivable	¥ 180,707	197,684	$ 1,737,567
Unguaranteed residual values	10,816	10,295	104,000
Executory costs	(2,533)	(2,523)	(24,356)
Unearned income	(20,880)	(23,279)	(200,769)
	168,110	182,177	1,616,442
Less allowance for doubtful receivables	(6,068)	(6,339)	(58,346)
	162,042	175,838	1,558,096
Less amount due within one year	(61,187)	(68,135)	(588,336)
	¥ 100,855	107,703	$ 969,760

The cost of equipment leased to customers under operating leases at December 31, 2004 and 2003 was ¥67,364 million ($647,731 thousand) and ¥78,712 million, respectively. Accumulated depreciation on equipment under operating leases at December 31, 2004 and 2003 was ¥52,493 million ($504,740 thousand) and ¥64,770 million, respectively.

The following is a schedule by year of the future minimum lease payments to be received under financing leases and non-cancelable operating leases at December 31, 2004.

Year ending December 31	Millions of yen		Thousands of U.S. dollars	
	Financing leases	Operating leases	Financing leases	Operating leases
2005	¥ 70,921	2,447	$ 681,933	23,529
2006	55,771	1,296	536,260	12,462
2007	33,718	670	324,212	6,442
2008	15,571	253	149,721	2,433
2009	4,523	82	43,490	788
Thereafter	203	8	1,951	77
	¥ 180,707	4,756	$ 1,737,567	45,731

(9) Goodwill and Other Intangible Assets

Intangible assets acquired for the year ended December 31, 2004 totaled ¥25,234 million ($242,635 thousand), which are subject to amortization and primarily consist of internal use software of ¥19,523 million ($187,721 thousand) and license fees of ¥5,072 million ($48,769 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, 2004 and 2003 were as follows:

December 31 (Millions of yen)	**2004**		2003	
	Gross Carrying Amount	**Accumulated Amortization**	Gross Carrying Amount	Accumulated Amortization
Software	**¥ 121,546**	**79,517**	¥ 115,675	80,534
License fees	**24,603**	**14,183**	21,975	14,012
Other	**6,976**	**3,585**	6,188	3,319
Total	**¥ 153,125**	**97,285**	¥ 143,838	97,865

(Thousands of U.S. dollars)	**2004**	
	Gross Carrying Amount	**Accumulated Amortization**
Software	**$ 1,168,712**	**764,587**
License fees	**236,567**	**136,375**
Other	**67,077**	**34,471**
Total	**$ 1,472,356**	**935,433**

Aggregate amortization expense for the years ended December 31, 2004, 2003 and 2002 was ¥18,295 million ($175,913 thousand), ¥12,438 million and ¥6,288 million, respectively. Estimated amortization expense for the next five years ending December 31 is ¥17,785 million ($171,010 thousand) in 2005, ¥14,528 million ($139,692 thousand) in 2006, ¥10,311 million ($99,144 thousand) in 2007, ¥6,804 million ($65,423 thousand) in 2008, and ¥3,751 million ($36,067 thousand) in 2009.

Intangible assets not subject to amortization other than goodwill at December 31, 2004 and 2003 were not significant.

The changes in the carrying amount of goodwill for the years ended December 31, 2004 and 2003 were as follows:

Year ended December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Balance at beginning of year	¥ 22,067	13,640	$ 212,183
Goodwill acquired during the year	3,156	7,839	30,346
Impairment losses	(42)	—	(404)
Recognition of acquired company's tax benefits	(1,298)	—	(12,481)
Translation adjustments	350	588	3,366
Balance at end of year	¥ 24,233	22,067	$ 233,010

During the year ended December 31, 2004, Canon recognized ¥1,298 million ($12,481 thousand) 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.

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

Short-term loans consisting of bank borrowings at December 31, 2003 were ¥2,941 million. The weighted average interest rate on short-term loans outstanding at December 31, 2003 was 2.10%.

Long-term debt consisted of the following:

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Loans, principally from banks, maturing in installments through 2013; bearing weighted average interest of 3.05% and 2.88% at December 31, 2004 and 2003, respectively, partially secured by mortgage of property, plant and equipment	¥ 2,949	27,452	$ 28,355
2.58% Japanese yen notes, due 2004	—	10,000	—
2.03% Japanese yen notes, due 2004	—	10,000	—
1.88% Japanese yen notes, due 2005	5,000	5,000	48,077
1.71% Japanese yen notes, due 2005	200	—	1,923
2.95% Japanese yen notes, due 2007	10,000	10,000	96,154
2.27% Japanese yen notes, due 2008	10,000	10,000	96,154
1.20% Japanese yen convertible debentures, due 2005	309	2,577	2,971
1.30% Japanese yen convertible debentures, due 2008	1,487	9,157	14,298
Capital lease obligations	8,585	11,269	82,548
	38,530	95,455	370,480
Less amount due within one year	(9,879)	(36,195)	(94,990)
	¥ 28,651	59,260	$ 275,490

The aggregate annual maturities of long-term debt outstanding at December 31, 2004 were as follows:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2005	¥ 9,879	$ 94,990
2006	5,046	48,520
2007	11,401	109,625
2008	12,074	116,095
2009	105	1,010
Thereafter	25	240
	¥ 38,530	$ 370,480

Certain property, plant and equipment with a net book carrying value of ¥11,247 million ($108,144 thousand) at December 31, 2004 was mortgaged to secure loans from banks.

In November 2004, Canon entered into an agreement whereby certain assets were deposited into an irrevocable trust to meet the debt service requirements of the: 1.88% Japanese yen notes; 2.95% Japanese yen notes; and 2.27% Japanese yen notes in the aggregate amount of ¥25,000 million ($240,385 thousand). The assets contributed by Canon consisted of certificates of deposit and debt securities with carrying amounts of ¥5,072 million ($48,769 thousand) and ¥21,460 million ($206,346 thousand), respectively, at December 31, 2004. Cash flows from such investments will be used solely to satisfy the principal and interest obligations for the debts. Accordingly, the certificates of deposit are included in the consolidated balance sheet under the caption of prepaid expenses and other current assets, and 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 1.20% Japanese yen convertible debentures due 2005 are convertible into approximately 206,000 shares of common stock at a conversion price of ¥1,497.00 ($14.39) per share at December 31, 2004.

The 1.30% Japanese yen convertible debentures due 2008 are convertible into approximately 993,000 shares of common stock at a conversion price of ¥1,497.00 ($14.39) per share at December 31, 2004. The debentures are redeemable at the option of the Company between January 1, 2005 and December 31, 2007 at declining premiums ranging from 3% to 1%, and at par thereafter.

(11) Trade Payables

Trade payables are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Notes	¥ 51,081	47,771	$ 491,164
Accounts	414,315	343,410	3,983,798
	¥ 465,396	391,181	$ 4,474,962

(12) 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 ($669,721 thousand) 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 ($834,538 thousand), which is calculated as the difference between the obligation settled and the assets transferred to the government. The net gain of ¥17,141 million ($164,817 thousand) 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, 2004, 2003 and 2002 consisted of the following components:

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2004	2003	2002	2004
Service cost — benefits earned during the year	¥ 26,571	29,024	39,206	$ 255,490
Interest cost on projected benefit obligation	19,108	20,806	19,270	183,731
Expected return on plan assets	(17,054)	(13,959)	(14,523)	(163,981)
Amortization of unrecognized net obligation at transition	344	344	344	3,308
Amortization of prior service cost	(6,814)	(5,515)	(3,246)	(65,519)
Recognized actuarial loss	12,505	15,807	14,743	120,241
Settlement loss resulting from plan termination	2,784	—	—	26,769
Settlement loss resulting from transfer of substitutional portion of EPFs to the government	69,651	—	—	669,721
	¥ 107,095	46,507	55,794	$ 1,029,760

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
	2004	2003	2004
Change in benefit obligations:			
Benefit obligations at beginning of year	¥ 752,390	766,452	$ 7,234,519
Service cost	26,571	29,024	255,490
Interest cost	19,108	20,806	183,731
Plan participants' contributions	1,142	2,102	10,981
Amendments	(2,781)	(52,749)	(26,741)
Actuarial gain	(5,728)	(3,398)	(55,077)
Benefits paid	(14,143)	(12,484)	(135,990)
Settlement on plan termination	(6,482)	—	(62,327)
Transfer of substitutional portion of EPFs to the government	(191,784)	—	(1,844,077)
Foreign currency exchange rate changes	3,957	630	38,048
Other	(38)	2,007	(365)
Benefit obligations at end of year	582,212	752,390	5,598,192
Change in plan assets:			
Fair value of plan assets at beginning of year	472,228	421,642	4,540,654
Actual return on plan assets	32,744	31,008	314,846
Employer contributions	31,018	29,944	298,250
Plan participants' contributions	1,142	2,102	10,981
Benefit paid	(14,143)	(12,484)	(135,990)
Settlement on plan termination	(2,274)	—	(21,865)
Transfer of substitutional portion of EPFs to the government	(104,992)	—	(1,009,539)
Foreign currency exchange rate changes	3,075	(20)	29,567
Other	—	36	—
Fair value of plan assets at end of year	418,798	472,228	4,026,904
Funded status	(163,414)	(280,162)	(1,571,288)
Unrecognized actuarial loss	191,376	297,839	1,840,154
Unrecognized prior service cost	(102,427)	(107,360)	(984,875)
Unrecognized net transition obligation being recognized over 22 years	4,300	4,644	41,346
Net amount recognized	¥ (70,165)	(85,039)	$ (674,663)
Amounts recognized in the consolidated balance sheets consist of:			
Prepaid pension cost	¥ 3,142	2,515	$ 30,212
Accrued pension and severance cost	(132,522)	(238,001)	(1,274,250)
Intangible assets	57	86	548
Accumulated other comprehensive income (loss)	59,158	150,361	568,827
Net amount recognized	¥ (70,165)	(85,039)	$ (674,663)

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

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Accumulated benefit obligation	¥ 540,615	702,049	$ 5,198,221

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
	2004	2003	2004
Plans with projected benefit obligations in excess of plan assets:			
Projected benefit obligations	¥ 577,022	752,390	$ 5,548,288
Fair value of plan assets	411,918	472,228	3,960,750
Plans with accumulated benefit obligations in excess of plan assets:			
Accumulated benefit obligations	512,216	697,711	4,925,154
Fair value of plan assets	386,921	466,970	3,720,394

Assumptions

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

December 31	2004	2003
Discount rate	2.7%	2.7%
Assumed rate of increase in future compensation levels	3.0%	2.0%

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

Year ended December 31	2004	2003	2002
Discount rate	2.7%	2.7%	2.7%
Assumed rate of increase in future compensation levels	2.0%	2.0%	3.4%
Expected long-term rate of return on plan assets	3.6%	3.6%	3.5%

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, 2004 and 2003 and target asset allocation by asset category are as follows:

December 31	2004	2003	Target allocation
Asset category:			
Equity securities	43.0%	32.1%	41.2%
Debt securities	37.2%	27.4%	36.7%
Cash	1.7%	19.6%	0.3%
Life insurance company general accounts	14.5%	19.0%	18.4%
Other	3.6%	1.9%	3.4%
	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 ¥946 million ($9,096 thousand) and ¥796 million at December 31, 2004 and 2003, respectively.

Contributions
Canon expects to contribute ¥36,183 million ($347,913 thousand) to its defined benefit plans for the year ending December 31, 2005.

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
2005	¥ 8,074	$ 77,635
2006	9,235	88,798
2007	10,552	101,462
2008	12,118	116,519
2009	13,410	128,942
2010 — 2014	86,720	833,846

(13) 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
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
2002: Income before income taxes and minority interests	¥ 237,677	92,340	330,017
Income taxes:			
Current	¥ 109,102	27,389	136,491
Deferred	(7,212)	5,424	(1,788)
	¥ 101,890	32,813	134,703

		Thousands of U.S. dollars	
	Japanese	Foreign	Total
2004: Income before income taxes and minority interests	**$ 4,306,385**	**1,002,423**	**5,308,808**
Income taxes:			
Current	**$ 1,564,222**	**214,183**	**1,778,405**
Deferred	**(10,241)**	**97,356**	**87,115**
	$ 1,553,981	**311,539**	**1,865,520**

The Company and its domestic subsidiaries are subject to a number of income taxes, which, in the aggregate, indicate a statutory income tax rate of approximately 42% for the years ended December 31, 2004, 2003 and 2002.

Amendments to the Japanese tax regulations were enacted on March 24, 2003. As a result of these amendments, the statutory income tax rate will be 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	2004	2003	2002
Japanese statutory income tax rate	**42.0%**	42.0%	42.0%
Increase (reduction) in income taxes resulting from:			
Expenses not deductible for tax purposes	**0.4**	0.2	0.5
Tax benefits not recognized on operating losses of subsidiaries	**0.1**	0.1	0.2
Income of foreign subsidiaries taxed at lower than Japanese statutory tax rate	**(2.1)**	(2.5)	(2.5)
Tax credit for research and development expenses	**(4.0)**	(4.0)	(1.6)
Effect of enacted changes in tax laws and rates	**—**	0.8	—
Other	**(1.3)**	(0.3)	2.2
Effective income tax rate	**35.1%**	36.3%	40.8%

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
	2004	2003	2004
Prepaid expenses and other current assets	**¥ 47,679**	44,198	**$ 458,452**
Other assets	**84,686**	124,706	**814,288**
Other current liabilities	**(2,873)**	(2,575)	**(27,625)**
Other noncurrent liabilities	**(30,049)**	(19,302)	**(288,932)**
	¥ 99,443	147,027	**$ 956,183**

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities at December 31, 2004 and 2003 are presented below:

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Deferred tax assets:			
Inventories	¥ 11,364	13,540	$ 109,269
Accrued business tax	10,149	8,684	97,587
Accrued pension and severance cost	34,680	45,149	333,462
Minimum pension liability adjustments	22,778	56,526	219,019
Research and development — costs capitalized for tax purposes	22,499	20,766	216,337
Property, plant and equipment	17,406	17,074	167,365
Accrued expenses	17,976	15,964	172,846
Net operating losses carried forward	1,799	6,279	17,298
Other	24,258	21,330	233,250
Total gross deferred tax assets	162,909	205,312	1,566,433
Less valuation allowance	(3,495)	(8,401)	(33,606)
Net deferred tax assets	159,414	196,911	1,532,827
Deferred tax liabilities:			
Undistributed earnings of foreign subsidiaries	(5,638)	(6,424)	(54,212)
Net unrealized gains on securities	(6,833)	(6,191)	(65,702)
Tax deductible reserve	(11,975)	(9,828)	(115,144)
Financing lease revenue	(30,196)	(25,049)	(290,346)
Other	(5,329)	(2,392)	(51,240)
Total gross deferred tax liabilities	(59,971)	(49,884)	(576,644)
Net deferred tax assets	¥ 99,443	147,027	$ 956,183

The net changes in the total valuation allowance for the years ended December 31, 2004, 2003, and 2002 were decreases of ¥4,906 million ($47,173 thousand), ¥1,282 million and ¥3,192 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, 2004.

At December 31, 2004, Canon had net operating losses which can be carried forward for income tax purposes of ¥5,065 million ($48,702 thousand) to reduce future taxable income. Periods available to reduce future taxable income vary in each tax jurisdiction and range from one year to ten years as follows:

	Millions of yen	Thousands of U.S. dollars
Within one year	¥ 182	$ 1,750
After one year through five years	4,805	46,202
After five years through ten years	78	750
Total	¥ 5,065	$ 48,702

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

Canon has not recognized deferred tax liabilities of ¥25,316 million ($243,423 thousand) for the portion of undistributed earnings of foreign subsidiaries that arose for the year ended December 31, 2004 and prior years because Canon currently does not expect those unremitted earnings to reverse and become taxable to the Company in the foreseeable future. Deferred tax liabilities will be recognized when Canon expects that it will recover those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investments. At December 31, 2004, such undistributed earnings of these subsidiaries were ¥471,301 million ($4,531,740 thousand).

(14) Common Stock

For the years ended December 31, 2004, 2003 and 2002, the Company issued 6,638,606 shares, 2,202,401 shares and 2,853,912 shares of common stock, respectively. The issuance of 243,360 shares during the year ended December 31, 2002 was in connection with the acquisition of the outstanding minority ownership interest of 37% of Canon Components, Inc. The remaining issuance of the shares of the Company was in connection with conversion of convertible debt. Conversion into common stock of convertible debt issued subsequent to October 1, 1982 has been 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.

(15) 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, 2004, 2003 and 2002 represent dividends paid out during those years and the related appropriations to the legal reserve. Retained earnings at December 31, 2004 do not reflect current year-end dividends aggregating ¥35,474 million ($341,096 thousand) which will be payable in March 2005 upon stockholder approval.

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 ¥1,141,596 million ($10,976,885 thousand) at December 31, 2004.

Retained earnings at December 31, 2004 included Canon's equity in undistributed earnings of affiliated companies accounted for by the equity method in the amount of ¥7,420 million ($71,346 thousand).

(16) Other Comprehensive Income (Loss)

Change in accumulated other comprehensive income (loss) is as follows:

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2004	2003	2002	2004
Foreign currency translation adjustments:				
Balance at beginning of year	¥ (83,801)	(68,524)	(52,660)	$ (805,779)
Adjustments for the year	4,050	(15,277)	(15,864)	38,942
Balance at end of year	(79,751)	(83,801)	(68,524)	(766,837)
Net unrealized gains and losses on securities:				
Balance at beginning of year	6,784	(1,168)	564	65,231
Adjustments for the year	686	7,952	(1,732)	6,596
Balance at end of year	7,470	6,784	(1,168)	71,827
Net gains and losses on derivative instruments:				
Balance at beginning of year	(297)	(334)	(2,423)	(2,855)
Adjustments for the year	(396)	37	2,089	(3,808)
Balance at end of year	(693)	(297)	(334)	(6,663)
Minimum pension liability adjustments:				
Balance at beginning of year	(65,961)	(96,441)	(80,649)	(634,241)
Adjustments for the year	37,623	30,480	(15,792)	361,760
Balance at end of year	(28,338)	(65,961)	(96,441)	(272,481)
Total accumulated other comprehensive income (loss):				
Balance at beginning of year	(143,275)	(166,467)	(135,168)	(1,377,644)
Adjustments for the year	41,963	23,192	(31,299)	403,490
Balance at end of year	¥ (101,312)	(143,275)	(166,467)	$ (974,154)

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
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**
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

Year ended December 31		Millions of yen		
		Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
2002:				
Foreign currency translation adjustments:				
Amount arising during the year	¥	(13,521)	(2,908)	(16,429)
Reclassification adjustments for gains and losses realized in net income		44	521	565
Net change during the year		(13,477)	(2,387)	(15,864)
Net unrealized gains and losses on securities:				
Amount arising during the year		(2,331)	872	(1,459)
Reclassification adjustments for gains and losses realized in net income		(589)	316	(273)
Net change during the year		(2,920)	1,188	(1,732)
Net gains and losses on derivative instruments:				
Amount arising during the year		(1,052)	442	(610)
Reclassification adjustments for gains and losses realized in net income		4,654	(1,955)	2,699
Net change during the year		3,602	(1,513)	2,089
Minimum pension liability adjustments		(26,472)	10,680	(15,792)
Other comprehensive income (loss)	¥	(39,267)	7,968	(31,299)

		Thousands of U.S. dollars		
		Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
2004:				
Foreign currency translation adjustments	**$**	**42,307**	**(3,365)**	**38,942**
Net unrealized gains and losses on securities:				
Amount arising during the year		**48,288**	**(21,173)**	**27,115**
Reclassification adjustments for gains and losses realized in net income		**(35,557)**	**15,038**	**(20,519)**
Net change during the year		**12,731**	**(6,135)**	**6,596**
Net gains and losses on derivative instruments:				
Amount arising during the year		**(16,087)**	**6,808**	**(9,279)**
Reclassification adjustments for gains and losses realized in net income		**8,933**	**(3,462)**	**5,471**
Net change during the year		**(7,154)**	**3,346**	**(3,808)**
Minimum pension liability adjustments		**751,721**	**(389,961)**	**361,760**
Other comprehensive income (loss)	**$**	**799,605**	**(396,115)**	**403,490**

(17) 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			Thosands of U.S. dollars
	2004	2003	2002	2004
Net income	¥ 343,344	275,730	190,737	$ 3,301,385
Effect of dilutive securities:				
1% Japanese yen convertible debentures, due 2002	—	—	26	—
1.20% Japanese yen convertible debentures, due 2005	24	36	48	231
1.30% Japanese yen convertible debentures, due 2008	72	86	91	692
Diluted net income	¥ 343,440	275,852	190,902	$ 3,302,308

	Number of shares		
Average common shares outstanding	885,365,124	878,648,844	876,716,443
Effect of dilutive securities:			
1% Japanese yen convertible debentures, due 2002	—	—	1,952,315
1.20% Japanese yen convertible debentures, due 2005	462,823	2,664,354	3,446,071
1.30% Japanese yen convertible debentures, due 2008	2,125,278	6,382,560	6,624,428
Diluted common shares outstanding	887,953,225	887,695,758	888,739,257

	Yen			U.S. dollars
Net income per share:				
Basic	¥ 387.80	313.81	217.56	$ 3.73
Diluted	386.78	310.75	214.80	3.72

(18) 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 the 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, 2003 and 2002 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 obligation, 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, 2004, 2003 and 2002. 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 ¥2,096 million ($20,154 thousand), ¥490 million and ¥668 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Derivatives not designated as hedges

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 value of the contracts are recorded in earnings immediately.

Contract amounts of foreign exchange contracts and interest rate swaps at December 31, 2004 and 2003 are set forth below:

December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
To sell foreign currencies	¥ 584,208	447,543	$ 5,617,385
To buy foreign currencies	34,201	22,384	328,856
Receive-fixed interest rate swaps	—	1,337	—
Pay-fixed interest rate swaps	—	21,227	—

(19) Commitments and Contingent Liabilities

Commitments

At December 31, 2004, commitments outstanding for the purchase of property, plant and equipment approximated ¥39,286 million ($377,750 thousand), and commitments outstanding for the purchase of parts and raw materials approximated ¥55,666 million ($535,250 thousand).

On September 14, 2004, the Company and Toshiba Corporation ("Toshiba") entered into an agreement to jointly establish SED Inc. for the development, production and marketing of next-generation flat-screen SED (Surface-conduction Electron-emitter Display) panels. The Company and Toshiba initially contributed approximately ¥500 million ($4,808 thousand) in cash, each. Under the agreement, the Company is further committed to contribute 50% of the financing requirements for SED Inc. through the establishment of a prototype production line.

Canon occupies sales offices and other facilities under lease arrangements accounted for as operating leases. Deposits made under such arrangements aggregated ¥14,307 million ($137,567 thousand) and ¥15,092 million at December 31, 2004 and 2003, respectively, and are reflected under noncurrent receivables on the accompanying consolidated balance sheets. Rental expenses under the operating lease arrangements amounted to ¥41,381 million ($397,894 thousand), ¥42,131 million and ¥44,195 million for the years ended December 31, 2004, 2003 and 2002, 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, 2004 are as follows:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2005	¥ 12,714	$ 122,250
2006	9,205	88,510
2007	6,653	63,971
2008	5,555	53,413
2009	5,116	49,192
Thereafter	10,289	98,933
Total future minimum lease payments	¥ 49,532	$ 476,269

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 risk of finance.

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 ¥43,634 million ($419,558 thousand) at December 31, 2004. The carrying amounts of the liabilities recognized for Canon's obligations as a guarantor under those guarantees at December 31, 2004 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, 2004 and 2003 are summarized as follows:

Year ended December 31	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Balance at beginning of year	¥ **10,512**	7,516	$ **101,077**
Addition	**13,319**	10,919	**128,067**
Utilization	**(9,400)**	(7,834)	**(90,385)**
Other	**(167)**	(89)	**(1,605)**
Balance at end of year	¥ **14,264**	10,512	$ **137,154**

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 ¥3,600 million ($34,615 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 damages. There are additional defenses that are yet to be litigated in a follow-up trial solely to the 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 Tokyo District Court in Japan. The lawsuit alleges that the former employee is entitled to ¥45,872 million ($441,077 thousand) as compensation for an invention related to certain technology used by the Company, and has sued for a partial payment of ¥1,000 million ($9,615 thousand) and interest thereon. The case is still pending and its final outcome is not yet determinable.

Canon is also involved in various other claims and legal actions arising in the ordinary course of business.

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.

20) 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, 2004 and 2003 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	
	2004		2003		2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt, including current installments	¥ (38,530)	(44,620)	(95,455)	(123,700)	$ (370,480)	(429,038)
Derivatives:						
Foreign exchange contracts:						
Assets	4,875	4,875	3,760	3,760	46,875	46,875
Liabilities	(11,020)	(11,020)	(7,697)	(7,697)	(105,962)	(105,962)
Interest rate swaps:						
Liabilities	—	—	(55)	(55)	—	—

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.

Derivative financial instruments

The fair values of derivative financial instruments, consisting principally of foreign exchange contracts and interest rate swaps, 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, 2004 and 2003, one customer accounted for approximately 13% and 16% of consolidated trade receivables, respectively. Although Canon does not expect that the customer will fail to meet their obligations, Canon is potentially exposed to concentrations of credit risk if the customer failed to perform according to the terms of the contracts.

21) Supplemental Cash Flow Information

For the years ended December 31, 2004, 2003 and 2002, aggregate common stock and additional paid-in capital arising from conversion of convertible debt amounted to ¥9,938 million ($95,557 thousand), ¥3,297 million and ¥3,908 million, respectively.

In March 2004, the Company acquired all of the outstanding common shares of Igari Mold Co. Ltd., 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 ($26,971 thousand). In connection with this transaction, the Company recognized goodwill, classified as other assets in the accompanying consolidated financial statements, of ¥1,585 million ($15,240 thousand).

As a result of the acquisition of the outstanding minority ownership interest of Canon Components Inc. and the issuance of common stock in connection with the acquisition during the year ended December 31, 2002, goodwill classified as other assets increased by ¥795 million, and minority interests decreased by ¥257 million.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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The Board of Directors and Stockholders of
Canon Inc.

We have audited the accompanying consolidated balance sheet of Canon Inc. and subsidiaries (the "Company") as of December 31, 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended, 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 audit. The consolidated balance sheet of Canon Inc. and subsidiaries as of December 31, 2003 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the two years in the period 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 to be disclosed in financial statements under U.S. generally accepted accounting principles. Such disclosure is not required by certain foreign issuers in Securities Exchange Act filings with the United States Securities and Exchange Commission.

We conducted our audit 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. An audit includes 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 audit provides a reasonable basis for our opinion.

The segment information required to be disclosed in financial statements under U.S. generally accepted accounting principles is not presented in the accompanying consolidated financial statements. Certain foreign issuers are presently exempted from such disclosure requirement in Securities Exchange Act filings with the United States Securities and Exchange Commission.

In our opinion, except for the omission of segment information as discussed in the preceding paragraph, the 2004 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Canon Inc. and subsidiaries at December 31, 2004, and the consolidated results of their operations and their cash flows for the year then ended 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, 2004 into United States dollars. In our opinion, the consolidated financial statements expressed in yen have been translated into United States dollars on the basis described in Note 2.

January 27, 2005

Ernst & Young ShinNihon

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SHAREHOLDERS' INFORMATION

Stock exchange listings:
Tokyo, Osaka, Nagoya, Fukuoka, Sapporo, New York and Frankfurt stock exchanges

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

Shareholders' annual general meeting:
March 30, 2005, in Tokyo

Other 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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