

REALNETWORKS INC  
Form 10-Q  
August 08, 2007

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the Quarterly Period Ended June 30, 2007**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from            to**  
**Commission file number 0-23137**

**RealNetworks, Inc.**

*(Exact name of registrant as specified in its charter)*

**Washington**

*(State of incorporation)*

**91-1628146**

*(I.R.S. Employer Identification Number)*

**2601 Elliott Avenue, Suite 1000**

**Seattle, Washington**

*(Address of principal executive offices)*

**98121**

*(Zip Code)*

**(206) 674-2700**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes ☐ No ☒

The number of shares of the registrant's Common Stock outstanding as of July 31, 2007 was 149,993,875.

TABLE OF CONTENTS

	Page
<b><u>Part I. Financial Information</u></b>	
<u>Item 1. Financial Statements</u>	3
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	34
<u>Item 4. Controls and Procedures</u>	35
<b><u>Part II. Other Information</u></b>	
<u>Item 1. Legal Proceedings</u>	36
<u>Item 1A. Risk Factors</u>	36
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	47
<u>Item 3. Default Upon Senior Securities</u>	48
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	48
<u>Item 5. Other Information</u>	49
<u>Item 6. Exhibits</u>	49
<u>Signature</u>	50
<u>EXHIBIT 10.2</u>	
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	
<u>EXHIBIT 32.2</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**REALNETWORKS, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except per share data)

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 219,548	\$ 525,232
Short-term investments	394,215	153,688
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	79,354	65,751
Deferred costs, current portion	5,089	1,643
Deferred tax assets, net, current portion	927	891
Prepaid expenses and other current assets	21,720	21,990
Total current assets	720,853	769,195
Equipment, software, and leasehold improvements:		
Equipment and software	94,038	83,587
Leasehold improvements	30,343	29,665
Total equipment, software, and leasehold improvements, at cost	124,381	113,252
Less accumulated depreciation and amortization	72,829	65,509
Net equipment, software, and leasehold improvements	51,552	47,743
Restricted cash equivalents	15,500	17,300
Equity investments	12,511	22,649
Other assets	5,412	5,148
Deferred tax assets, net, non-current portion	30,687	27,150
Other intangible assets, net	104,760	105,109
Goodwill	325,009	309,122
Total assets	\$ 1,266,284	\$ 1,303,416
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 50,231	\$ 52,097
Accrued and other liabilities	108,013	104,328
Deferred revenue, current portion	37,233	24,137
Accrued loss on excess office facilities, current portion	4,132	4,508
Total current liabilities	199,609	185,070
Deferred revenue, non-current portion	2,757	3,440

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Accrued loss on excess office facilities, non-current portion	8,574	9,993
Deferred rent	4,446	4,331
Deferred tax liabilities, net, non-current portion	24,580	27,076
Convertible debt	100,000	100,000
Other long-term liabilities	6,912	3,740
 Total liabilities	 346,878	 333,650
Shareholders' equity:		
Preferred stock, \$0.001 par value, no shares issued and outstanding		
Series A: authorized 200 shares		
Undesignated series: authorized 59,800 shares		
Common stock, \$0.001 par value authorized 1,000,000 shares; issued and outstanding 152,028 shares in 2007 and 163,278 shares in 2006	152	162
Additional paid-in capital	706,848	791,108
Accumulated other comprehensive income	16,107	23,485
Retained earnings	196,299	155,011
 Total shareholders' equity	 919,406	 969,766
 Total liabilities and shareholders' equity	 \$ 1,266,284	 \$ 1,303,416

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

**REALNETWORKS, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE (LOSS) INCOME**

(In thousands, except per share data)

	<b>Three Months ended</b>		<b>Six Months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net revenue (A)	\$ 136,171	\$ 89,409	\$ 265,643	\$ 176,011
Cost of revenue (B)	49,199	26,646	95,142	53,399
Gross profit	86,972	62,763	170,501	122,612
Operating expenses:				
Research and development	25,005	18,684	48,484	36,783
Sales and marketing	50,081	37,961	99,781	74,044
General and administrative	17,063	14,317	34,417	27,543
Loss on excess office facilities				738
Subtotal operating expenses	92,149	70,962	182,682	139,108
Antitrust litigation benefit, net		(57,858)	(60,747)	(97,693)
Total operating expenses, net	92,149	13,104	121,935	41,415
Operating (loss) income	(5,177)	49,659	48,566	81,197
Other income (expenses):				
Interest and other, net	8,065	9,381	17,167	17,360
Gain on sale of equity investment	132	2,286	132	2,286
Equity in net loss of investments			(132)	
Other income, net	485	73	952	190
Other income, net	8,682	11,740	18,119	19,836
Income before income taxes	3,505	61,399	66,685	101,033
Income taxes	(2,178)	(22,521)	(25,397)	(37,272)
Net income	\$ 1,327	\$ 38,878	\$ 41,288	\$ 63,761
Basic net income per share	\$ 0.01	\$ 0.24	\$ 0.26	\$ 0.40

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Diluted net income per share	\$ 0.01	\$ 0.22	\$ 0.24	\$ 0.36
Shares used to compute basic net income per share	153,880	159,938	157,929	160,410
Shares used to compute diluted net income per share	169,033	177,337	173,822	177,127
Comprehensive income:				
Net income	\$ 1,327	\$ 38,878	\$ 41,288	\$ 63,761
Unrealized holding losses on short-term and equity investments, net of income taxes	(2,663)	(5,094)	(5,719)	(12,915)
Foreign currency translation gains (losses)	1,268	1,005	(1,659)	1,372
Comprehensive (loss) income	\$ (68)	\$ 34,789	\$ 33,910	\$ 52,218
(A) Components of net revenue:				
License fees	\$ 22,212	\$ 22,850	\$ 44,049	\$ 45,486
Service revenue	113,959	66,559	221,594	130,525
	\$ 136,171	\$ 89,409	\$ 265,643	\$ 176,011
(B) Components of cost of revenue:				
License fees	\$ 7,882	\$ 9,329	\$ 16,174	\$ 19,190
Service revenue	41,317	17,317	78,968	34,209
	\$ 49,199	\$ 26,646	\$ 95,142	\$ 53,399

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents**

**REALNETWORKS, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Cash flows from operating activities:		
Net income	\$ 41,288	\$ 63,761
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	20,905	8,219
Stock-based compensation	11,307	7,311
Loss on disposal of equipment, software, and leasehold improvements	163	76
Equity in net loss of investments	132	
Gain on sale of equity investment	(132)	(2,286)
Excess tax benefit from stock option exercises	(596)	
Accrued loss on excess office facilities	(1,795)	(1,742)
Unrealized gain on trading securities	(2,102)	
Deferred income taxes	(6,069)	35,246
Purchases of trading securities	(270,000)	
Other	51	48
Net change in certain operating assets and liabilities, net of acquisitions	552	(50,651)
 Net cash (used in) provided by operating activities	 (206,296)	 59,982
 Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(11,525)	(5,381)
Purchases of short-term investments	(38,768)	(102,853)
Proceeds from sales and maturities of short-term investments	70,343	86,422
Purchases of other intangibles assets	(2,060)	
Proceeds from sale of equity investments	1,615	2,286
Purchases of equity investments		(450)
Decrease in restricted cash equivalents	1,800	
Cash used in acquisitions, net of cash acquired	(25,351)	(7,086)
 Net cash used in investing activities	 (3,946)	 (27,062)
 Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	12,277	34,522
Excess tax benefit from stock options exercises	596	
Repurchase of common stock	(107,905)	(96,972)



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Net cash used in financing activities	(95,032)	(62,450)
Effect of exchange rate changes on cash and cash equivalents	(410)	739
Net decrease in cash and cash equivalents	(305,684)	(28,791)
Cash and cash equivalents, beginning of period	525,232	651,971
Cash and cash equivalents, end of period	\$ 219,548	\$ 623,180

**Supplemental disclosure of cash flow information:**

Cash paid for income taxes	\$ 13,160	\$ 12,042
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**Supplemental disclosure of non-cash investing and financing activities:**

Accrued acquisition costs	\$ 368	\$
Accrued acquisition consideration	\$	\$ 2,054

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents**

**REALNETWORKS, INC. AND SUBSIDIARIES**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Three and Six Months Ended June 30, 2007 and 2006**

**Note 1. Summary of Significant Accounting Policies**

*Description of Business.* RealNetworks, Inc. and subsidiaries (RealNetworks or Company) is a leading global provider of network-delivered digital media products and services. The Company also develops and markets software products and services that enable the creation, distribution and consumption of digital media, including audio and video.

Inherent in the Company's business are various risks and uncertainties, including limited history of certain of its product and service offerings and its limited history of offering premium subscription services on the Internet. The Company's success will depend on the acceptance of the Company's technology, products, and services and the ability to generate related revenue.

*Basis of Presentation.* The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The Company acquired 99.7% of WiderThan Co., Ltd. (WiderThan) during the three months ended December 31, 2006. The Company acquired substantially all of the remaining 0.3% of WiderThan during the three months ended June 30, 2007. The accompanying unaudited condensed consolidated financial statements include 100% of the financial results of WiderThan from the date of acquisition. The minority interest in the earnings of WiderThan for the three and six months ended June 30, 2007 was nominal. The minority interest liability as of June 30, 2007 and December 31, 2006 was nominal.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company's management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2007. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

*Revenue Recognition.* The Company recognizes revenue in accordance with the following authoritative literature: AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*; SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements*; SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*; Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*; and EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Generally the Company recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

The Company recognizes revenue under the residual method for multiple element software arrangements when vendor specific objective evidence (VSOE) exists for all of the undelivered elements of the arrangement, but does not exist for one or more of the delivered elements in the arrangement, under SOP No. 97-2. Under the residual method, at the outset of the arrangement with a customer, the Company defers revenue for the fair value of the arrangement's undelivered elements such as post contract support (PCS), and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered, such as software licenses. VSOE for PCS is

established on standard products for which no installation or customization is required based upon amount charged when PCS is sold separately. For multiple element software arrangements involving significant production, modification, or customization of the software, which are accounted for in accordance with the provisions of SOP No. 81-1, VSOE for PCS is established if customers have an optional renewal rate specified in the arrangement and the rate is substantive.

**Table of Contents**

**REALNETWORKS, INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has arrangements whereby customers pay one price for multiple products and services and in some cases, involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the individual deliverables in accordance with EITF Issue No. 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. The Company applies significant judgment in establishing the fair value of multiple elements within revenue arrangements.

The Company recognizes revenue on a gross or net basis in accordance with EITF Issue No. 99-19. In most arrangements, the Company contracts directly with end user customers, is the primary obligor and carries all collectibility risk. In such arrangements the Company reports revenue on a gross basis. In some cases, the Company utilizes third-party distributors to sell products or services directly to end user customers and carries no collectibility risk. In such instances the Company reports revenue on a net basis.

Revenue generated from advertising on the Company's websites and from advertising included in its products is recognized as revenue as the delivery of the advertising occurs.

*Accounting for Taxes Collected From Customers.* The Company collects various types of taxes from its customers, assessed by governmental authorities, that is imposed on and concurrent with revenue-producing transactions. Such taxes are not included in net revenue of the Company.

*Reclassifications.* Certain reclassifications have been made to the 2007 year-to-date information to conform to the presentation for the three months ended June 30, 2007.

**Note 2. Recent Accounting Pronouncements**

In June 2006, the FASB issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of tax positions taken or expected to be taken in tax returns. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, date of adoption of FIN No. 48, the Company had \$7.5 million of unrecognized tax benefits, of which \$7.2 million would affect the effective tax rate if recognized. Although the implementation of FIN No. 48 did not impact the amount of liability for unrecognized tax benefits, the Company reclassified \$5.3 million of liability for unrecognized tax benefits from current income taxes payable to other long-term liabilities to conform with the balance sheet presentation requirements of FIN No. 48.

In accordance with FIN No. 48, the Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of January 1, 2007, the Company had approximately \$300,000 of accrued interest and penalties related to uncertain tax positions, which is included as a component of the \$5.3 million of unrecognized tax benefit noted above. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision. The Company does not anticipate that total unrecognized tax benefits will significantly change within the next twelve months.

The Company files numerous consolidated and separate income tax returns in the United States Federal, state, local, and foreign jurisdictions. With few exceptions, the Company is no longer subject to United States Federal, state, local, or foreign income tax examinations for years before 1993.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS No. 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 159 on its consolidated financial statements.

**Note 3. Stock-Based Compensation**

The Company accounts for stock-based compensation in accordance with SFAS No. 123R revised 2004, *Share-Based Payment*. Under the fair value provisions of the statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R. The Company recognizes compensation cost related to stock options granted prior to the adoption of SFAS No. 123R on an accelerated basis over the applicable vesting period using the methodology described in FIN No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. The Company recognizes compensation cost related to options granted subsequent to the adoption of SFAS No. 123R on a straight-line basis over the applicable vesting period.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, including the contractual terms, vesting schedules, and expectations of future employee behavior. Expected stock price volatility is based on a combination of historical volatility of the Company's stock for the related expected term and the implied volatility of its traded options. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a term equivalent to the expected term of the stock options. The Company has not paid dividends in the past.

The fair value of options granted was determined using the Black-Scholes model and the following weighted average assumptions:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.73%	4.99%	4.72%	4.79%
Expected life (years)	4.1	4.3	4.1	4.3
Volatility	42%	49.1%	42%	48.4%

Recognized stock-based compensation expense is as follows (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Cost of service revenue	\$ 154	\$ 41	\$ 313	\$ 91
Research and development	1,641	1,318	3,413	2,687
Sales and marketing	2,203	1,434	4,590	2,793
General and administrative	1,624	880	2,991	1,740
Total stock-based compensation expense	\$ 5,622	\$ 3,673	\$ 11,307	\$ 7,311

No stock-based compensation was capitalized as part of the cost of an asset during the six months ended June 30, 2007 and 2006. As of June 30, 2007, \$43.4 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options is expected to be recognized over a weighted-average period of 2.8 years.

**Note 4. Business Combinations***Business Combinations During 2007*

Sony NetServices GmbH

On May 15, 2007, the Company acquired all of the outstanding securities of Sony NetServices GmbH (SNS) in exchange for \$12.8 million in cash payments, including \$902,000 in direct acquisition related costs consisting primarily of professional fees.

SNS is located in Salzburg, Austria and is a provider of end-to-end white label digital music services to mobile operators in Europe. The Company believes that combining SNS' assets and technology with its existing business will enhance the Company's

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

digital music offerings in the European market. The results of SNS operations are included in the Company's condensed consolidated financial statements starting from the date of acquisition.

A summary of the preliminary purchase price is as follows (in thousands):

Cash paid at acquisition	\$ 11,924
Estimated direct acquisition costs	902
 Total	 \$ 12,826

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third-party appraisal as of the date of acquisition and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of \$9.3 million. Goodwill in the amount of \$9.3 million is not deductible for tax purposes.

A summary of the preliminary allocation of the purchase price is as follows (in thousands):

Current assets	\$ 5,110
Property and equipment	2,351
Intangible assets subject to amortization:	
Technology	1,760
Customer relationships	1,610
Goodwill	9,341
 Total assets acquired	 20,172
 Current liabilities	 (7,346)
 Net assets acquired	 \$ 12,826

Technology has weighted average estimated useful life of seven years. Customer relationships have weighted average estimated useful lives of nine years. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company's overall unaudited condensed consolidated financial statements.

**Exomi Oy**

On June 8, 2007, the Company acquired all of the outstanding securities of Exomi Oy (Exomi) in exchange for \$11.2 million in cash payments, including \$468,000 in direct acquisition related costs consisting primarily of professional fees. The Company may be obligated to pay an additional 3.6 million (\$4.9 million at June 30, 2007) over a three-year period, dependent on whether certain performance criteria are achieved. Such amounts are not included in the initial aggregate purchase price and, to the extent earned, will be recorded as goodwill when the performance criteria are achieved. No such payments were accrued during the period ended June 30, 2007.

Exomi is located in Helsinki, Finland and is a provider of short message service (SMS) messaging and gateway products and services with customers primarily in Europe and Latin America. The Company believes that combining



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Exomi's assets and network with the Company's products and services will enhance its presence in the European and Latin American markets. The results of Exomi's operations are included in the Company's condensed consolidated financial statements starting from the date of acquisition.

A summary of the purchase price is as follows (in thousands):

Cash paid at acquisition	\$ 10,745
Estimated direct acquisition costs	468
Total	\$ 11,213

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third-party appraisal as of the date of acquisition and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of \$2.9 million. Goodwill in the amount of \$2.9 million is not deductible for tax purposes.

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A summary of the preliminary allocation of the purchase price is as follows (in thousands):

Current assets	\$ 5,409
Property and equipment	265
Other long-term assets	109
Intangible assets subject to amortization:	
Customer relationships	3,270
Technology	2,545
Tradenames and trademarks	287
Non-compete agreements	80
Goodwill	2,852
 Total assets acquired	 14,817
 Current liabilities	 (1,761)
Net deferred tax liabilities	(1,472)
Other long-term liabilities	(371)
 Total liabilities acquired	 (3,604)
 Net assets acquired	 \$ 11,213

Customer relationships have weighted average estimated useful lives of eight years. Technology and tradenames and trademarks have weighted average estimated useful lives of four years. Non-compete agreements have weighted average estimated useful life of one year. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company's overall unaudited condensed consolidated financial statements.

*Business Combinations During 2006**WiderThan Co. Ltd.*

The Company acquired 99.7% of the outstanding common shares and American Depositary Shares of WiderThan Co. Ltd. (WiderThan) during the three months ended December 31, 2006 for a total purchase price of \$342.7 million. The results of WiderThan operations are included in the Company's unaudited condensed consolidated financial statements starting from the closing date of October 31, 2006. The Company acquired substantially all of the remaining 0.3% of the outstanding common shares and American Depositary Shares of WiderThan during the three months ended June 30, 2007.

*Zylom Media Group B.V.*

On January 31, 2006, the Company acquired all of the outstanding securities of Zylom Media Group B.V. (Zylom) in exchange for \$8.2 million in cash payments, including \$293,000 in direct acquisition related costs consisting primarily of professional fees. The Company is also obligated to pay an additional \$2.0 million, through individual payments of \$1.0 million on the first and second anniversaries of the acquisition date. The first payment of \$1.0 million was made during the six months ended June 30, 2007.

Additionally, the Company may be obligated to pay up to \$10.9 million over a three-year period, dependent on whether certain performance criteria are achieved. Such amounts are not included in the initial aggregate purchase price and, to the extent earned, will be recorded as goodwill when the performance criteria are achieved. During the six months ended June 30, 2007, the Company accrued and paid \$4.4 million towards such payments based on achievement of certain performance criteria.

Zylom is located in Eindhoven, The Netherlands and is a distributor, developer, and publisher of PC-based games in Europe. The Company believes that combining Zylom's assets and distribution network with the Company's downloadable PC-based games assets and distribution platform will enhance the Company's presence in the European games market. The results of Zylom's operations are included in the Company's condensed consolidated financial statements starting from the date of acquisition.

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A summary of the purchase price is as follows (in thousands):

Cash paid at acquisition	\$ 7,922
Additional payments related to initial purchase price	2,000
Additional payments for achievement of performance criteria	4,364
Direct acquisition costs	293
 Total	 \$ 14,579

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third-party appraisal as of the date of acquisition and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of \$12.5 million. Goodwill in the amount of \$12.5 million is not deductible for tax purposes.

A summary of the allocation of the purchase price is as follows (in thousands):

Current assets	\$ 1,830
Property and equipment	166
Intangible assets subject to amortization:	
Distributor and customer relationships	1,290
Technology and games	570
Tradenames and trademarks	560
Non-compete agreements	180
Goodwill	12,532
 Total assets acquired	 17,128
 Current liabilities	 (1,781)
Net deferred tax liabilities	(768)
 Total liabilities acquired	 (2,549)
 Net assets acquired	 \$ 14,579

Distributor and customer relationships have weighted average estimated useful lives of five years. Technology, games, tradenames, and trademarks have weighted average estimated useful lives of three years. Non-compete agreements have weighted average estimated useful life of four years. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company's overall unaudited condensed consolidated financial statements.

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 5. Cash, Cash Equivalents, Trading Securities, Short-Term Investments, and Restricted Cash Equivalents**

Cash, cash equivalents, trading securities, short-term investments, and restricted cash equivalents as of June 30, 2007 consist of the following (in thousands):

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
Cash and cash equivalents:				
Cash	\$ 137,275	\$	\$	\$ 137,275
Money market mutual funds	54,930			54,930
Corporate notes and bonds	27,338	5		27,343
 Total cash and cash equivalents	 219,543	 5		 219,548
 Trading securities:				
Money market mutual fund	270,000	2,102		272,102
 Available-for-sale investments:				
Corporate notes and bonds	53,215	15	(140)	53,090
U.S. Government agency securities	69,027	23	(27)	69,023
 Total available-for-sale investments	 122,242	 38	 (167)	 122,113
 Total short-term investments	 392,242	 2,140	 (167)	 394,215
 Total cash, cash equivalents, trading securities, and short-term investments	 \$ 611,785	 \$ 2,145	 \$ (167)	 \$ 613,763
 Restricted cash equivalents	 \$ 15,500	 \$	 \$	 \$ 15,500

Cash, cash equivalents, short-term investments, and restricted cash equivalents as of December 31, 2006 consist of the following (in thousands):

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
Cash and cash equivalents:				
Cash	\$ 108,415	\$	\$	\$ 108,415
Money market mutual funds	231,634			231,634

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Corporate notes and bonds	182,184			182,184
U.S. Government agency securities	2,999			2,999
 Total cash and cash equivalents	 525,232			 525,232
 Short-term investments:				
U.S. Government agency securities	153,520	188	(20)	153,688
 Total short-term investments	 153,520	 188	 (20)	 153,688
 Total cash, cash equivalents, and short-term investments	 \$ 678,752	 \$ 188	 \$ (20)	 \$ 678,920
 Restricted cash equivalents	 \$ 17,300	 \$	 \$	 \$ 17,300

At June 30, 2007 and December 31, 2006, restricted cash equivalents represent cash equivalents pledged as collateral against two letters of credit for a total of \$15.5 million and \$17.3 million, respectively, in connection with two lease agreements.

Realized gains or losses on sales of available-for-sale securities for the three and six months ended June 30, 2007 and 2006 were not significant.

Unrealized gain on trading securities for the six months ended June 30, 2007 of \$2.1 million is included in interest and other, net in the unaudited condensed consolidated statements of operations and comprehensive (loss) income. Unrealized gain on trading securities at June 30, 2007, was \$2.1 million. The Company did not have any investments in trading securities during 2006.

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Changes in estimated fair values of short-term investments are primarily related to changes in interest rates and are considered to be temporary in nature.

The contractual maturities of available-for-sale investments at June 30, 2007 are as follows (in thousands):

	<b>Amortized Cost</b>	<b>Estimated Fair Value</b>
Within one year	\$ 83,207	\$ 83,204
Between one year and five years	39,035	38,909
Total available-for-sale investments	\$ 122,242	\$ 122,113

**Note 6. Allowance for Doubtful Accounts Receivable and Sales Returns**

Activity in the allowance for doubtful accounts receivable and sales returns is as follows (in thousands):

	<b>Allowance For Doubtful Accounts Receivable</b>		<b>Sales Returns</b>	
Balances, December 31, 2006	\$ 1,101		\$ 1,389	
Additions charged to expenses/revenue	75		2,688	
Amounts written off	(117)		(2,700)	
Balances, June 30, 2007	\$ 1,059		\$ 1,377	

As of June 30, 2007 and December 31, 2006 one international customer accounted for 22% and 25%, respectively, of trade accounts receivable. The same international customer accounted for 13% and 12% of total revenue during the three and six months ended June 30, 2007, respectively. No one customer accounted for more than 10% of total revenue during the three and six months ended June 30, 2006.

**Note 7. Equity Investments**

As of June 30, 2007 and December 31, 2006, the carrying value of equity investments in publicly traded companies consists primarily of approximately 10.6% of outstanding shares of J-Stream Inc. (J-Stream), a Japanese media services company. These equity investments are accounted for as available-for-sale and the increase over the cost basis, net of income taxes, is reflected as a component of accumulated other comprehensive income.

Summary of equity investments is as follows (in thousands):

	<b>June 30, 2007</b>		<b>December 31, 2006</b>	
	<b>Cost</b>	<b>Carrying Value</b>	<b>Cost</b>	<b>Carrying Value</b>
Publicly traded investments	\$ 913	\$ 11,586	\$ 913	\$ 20,235
Privately held investments	1,551	925	1,879	2,414
Total equity investments	\$ 2,464	\$ 12,511	\$ 2,792	\$ 22,649

**Note 8. Other Intangible Assets**

Other intangible assets at June 30, 2007 consist of the following (in thousands):

	<b>Gross Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Customer relationships	\$ 77,540	\$ 8,901	\$ 68,639
Developed technology	41,085	13,974	27,111
Patents, trademarks and tradenames	7,402	3,252	4,150
Service contracts and other	6,821	1,961	4,860
 Total other intangible assets	 \$ 132,848	 \$ 28,088	 \$ 104,760



**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Other intangible assets at December 31, 2006 consist of the following (in thousands):

	<b>Gross Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Customer relationships	\$ 73,061	\$ 3,386	\$ 69,675
Developed technology	36,891	9,981	26,910
Patents, trademarks and tradenames	7,114	2,226	4,888
Service contracts and other	4,680	1,044	3,636
 Total other intangible assets	 \$ 121,746	 \$ 16,637	 \$ 105,109

Amortization expense related to other intangible assets during the three and six months ended June 30, 2007 was \$5.7 million and \$11.3 million, respectively. Amortization expense related to other intangible assets during the three and six months ended June 30, 2006 was \$482,000 and \$1.2 million, respectively.

As of June 30, 2007, estimated future amortization of other intangible assets is as follows (in thousands):

2007 (remaining six months)	\$ 11,663
2008	22,656
2009	20,853
2010	16,939
2011	11,128
Thereafter	21,521
 Total	 \$ 104,760

**Note 9. Goodwill**

Changes in goodwill are as follows (in thousands):

Balance, December 31, 2006	\$ 309,122
Increases for payments due to Zylom	4,364
Adjustments to purchase price for WiderThan	(1,296)
Purchase of additional shares of WiderThan	1,160
Increase due to acquisitions	12,193
Effects of foreign currency translation	(534)
 Balance, June 30, 2007	 \$ 325,009

**Note 10. Accrued and Other Liabilities**

Accrued and other liabilities consist of (in thousands):

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
Royalties and other fulfillment costs	\$ 32,127	\$ 29,968

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Employee compensation, commissions and benefits	21,379	25,244
Income taxes payable	12,811	8,455
Sales, VAT and other taxes payable	10,787	13,364
Legal fees and contingent legal fees	4,187	4,075
Accrued charitable donations	79	2,048
Other	26,643	21,174
Total	\$ 108,013	\$ 104,328

**Note 11. Loss on Excess Office Facilities**

In October 2000, the Company entered into a 10-year lease agreement for additional office space located near its corporate headquarters in Seattle, Washington. Due to a subsequent decline in the market for office space in Seattle and the Company's re-assessment of its facilities requirements in 2001, the Company accrued for estimated future losses on excess office facilities. The Company has accrued additional estimates of future losses on this facility since 2001 based on changes in market conditions, securing tenants at rates lower than those used in the original estimate, and certain other factors.

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

During the three months ended March 31, 2006 the Company recorded \$738,000 of additional loss due to building operating expenses that are not expected to be recovered under the terms of the existing sublease arrangements. The Company did not identify any factors which caused it to revise its estimates during the period ended June 30, 2007. The estimated loss as of June 30, 2007 consists of \$8.8 million of sublease income under existing sublease arrangements.

A summary of activity for accrued loss on excess office facilities is as follows (in thousands):

Accrued loss on excess office facilities, December 31, 2006	\$ 14,501
Less amounts paid on accrued loss on excess office facilities, net of sublease income	(1,795)
Accrued loss on excess office facilities, June 30, 2007	12,706
Less current portion	4,132
Accrued loss on excess office facilities, non-current portion	\$ 8,574

**Note 12. Repurchase of Common Stock**

In April 2006, the Company's Board of Directors authorized a share repurchase program of up to an aggregate of \$100.0 million of the Company's outstanding common stock. During the three months ended March 31, 2007, the Company purchased 9.8 million shares at an average cost of \$7.99 per share for an aggregate value of \$78.5 million. No amounts remained authorized for repurchase under the repurchase program as of March 31, 2007.

In May 2007, the Board of Directors of the Company authorized a new share repurchase program for the repurchase of up to an aggregate of \$100.0 million of the Company's outstanding common stock. During the three months ended June 30, 2007, the Company purchased 3.5 million shares at an average cost of \$8.31 per share for an aggregate value of \$29.4 million. As of June 30, 2007, \$70.6 million remained authorized for repurchase under the May 2007 repurchase program.

**Note 13. Earnings Per Share**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive potential common shares outstanding during the period. Share count used to compute basic and diluted net income per share is calculated as follows (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Weighted average common shares outstanding used to compute basic net income per share	153,880	159,938	157,929	160,410
Dilutive potential common shares:				
Stock options and restricted stock	4,403	6,649	5,143	5,967
Convertible debt	10,750	10,750	10,750	10,750
Shares used to compute diluted net income per share	169,033	177,337	173,822	177,127

During the three and six months ended June 30, 2007, 19.5 million and 17.4 million, respectively, shares of common stock potentially issuable from stock options are excluded from the calculation of diluted net income per share because of their antidilutive effect. During the three and six months ended June 30, 2006, 3.2 million and

3.9 million, respectively, shares of common stock potentially issuable from stock options are excluded from the calculation of diluted net income per share because of their antidilutive effect.

**Note 14. Commitments and Contingencies**

*Borrowing Arrangements.* The Company's subsidiary, WiderThan, has entered into three lines of credit with three Korean domestic banks with an aggregate maximum available limit of \$4.3 million at interest rates ranging primarily from 1.3% to 1.63% over the rate earned on the underlying deposits. WiderThan has entered into a separate line of credit with a Korean domestic bank with maximum available limit of \$1.1 million bearing interest at 6.0%. During the six months ended June 30, 2007 the Company did not draw on these lines of credit and there were no balances outstanding as of June 30, 2007 and December 31, 2006.

**Table of Contents**

**REALNETWORKS, INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company's subsidiary, WiderThan India Pvt. Ltd., has entered into two separate lines of credit with a Korean bank in India with maximum available limit of \$122,000 bearing interest at 10.25%. At June 30, 2007 the Company had \$122,000 outstanding under these arrangements which is included in accrued and other liabilities in the accompanying unaudited condensed consolidated balance sheets.

The Company's subsidiary, WiderThan, uses corporate charge cards issued by a Korean domestic bank with an aggregate line of credit of up to \$5.4 million. The charged amounts are generally payable in the following month depending on the billing cycle and are included in accounts payable in the accompanying unaudited condensed consolidated balance sheets. In general, the term of the arrangement is one year, with automatic renewal in April of each year. The arrangement may be terminated in writing by mutual agreement between the bank and the Company. The Company is not subject to any financial or other restrictive covenants under the terms of this arrangement.

The Company's subsidiary, WiderThan, has a letter of credit of up to \$5.0 million with a Korean domestic bank for importing goods, with one-year maturity (renewable every April), and bears interest at 2.5% over the London Inter-Bank Offer Rate (LIBOR). Borrowings under this letter of credit are collateralized by import documents and goods being imported under such documentation. To the extent that the Company has any outstanding balance, the Company is subject to standard covenants and notice requirements under the terms of this facility, such as covenants to consult with the lender prior to engaging in certain events, which include, among others, mergers and acquisitions or sale of material assets or to furnish certain financial and other information. The Company is not, however, subject to any financial covenant requirements or other restrictive covenants that restrict the Company's ability to utilize this facility or to obtain financing elsewhere. During the six months ended June 30, 2007 the Company did not draw on the letter of credit and there was no balance outstanding as of June 30, 2007 and December 31, 2006.

The Company's subsidiary, WiderThan, has purchased guarantees amounting to \$390,000 from Seoul Guarantee Insurance which guarantees payments for one year under certain supply contracts the Company has with a customer in Korea.

*Litigation.* In August 2005, a lawsuit was filed against the Company in the U.S. District Court for the District of Maryland by Ho Keung Tse, an individual residing in Hong Kong. The suit alleges that certain of the Company's products and services infringe the plaintiff's patent relating to the distribution of digital files, including sound tracks, music, video and executable software in a manner which restricts unauthorized use. The plaintiff seeks to enjoin the Company from the allegedly infringing activity and to recover treble damages for the alleged infringement. The Company's co-defendants were granted a motion to transfer the lawsuit from the District of Maryland to the Northern District of California in 2006. The Company disputes the plaintiff's allegations in the action and intends to vigorously defend itself.

In June 2005, an association representing certain music producers in the Republic of Korea sent the Company's WiderThan subsidiary a notice demanding payment of fees for the Company's use in its carrier application services since July 2004 of songs over which the association claims it holds certain rights. The Company used, and paid fees for, these songs under licensing agreements with independent music label companies and such agreements contain representations that these music label companies are the rightful, legal owner of the songs. Nevertheless, the association is claiming that it is the rightful owner. The Company is currently investigating the merit of the association's claims and the scope of any potential liability. Under the Company's licensing agreements, the independent music label companies are required to indemnify the Company for any losses resulting from their breach of representations. Should the Company become liable to the association in this matter, the Company intends to exercise its indemnity rights under its licensing agreements with the independent music label companies.

In June 2003, a lawsuit was filed against the Company and Listen.com, Inc. (Listen) in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of the Company's and Listen's products and services willfully infringe certain patents relating to allowing users to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously. Friskit sought to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The court granted the Company's motion for summary judgment on July 26, 2007 and invalidated all claims on

grounds of obviousness. Friskit has a 30-day period to appeal the court's ruling.

In December 2003, the Company filed suit against Microsoft Corporation (Microsoft) in the U.S. District Court for the Northern District of California, pursuant to U.S. and California antitrust laws, alleging that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice, and attempt to monopolize the field of digital media. On October 11, 2005, the Company and Microsoft entered into a settlement agreement pursuant to which the Company agreed to settle all antitrust disputes worldwide with Microsoft, including the U.S. litigation. Upon settlement of the legal disputes, the Company and Microsoft entered into two commercial agreements that provide for collaboration in digital music and casual games. The combined contractual payments related to the settlement agreement and the two commercial agreements to be made by Microsoft to the Company over the terms of the

**Table of Contents****REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

agreements are \$761.0 million. The Company had received such payments in full as of March 31, 2007. The Company recorded a gain of \$60.7 million during the three months ended March 31, 2007 that is included in antitrust litigation benefit, net in the unaudited condensed consolidated statement of operations and comprehensive income. No such gain was recorded during the three months ended June 30, 2007. Gain of \$57.9 million and \$97.7 million, was recorded during the three and six ended June 30, 2006, respectively, that is included in antitrust litigation benefit, net in the unaudited condensed consolidated statement of operations and comprehensive income.

In April 2007, the Copyright Royalty Board (CRB) issued a decision setting new royalty rates for the use of sound recordings in Internet radio from 2006 through 2010. As part of the new rates, the CRB established a new minimum fee applicable to commercial webcasters, including the Company. The CRB determined that webcasters must pay a minimum fee of \$500 per channel. The decision is not clear regarding how the minimum fee would apply to radio services like those delivered by the Company which enable users to customize the channel or which use an algorithm to help ensure that the channel reflects the relevant genre or artists. Currently, the CRB decision is being appealed to the United States Court of Appeals. Depending upon how the minimum fee provision is interpreted, if the CRB's minimum fee decision is upheld on appeal the Company could incur additional liability for minimum fees relating to its provision of Internet radio. At this time, the amount of this potential liability is not determinable. Prior to the April 2007 CRB decision, webcasting services were subject to a \$2,500 per webcaster yearly minimum fee.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of its business, including employment claims, contract-related claims, and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. These claims, including those described above, even if not meritorious, could force the Company to spend significant financial and managerial resources. The Company is not aware of any legal proceedings or claims that the Company believes will have, individually or taken together, a material adverse effect on the Company's business, prospects, financial condition or results of operations. However, the Company may incur substantial expenses in defending against third-party claims and certain pending claims are moving closer to trial. The Company expects that its potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability, and/or be required to change its business practices. Either of these could have a material adverse effect on the Company's financial position and results of operations.

**Note 15. Segment Information**

The Company operates in two business segments: Consumer Products and Services and Technology Products and Solutions, for which the Company receives revenue from its customers. The Company's Chief Operating Decision Maker is considered to be the Company's CEO Staff (CEOS), which is comprised of the Company's Chief Executive Officer, Chief Financial Officer, President, and Senior Vice Presidents. The CEOS reviews financial information presented on both a consolidated basis and on a business segment basis, accompanied by disaggregated information about products and services and geographical regions for purposes of making decisions and assessing financial performance. The CEOS reviews discrete financial information regarding profitability of the Company's Consumer Products and Services and Technology Products and Solutions segments and, therefore, the Company reports these as operating segments as defined by SFAS No. 131, *Disclosure About Segments of an Enterprise and Related Information*.

The Company's customers consist primarily of end users located in the U.S., Republic of Korea, and various foreign countries. Revenue by geographic region is as follows (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
United States	\$ 88,035	\$ 66,542	\$ 172,589	\$ 132,242
Europe	20,522	15,925	38,232	29,830

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Republic of Korea	18,885		37,284	
Rest of the World	8,729	6,942	17,538	13,939
Total net revenue	\$ 136,171	\$ 89,409	\$ 265,643	\$ 176,011

The Company's segments are defined as follows:

Consumer Products and Services segment primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass; sales and distribution of third-party software and services; sales of digital content such as music and game downloads; sales of premium versions of RealPlayer and related products; and advertising. These products and services are

17

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Table of Contents**REALNETWORKS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

sold and provided primarily through the Internet and the Company charges customers credit cards at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Technology Products and Solutions segment includes revenue from: sales of ringback tone, music-on-demand, video-on-demand, messaging, and information services; sales of media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through original equipment manufacturer (OEM) channels; support and maintenance services sold to customers who purchase software products; broadcast hosting services; and consulting and professional services that are offered to customers. These products and services are primarily sold to corporate customers.

Revenue by segment is as follows (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Consumer products and services	\$ 87,115	\$ 77,442	\$ 172,155	\$ 152,253
Technology products and solutions	49,056	11,967	93,488	23,758

(i) The increased amount of stated capital will be one half (1/2) of the maximum amount of increases of stated capital, etc. to be calculated in accordance with Article 40, Paragraph 1 of the Companies Accounting Regulations (*Kaisha Keisan Kisoku*). Any fractional amount of less than one (1) yen resulting

from such  
calculation  
will be  
rounded up  
to one (1)  
yen.

- (ii) The increased amount of capital reserves shall be the amount of the maximum amount of increases of stated capital, etc., mentioned in (i) above, after the subtraction of increased amount of stated capital mentioned in (i) above.

**(5) Restriction on Acquisition of Share Options by Transfer**

An acquisition of share options by way of transfer requires the approval of the Board of Directors.

**(6) Events for the Company's Acquisition of Share Options**

If a proposal for the approval of a merger agreement under which the Company will become an extinguishing company or a proposal for the approval for a share exchange agreement or a share transfer plan under which the Company will become a wholly-owned subsidiary is approved by the Company's shareholders at a shareholders' meeting (or by the Board of Directors if no resolution of a shareholders meeting is required for such approval), the Company will be entitled to acquire the

share options, without compensation, on a date separately designated by the Board of Directors.

**(7) Handling of Fractions**

Any fraction of a share (less than one (1) share) to be delivered to any holder of share options who has exercised share options will be disregarded.

**(8) Other Conditions for Exercise of Share Options**

- (i) One share option may not be exercised partially.
- (ii) Each holder of share options must continue to be a director, executive officer or employee of the Company until the end of the Company's general meeting of shareholders regarding the final business term within two (2) years from the end of the Ordinary General Meeting of Shareholders for the 108th Business Term of the Company.
- (iii) Holders of share options will be entitled to exercise their share options for two (2) years, and during the exercisable period, even after they lose their positions as directors, executive officers or employees. However, if a holder of share options loses such position due to resignation at his/her initiative, or due to dismissal or discharge by the Company, his/her share options will immediately lose effect.
- (iv) No succession by inheritance is authorized for the share options.
- (v) Any other conditions for the exercise of share options may be established by the Board of Directors.

**6. Specific Method of Calculation of Remuneration to Directors**

The amount of share options to be issued to the directors of the Company, as remuneration, will be the amount to be obtained by multiplying the fair market value per share option as of the allotment date thereof by the total number (not more than five thousand seven hundred (5,700) share options) of share options to be allotted to the directors existing as of such allotment date. The fair market value of a share option will be calculated with the use of the Black-Scholes model on the basis of various conditions applicable on the allotment date. Upon the approval of Proposal No. 3, regarding election of directors, the number of directors will be Twenty-five (25).

The map of the place of  
the General Meeting of Shareholders

Place: Head Office of the Company  
30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo

Station: Shimomaruko Station of the Tokyu Tamagawa Line (About 10 minutes walk)



## Table of Contents

To Our Shareholders	21
<i>(Materials delivered pursuant to Article 437 and Article 444 of the Corporation Law)</i>	
Business Report	22
Consolidated Balance Sheets	56
Consolidated Statements of Income	57
Consolidated Statement of Stockholders' Equity	58
Notes to Consolidated Financial Statements	59
Accounting Audit Report of Accounting Auditor on Consolidated Financial Statements	62
Audit Report of Board of Corporate Auditors on Consolidated Financial Statements	64
Non-Consolidated Balance Sheets	66
Non-Consolidated Statements of Income	68
Non-Consolidated Statement of changes in Net Assets	70
Notes to Non-Consolidated Financial Statements	72
Accounting Audit Report of Accounting Auditor	78
Audit Report of Board of Corporate Auditors	80
(For Reference)	
Information on Shares	82

\* The products mentioned in this report may have different names in other regions.

To Our Shareholders

We are pleased to present our report for the 108th business term (from January 1, 2008 to December 31, 2008).

Regarding economic conditions during the business term, the financial market turmoil that began in the U.S. eventually affected the real economy throughout the world, and the global economies followed a downward trend. Toward the end of the term, in particular, due to the abrupt appreciation of the yen in the foreign exchange markets and drastic stock market downturns, economic decline had further amplified and serious conditions were created.

Under these circumstances, the Canon Group, in the third year of Phase III (2006 to 2010) of our Excellent Global Corporation Plan, took steps to improve our business performance by building a stable business base. Full-scale efforts were made to energetically move ahead with measures in the areas of development, production and sales, as well as focusing on cost reduction, inventory management and other measures. However, profits declined significantly under the effect of global economic upheaval.

Regarding dividends, though business conditions are severe, we propose a term-end dividend of 55.00 yen per share at the Ordinary General Meeting of Shareholders for the 108th Business Term in appreciation for the ongoing support of our shareholders. Combined with the interim dividend (55.00 yen per share), dividends for the year will be 110.00 yen per share which is the same amount with the previous Business Term.

Conditions for the Canon Group are expected to become more difficult in the future, but we will strive to improve our management quality and remain united to overcome these difficult circumstances.

We look forward to your continued support and encouragement.

March, 2009

FUJIO MITARAI  
*Chairman & CEO*  
TSUNEJI UCHIDA  
*President & COO*

21

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*(Materials delivered pursuant to Article 437 and Article 444 of the Corporation Law)*

**BUSINESS REPORT**

(From January 1, 2008 to December 31, 2008)

**1. Current Conditions of the Canon Group**

**(1) Business Progress and Results**

**n General Business Conditions**

Reviewing Japanese and overseas economies during the term, the U.S. economy entered a recessionary phase by weak domestic demand due to downturns in residential investment, capital investments and consumer spending, and by worsening employment conditions. The European economies also contracted with unabating drops in residential prices, cooling consumer spending, export weakness, etc. Asian economies in general entered a trend of reduced growth due to the slowing European and U.S. economies, despite continued growth in China. Meanwhile, against the background of global economic deceleration, the Japanese economy moved along with a touch of stagnation which, toward the end of the term, developed into clear signs of serious difficulties as indicated by major declines in corporate profits and resulting reductions in capital investments. In the foreign exchange markets, compared with the previous term, the yen rose substantially during the term against both the U.S. dollar and the euro.

As to the conditions of the markets in which the Canon Group operates, although demand for digital cameras grew as a whole, prices for compact types fell. Meanwhile, demand was generally flat for networked multifunctional devices, inkjet printers, laser beam printers and other business machines. Demand for mirror projection mask aligners for LCDs expanded greatly as increased demand for large-size LCD panels energized capital investments. On the other hand, demand for semiconductor production equipment weakened, due to ongoing capital investment restraint by semiconductor manufacturers.

Under these business conditions, the Canon Group designated the term, which is the third year of Phase III (2006 to 2010) of our Excellent Global Corporation Plan, as a year for firmly positioning toward achieving 2010 objectives, and took various initiatives.

To begin with, in the area of development, we moved ahead with efforts to integrate our business and technology strategies, launched structural improvements in the R&D field aimed at radically strengthening and streamlining of our R&D capabilities and formulated a technology roadmap for the future.



In the area of production, the entire Group worked to accelerate automation and in-house production in order to strengthen our manufacturing base and boost productivity. We enhanced our facilities with the aim of automating production of the Group. For example, the Oita Office of Oita Canon Materials Inc. installed an integrated production line for ink cartridges, and the Moriyama Office of Canon Machinery Inc. established a plant that manufactures automatic assembly machines for toner and ink cartridges for Canon Group. Meanwhile, we also established an R&D building for CMOS sensors and other semiconductor devices at our Kawasaki Office and moved forward with efforts to strengthen our in-house production infrastructure. Additionally, we embarked on construction of a new toner cartridge plant at Canon Virginia, Inc. in the U.S., in order to create an optimal production structure by locating production facilities in areas where products are consumed. On another front, Canon Finetech Inc. made Nisca Corporation into a wholly owned subsidiary with the aim of strengthening development capabilities and improving productivity.

Meanwhile, we acquired shares of Hitachi Displays, Ltd. to accelerate commercialization of organic electro-luminescence (EL) displays and to put small and medium-sized displays into business operations.

In the area of sales, we focused on structural reinforcement by means such as reorganization of Group sales subsidiaries in the area of solutions business whose importance is increasing. Canon Marketing Japan Inc. established Canon IT Solutions Inc. by integrating domestic Group companies, and offered high-value-added services. Also, Canon U.S.A., Inc. integrated the regional solution companies and acquired NEWCAL Industries Inc., which led to strengthening its system to pursue nationwide sales and services.

As described above, the resources of the entire Canon Group were brought to advance measures on various fronts. Despite our efforts, under the effect of worsening business conditions, we recorded net sales of 4,094.2 billion yen (down 8.6% from the previous term), income before income taxes and minority interests of 481.1 billion yen (down 37.4%), and net income of 309.1 billion yen (down 36.7%), all on a consolidated basis. On a non-consolidated basis, we recorded net sales of 2,721.1 billion yen (down 5.8%), ordinary profit of 359.1 billion yen (down 35.0%), and net income of 224.1 billion yen (down 38.9%).



## n Business Conditions by Operations

### Sales by Operations

#### Consolidated

Operations	Sales (100 millions of yen)	Change from Previous Term (%)
<b>Business Machines</b>	26,600	(9.4)
Office Imaging Products	11,195	(13.3)
Computer Peripherals	14,548	(5.4)
Business Information Products	857	(20.1)
<b>Cameras</b>	10,420	(9.6)
<b>Optical and Other Products</b>	3,922	(0.2)
<b>Total</b>	40,942	(8.6)

#### Non-Consolidated

Operations	Sales (100 millions of yen)	Change from Previous Term (%)
<b>Business Machines</b>	17,184	(8.3)
Office Imaging Products	4,731	(12.5)
Computer Peripherals	12,453	(6.5)
<b>Cameras</b>	8,082	(5.1)
<b>Optical and Other Products</b>	1,945	19.0
<b>Total</b>	27,211	(5.8)

Note: Regarding the segment of Business information products within the Business machines category in the consolidated information above, there were no sales on a non-consolidated basis.

## 1 Business Machines Operations

### Office Imaging Products

Regarding the imageRUNNER series of office-use digital networked multifunctional devices, as the Japanese and overseas markets for multifunctional devices continued to shift toward color machines and away from black-and-white, we launched nine new models for five product types of color devices in the Japanese market. We strengthened our line of color machines by working to expand sales of the newly launched iR C4080F which is capable of printing 36 pages per minute in color and 40 pages per minute in black-and-white, and by launching the iR C2110F which offers both compact size and high functionality, as well as enhanced operability through a color TFT LCD and scroll wheel. In the area of black-and-white machines, we launched six new models for three product types in the Japanese market. These included the iR3245F which, despite it being a black-and-white machine, employs a high-speed and compact color scanner capable of digitalizing and transmitting color data files for scanned images. We also worked to promote our solutions business by proposing printing environments adjusted to customers' business formats and needs by using the Multifunctional Embedded Application Platform ( MEAP ) capable of expanding range of functions which is installed on our imageRUNNER series.

For our imagePRESS series printers for digital commercial printing, we launched the imagePRESS C6000 which is capable of printing 60 pages per minute in both black-and-white and color. We also strengthened this product line with the launch of the imagePRESS C1+ which can print 14 pages per minute in color and 60 pages per minute in black-and-white and employs a newly developed clear toner that enables a broad range of expression possibilities such as coating or metallic tone design effects.

Regarding products for small business owners for which demand is expanding, we launched several new products, including the Satera MF8450 multifunctional color machine, the top-line product in the Satera series.

Sales for this segment fell by 13.3% on a consolidated basis and by 12.5% on a non-consolidated basis, both in comparison to the previous term.



## Computer Peripherals

Regarding inkjet printers, amid market contraction and other difficult business conditions, we pursued aggressive sales activities including the introduction of new products employing the ChromaLife100 system which offers significantly better photo print stability through the combination of genuine Canon photo paper with a newly developed dye ink which realizes richer and more vibrant colors. Under the ongoing shift from single-function to multifunctional devices, we launched PIXUS MP980 multifunctional device using ink of six colors including the newly adopted gray ink and PIXUS MP630 multifunctional device offering automated double-sided printing function as standard and a broad array of direct printing functions. In single-function devices, we enhanced our lineup by launching products such as the PIXUS iP4600 which can rapidly print a borderless L-size photo in about 18 seconds. As a result, we were able to increase unit sales of inkjet printers despite the sluggish market. Meanwhile, sales of consumables including ink cartridges were also strong.

Regarding laser beam printers, OEM-brand products saw a leveling off in color products which had previously shown consistent growth. As for low-end products, which had contributed to the growth of black-and-white machines, multifunctional devices reflected continuing growth but single-function devices showed weakness in sales. For Canon-brand products, we strengthened our product line by launching Satera LBP5050/5050N color devices and, in black-and-white devices, products such as the Satera LBP3980 capable of printing 35 pages per minute and up to A3 size. Additionally, we worked to expand our solutions business utilizing the MEAP-Lite function expansion system.

In image scanners, we launched new products, including the CanoScan 5600F which adopts CCD technology and the CanoScan LiDE 200 which employs CIS (Contact Images Sensor) technology.

Sales for this segment fell by 5.4% on a consolidated basis and by 6.5% on a non-consolidated basis, both in comparison to the previous term.



### Business Information Products

In the area of office-use document scanners, due to corporations carrying out upgrades of their internal network environments and further advanced document digitization, the market for low-priced and compact products continued to expand. Under these conditions, for the imageFORMULA series handled by Canon Electronics Inc., we launched the DR-X10C as a new version of the flagship model and the DR-7090C capable of a high reading speed of 70 pages per minute. Sales promotion efforts for both products enabled us to achieve growth in unit sales.

Calculators handled by Canon Electronic Business Machines (H.K.) Co., Ltd. saw shrinkage in the Japanese market, but maintained high growth rates in other Asian markets. In the U.S., focused sales efforts for MP-25DV print-capable calculator boosted unit sales. Also, we introduced new products for electronic dictionaries handled by that company including the wordtank V903 which offers rich Chinese language content for learners of Chinese and the wordtank M600 for people who enjoy pastimes like foreign travel and *haiku*.

Sales for servers and personal computers handled by Canon Marketing Japan Inc. declined as that company moved forward with its shift from sales of single products to the solutions business.

Sales for this segment fell by 20.1% on a consolidated basis in comparison to the previous term. For this segment, there were no sales on a non-consolidated basis.

30

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## **n Camera Operations**

In digital cameras, as for our SLR type which continues to enjoy growing demand, we launched in our EOS DIGITAL series the EOS 50D equipped with a 15.1 megapixel CMOS sensor and a newly designed DIGIC 4 image processor for even higher image quality and higher-speed image processing. We also introduced the EOS 5D Mark II which is equipped with a 21.1 megapixel 35mm full-frame CMOS sensor and a DIGIC 4 image processor, and offers full HD video functionality. Sales promotion activities for these models as well as the EOS Kiss X2 in the EOS Kiss series, resulted in higher SLR unit sales. Consequently, sales of our EF lens series, dedicated flashes and other products also marked sound sales increases.

In the area of compact digital cameras, we launched six new models in our stylish IXY DIGITAL series. These included the 10.0 megapixel IXY DIGITAL 920 IS equipped with a DIGIC 4 image processor and 4.0x zoom. Additionally, in the PowerShot series with its ample product range for a variety of photographic styles, we launched ten new models, including the 14.7 megapixel PowerShot G10 with a DIGIC 4 image processor and 5.0x zoom.

In digital video cameras, we introduced new products such as the iVIS HF11 which enables recording up to 24 hours using double memory capacity that consists of both an internal flash memory and an SD card slot as recording medium. As a result, we increased our share of the market for HD video cameras.

On the LCD projector front, we expanded our line of high-resolution models by launching the SX80 equipped with our own LCOS reflective LCD panel for SXGA+ (1,400X1,050 pixels) resolution.

Sales for this segment fell by 9.6% on a consolidated basis and by 5.1% on a non-consolidated basis, both in comparison to the previous term.



## **n Optical and Other Products Operations**

Regarding mirror projection mask aligners for LCDs, with an improving demand-supply balance for large-size LCD panels through the first half of the term, and a trend of increase in panel prices, panel manufacturers engaged in active capital investments that, despite a slowdown toward the end of the term, resulted in a significant improvement. Under these circumstances, we worked to promote sales of our MPAsp-H700 series eighth-generation mirror projection mask aligner and produced a significant improvement in sales.

In semiconductor production equipment, we experienced lower sales due to falling demand caused by semiconductor manufacturers curbing capital investment for mass-production in response to slumping semiconductor prices.

For the imagePROGRAF series of large-format inkjet printers, we launched new products such as the iPF820 for businesses using CAD drawings and the iPF6200 for graphic art businesses. We also engaged in solutions business by introducing PosterArtist 2008 software application for the easy creation of professional-quality posters.

Meanwhile, sales of medical equipment remained steady as a result of sales expansion efforts that included the introduction of CR-1, a non-mydratic digital retinal camera capable of producing high-quality images for medical examinations at about one-third of the flash intensity than before.

Die bonders handled by Canon Machinery Inc. and magnetic head film deposition equipment and other devices handled by Canon ANELVA Corporation were depressed amid market weakness caused by lower capital investments on the part of customers.

Sales for this segment fell by 0.2% on a consolidated basis and grew by 19.0% on a non-consolidated basis, both in comparison to the previous term.



(2) Facilities Investment

The investment in facilities during this term totaled 362.0 billion yen (211.6 billion yen by the Company), which are mainly as follows:

**Main facilities completed during this term**

- Kawasaki Office of the Company: New Production Engineering Building and R&D Building  
(Headquarters Operations)

Location: Kawasaki-shi, Kanagawa Pref.

Date of Completion: July, 2008

- Oita Canon Materials Inc.: New Production Base  
(Business Machines Operations)

Location: Oita-shi, Oita Pref.

Date of Completion: February, 2008

\*Leased to Oita Canon Materials Inc. by the Company

- Head Office of the Company: Takeshi Mitarai Memorial Hall  
(Headquarters Operations)

Location: Ohta-ku, Tokyo

Date of Completion: January, 2008

- Canon Precision Inc.: New Production Base  
(Business Machines Operations)

Location: Hirosaki-shi, Aomori Pref.

Date of Completion: August, 2008

\*Leased to Canon Precision Inc. by the Company

**Main facilities under construction for establishment/expansion as of the end of this term**

- Kawasaki Office of the Company: New R&D Building  
(Headquarters Operations)

Location: Kawasaki-shi, Kanagawa Pref.

- Oita Canon Materials Inc.: New Production Base  
(Business Machines Operations)

Location: Oita-shi, Oita Pref.

\*To be leased to Oita Canon Materials Inc. by the Company

- Toride Office of the Company: New Production Base  
(Business Machines Operations)

Location: Toride-shi, Ibaraki Pref.

- Canon Virginia, Inc.: New Production Base  
(Business Machines Operations)

Location: Virginia, U.S.A.

(3) Management Perspectives

Regarding the global economy, given the combined effects of economic downturns in the leading industrialized countries and deceleration in emerging countries, it is expected that growth rate will decrease greatly and a strong sense of stagnation is to continue. The business conditions for the Canon Group are also expected to continue severe due to factors such as trend of strong yen in the foreign exchange markets.

Under these conditions, the Canon Group, in the fourth year of Phase III (2006 to 2010) of our Excellent Global Corporation Plan, will make the most of management reforms achieved to date and take all measures for next growth in order to achieve further improvements in management quality. In other words, we will respond swiftly to the present difficult business conditions and restructure ourselves as a lean organization by setting this year as to be prepared to take advantage of improved conditions in the future.

Toward that goal, our key objectives will be, first of all, to achieve timely introductions of new products satisfactory to customers in every aspect of functionality, design, ease of use, reliability and cost performance, and to secure No.1 market positions above and beyond the rest in each of our businesses.

Next, amid a strong yen, drastic fluctuations in raw material prices, falling product prices and other changing conditions, we will work to lower our cost rate by, for example, pursuing production and procurement reform activities to an even greater degree and practicing prototype-less development. Furthermore, in the face of stagnant market conditions, we will improve the quality of products thoroughly by renewing our appreciation of product quality as the lifeblood of a manufacturer and taking to heart the supremacy of quality.

Additionally, through our collaboration with Hitachi Displays, Ltd., to which we infused capital during the current term, we will concentrate on strengthening display operations as a new core business. We also aim to add significant strength to new businesses by actively launching new products in the field of medical equipment and by pursuing other initiatives as well.

With eyes focused on taking the Canon Group to new heights, promoting its perpetual development and transforming it into a truly excellent global company that continues to prosper, we will work to strengthen our unique core technology research system and develop management personnel, while also devoting even greater efforts to social contribution activities.

## (4) Status of Assets and Earnings

**Consolidated**

	104th Business Term (Jan. 1, 2004-Dec. 31, 2004)	105th Business Term (Jan. 1, 2005-Dec. 31, 2005)
Net Sales (100 millions of yen)	34,679	37,542
Income before Income Taxes and Minority Interests (100 millions of yen)	5,521	6,120
Net Income (100 millions of yen)	3,433	3,841
Basic Net Income Per Share (yen)	258.53	288.63
Total Assets (100 millions of yen)	35,870	40,436
Total Stockholders' Equity (100 millions of yen)	22,099	26,047

- Notes: 1. Canon's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles.
2. Basic net income per share is calculated based on the weighted average number of outstanding shares during the term.

**Non-Consolidated**



	104th Business Term (Jan. 1, 2004-Dec. 31, 2004)	105th Business Term (Jan. 1, 2005-Dec. 31, 2005)
Net Sales (100 millions of yen)	22,784	24,815
Ordinary Profit (100 millions of yen)	3,963	4,407
Net Income (100 millions of yen)	2,493	2,893
Net Income Per Share (yen)	281.30	325.83
Total Assets (100 millions of yen)	23,848	26,528
Net Assets (100 millions of yen)	16,514	18,754

- Notes:
1. Net income per share is calculated based on the weighted average number of outstanding shares during the term.
  2. The Company implemented a three-for-two stock split on July 1, 2006. The net income per share for the 106th business term has been calculated on the basis that the stock split was made at the beginning of the term.

106th Business Term (Jan. 1, 2006-Dec. 31, 2006)	107th Business Term (Jan. 1, 2007-Dec. 31, 2007)	108th Business Term (Jan. 1, 2008-Dec. 31, 2008)
41,568	44,813	40,942
7,191	7,684	4,811
4,553	4,883	3,091
341.95	377.59	246.21
45,219	45,126	39,699
29,866	29,223	26,598

3. Canon has made a three-for-two stock split on July 1, 2006. Basic net income per share for the 104th and 105th business terms have been calculated based on the number of issued shares following the implementation of the stock split. The basic net income per share for the 106th business term has been calculated on the basis that the stock split was made at the beginning of the term.

106th Business Term (Jan. 1, 2006-Dec. 31, 2006)	107th Business Term (Jan. 1, 2007-Dec. 31, 2007)	108th Business Term (Jan. 1, 2008-Dec. 31, 2008)
27,297	28,879	27,211
5,240	5,528	3,591

3,375	3,670	2,241
253.48	283.75	178.50
29,381	27,909	26,190
21,093	18,906	18,650

3. Effective from 106th business term, the Company adopted Accounting Standards Board Statement No. 5 Accounting Standard for Presentation of Net Assets in the Balance Sheet issued by the Accounting Standards Board of Japan on December 9, 2005 and Accounting Standards Board Guidance No. 8 Guidance on Accounting Standards for Presentation of Net Assets in the Balance Sheet issued by the Accounting Standards Board of Japan on December 9, 2005.

(5) Main Activities

Canon Group is engaged in the development, manufacture and sales of the following products.

Operations	Main Products	
<b>Business Machines</b>	Office Imaging Products	Network Multifunction Devices, Laser Multifunction Printers, Copying Machines
	Computer Peripherals	Laser Beam Printers, Inkjet Printers, Inkjet Multifunction Printers, Image Scanners
	Business Information Products	Computers,  Document Scanners, Handy Terminals, Calculators, Electronic Dictionaries
<b>Cameras</b>		Digital Cameras, Digital Video Cameras, Interchangeable Lenses, LCD Projectors
<b>Optical and Other Products</b>		Semiconductor Production Equipment, Mirror Projection Mask Aligners for LCDs, Broadcast-use Television Lenses, Medical Image Recording Equipment, Large-Format Inkjet Printers, Vacuum Equipment for Electronic Components

(6) Canon Group Global Network

n **Major Domestic Bases**

Name [Location]

**Canon Inc.**

Headquarters [Tokyo]  
 Kawasaki Office [Kanagawa Pref.]  
 Ayase Office [Kanagawa Pref.]  
 Hiratsuka Development Center [Kanagawa Pref.]  
 Optics R&D Center [Tochigi Pref.]  
 Tamagawa Plant [Kanagawa Pref.]  
 Kosugi Office [Kanagawa Pref.]  
 Toride Plant [Ibaraki Pref.]  
 Fuji-Susono Research Park [Shizuoka Pref.]  
 Yako Office [Kanagawa Pref.]  
 Utsunomiya Plant [Tochigi Pref.]  
 Utsunomiya Optical Products Plant [Tochigi Pref.]  
 Ami Plant [Ibaraki Pref.]

**Manufacturing**

Oita Canon Inc. [Oita Pref.]  
 Canon Chemicals Inc. [Ibaraki Pref.]  
 Nagahama Canon Inc. [Shiga Pref.]  
 Fukushima Canon Inc. [Fukushima Pref.]  
 Oita Canon Materials Inc. [Oita Pref.]

**Marketing**

Canon Marketing Japan Inc. [Tokyo]  
 Canon Software Inc. [Tokyo]  
 Canon System & Support Inc. [Tokyo]  
 Canon IT Solutions Inc. [Tokyo]

**R&D, Manufacturing and Marketing**

Canon Electronics Inc. [Saitama Pref.]  
 Canon Finetech Inc. [Saitama Pref.]  
 Canon Machinery Inc. [Shiga Pref.]  
 Canon Precision Inc. [Aomori Pref.]  
 Canon ANELVA Corporation [Kanagawa Pref.]

Note:

Optics R&D Center, Utsunomiya Plant and Utsunomiya Optical Products Plant were combined to form Utsunomiya Plant as of January 1, 2009.

## n Major Overseas Bases

Name [Location]

### R&D

Canon Development Americas, Inc. [U.S.A.]  
 Canon Technology Europe Ltd. [U.K.]  
 Canon Research Centre France S.A.S. [France]  
 Canon Information Systems Research Australia Pty. Ltd. [Australia]

### Manufacturing

Canon Virginia, Inc. [U.S.A.]  
 Canon Giessen GmbH [Germany]  
 Canon Bretagne S.A.S. [France]  
 Canon Dalian Business Machines, Inc. [China]  
 Canon Zhuhai, Inc. [China]  
 Canon Zhongshan Business Machines Co., Ltd. [China]  
 Canon (Suzhou) Inc. [China]  
 Canon Inc., Taiwan [Taiwan]  
 Canon Hi-Tech (Thailand) Ltd. [Thailand]  
 Canon Vietnam Co., Ltd. [Vietnam]  
 Canon Opto (Malaysia) Sdn. Bhd. [Malaysia]

### Marketing

Canon U.S.A., Inc. [U.S.A.]  
 Canon Canada Inc. [Canada]  
 Canon Latin America, Inc. [U.S.A.]  
 Canon Europa N.V. [Netherlands]  
 Canon Europe Ltd. [U.K.]  
 Canon (UK) Ltd. [U.K.]  
 Canon France S.A.S. [France]  
 Canon Deutschland GmbH [Germany]  
 Canon North-East Oy [Finland]  
 Canon Middle East FZ-LLC [U.A.E.]  
 Canon (China) Co., Ltd. [China]  
 Canon Hongkong Co., Ltd. [Hong Kong]  
 Canon Korea Consumer Imaging Inc. [Korea]  
 Canon Singapore Pte. Ltd. [Singapore]  
 Canon Australia Pty. Ltd. [Australia]  
 Canon do Brasil Indústria e Comércio Limitada [Brazil]  
 Canon Chile, S.A. [Chile]  
 Canon South Africa Pty. Ltd. [South Africa]

**R&D, Manufacturing and Marketing**

Canon Electronic Business Machines (H.K.) Co., Ltd. [Hong  
Kong]



(7) Employees  
**Consolidated**

Number of employees	166,980 persons (Increase of 35,628 persons from the previous term)
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Americas	11,112 persons
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Europe	12,735 persons
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Japan	72,445 persons
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Others	70,688 persons
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**Non-Consolidated**

Number of employees	25,412 persons  (Increase of 4,526 persons from the previous term)
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(8) Acquisition of shares of other companies

(i) Canon Finetech Inc., aiming to strengthen its basis of peripheral devices for business machines business, made Nisca Corporation its wholly-owned subsidiary on July 1, 2008, by tender offer and share exchange.

(ii) Canon Electronics Inc., aiming to strengthen its information related equipment business, made Asia Pacific System Research Co., Ltd. (listed on the JASDAQ stock exchange) its consolidated subsidiary on November 21, 2008 by tender offer.

(9) Principal Subsidiaries  
n **Subsidiaries**

Company Name	Capital Stock (millions of yen)	Ratio of Voting Rights of the Company (%)	Main Activities
Canon Marketing Japan Inc.	73,303	55.2	Domestic sale of business machines, cameras, etc.
Canon Electronics Inc.	4,969	55.1	Manufacture and sale of information related equipment and precision machinery units for cameras
Canon Finetech Inc.	3,451	58.1	Manufacture and sale of printers, peripheral devices for business machines and chemicals, etc.
Canon Software Inc.	1,348	57.6	Development and sale of computer software
Canon Machinery Inc.	2,707	64.7	Manufacture and sale of semiconductor production equipment and automation/ laborsaving equipment
Tokki Corporation	6,573	66.5	Development, manufacture and sale of equipment for manufacturing organic EL display panels, etc.
Asia Pacific System Research Co., Ltd.	2,400	87.9	Design, development, operation and maintenance of software and systems
e-System Corporation	5,005	62.1	Introduction of Customer Relationship Management System, etc.
Oita Canon Inc.	80	100.0	Manufacture of cameras
Canon U.S.A., Inc.	204,355 thousands of	100.0	Sale of business machines, cameras, etc. in the Americas

U.S.\$

Canon Europa N.V.	290,600 thousands of Euro	100.0	Sale of business machines, cameras, etc. in Europe
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Notes: 1. The ratio of the Company's voting rights in Canon Marketing Japan Inc. and Canon Finetech Inc. are calculated together with the number of voting rights held by subsidiaries.  
 2. The ratio of the Company's voting rights in Canon Software Inc., Asia Pacific System Research Co., Ltd. and e-System Corporation are based on the number of voting rights held by subsidiaries.  
 3. The ratio of the Company's voting rights in Tokki Corporation and Asia Pacific System Research Co., Ltd. are calculated based on the number of voting rights as of June 30, 2008 and September 30, 2008, respectively.

**n Consolidated Status**

The number of consolidated subsidiaries was 245, and the number of affiliated companies accounted for by the equity method was 18.

44

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## 2. Shares of the Company

**Number of Shares Issuable** 3,000,000,000 shares**Issued Shares, Capital Stock and Number of Shareholders**

	As of the end of the Previous Term	Change during This Term	As of the end of This Term
Issued Shares (share)	1,333,636,210	127,254	1,333,763,464
Capital Stock (yen)	174,698,297,729	63,499,746	174,761,797,475
Number of Shareholders (person)	158,388	26,401	184,789

Note: The increase of the issued shares and the capital stock during this term reflect the conversion of convertible debentures into shares.

# Major Shareholders (Ten shareholders)

Name of Shareholders	Investment by the Shareholders in the Company	
	Number of Shares Held (thousands of shares)	Share- holding Ratio (%)
The Dai-Ichi Mutual Life Insurance Co.	93,312	7.6
Moxley & Co.	64,552	5.2
Japan Trustee Services Bank, Ltd. (Trust Account)	57,055	4.6
Japan Trustee Services Bank, Ltd. (Trust Account 4G)	53,469	4.3
The Master Trust Bank of Japan, Ltd. (Trust Account)	47,213	3.8
JP Morgan Chase & Co. 380055	30,220	2.4
State Street Bank and Trust Company	25,969	2.1
Mizuho Corporate Bank, Ltd.	25,919	2.1
Sompo Japan Insurance Inc.	22,910	1.9
The Chase Manhattan Bank, N.A. London S.L. Omnibus Account	21,615	1.8

- Notes: 1. Shareholding ratio is calculated by deducting treasury stock (99,275 thousand shares) from total shares issued.
2. With respect to Mizuho Corporate Bank, Ltd., in addition to the above, there are 7,704 thousand shares of the Company's stock, in the form of trust property relating to retirement allowance trust.

**Shareholding Ratio by Category**

46

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### 3. Share Options of the Company

#### (1) Share Options Issued as Stock Options

##### (i) Share Options Held by the Directors and Corporate Auditors of the Company as of the end of this term

	Number of share options (Exercise price per share)	Class and number of shares to be acquired	Exercise period	Number of holders
1st Share Options	3,500 options (5,502 yen)	Common stock 350,000 shares	May 1, 2010 to April 30, 2014	Directors 25 persons

##### (ii) Share Options Issued to the Employees of the Company during this term

	Number of share options (Exercise price per share)	Class and number of shares to be acquired	Exercise period	Number of holders
1st Share Options	2,420 options (5,502 yen)	Common stock 242,000 shares	May 1, 2010 to April 30, 2014	Employees of the Company 38 persons

##### (iii) Issue Price of Share Options

No cash payment is required.

##### (iv) Other Conditions for Exercise of Share Options

- a. One share option may not be exercised partially.
- b. Each holder of share options must continue to be a director, executive officer or employee of the Company until the end of the Company's general meeting of shareholders regarding the final business term within two (2) years from the end of the Ordinary General Meeting of Shareholders which the issuance of such share options was resolved.
- c. Holders of share options will be entitled to exercise their share options for two (2) years, and during the exercisable period, even after they lose their positions as directors, executive officers or employees. However, if a holder of share options loses such position due to resignation at his/her initiative, or due to dismissal or discharge by the Company, his/her share options will immediately lose effect.
- d. No succession by inheritance is authorized for the share options.
- e. Besides the above, other conditions shall be stipulated in an agreement to be executed between the Company and grantee of share options, based on the resolution of the Board of Directors' meeting.

##### (2) Convertible Debentures

The third series of Unsecured Convertible Debentures issued on November 24, 1993, matured on December 19, 2008 (the date of redemption).





#### 4. Directors and Corporate Auditors

##### (1) Directors and Corporate Auditors

Position	Name	Business in Charge or Representatives of other Organizations
Chairman & CEO	Fujio Mitarai	Chairman of Nippon Keidanren
President & COO	Tsuneji Uchida	
Executive Vice President & CFO	Toshizo Tanaka	Group Executive of Policy & Economy Research Headquarters
Senior Managing Director	Nobuyoshi Tanaka	Group Executive of Corporate Intellectual Property and Legal Headquarters
Senior Managing Director	Junji Ichikawa	Chief Executive of Optical Products Operations
Senior Managing Director	Akiyoshi Moroe	Group Executive of External Relations Headquarters and Group Executive of General Affairs Headquarters
Senior Managing Director	Kunio Watanabe	Group Executive of Corporate Planning Development Headquarters and Deputy Group Executive of Policy & Economic Research Headquarters
Managing Director	Yoroku Adachi	President & CEO of Canon U.S.A., Inc.
Managing Director	Yasuo Mitsuhashi	Chief Executive of Peripheral Products Operations
Managing Director	Tomonori Iwashita	Group Executive of Environment Headquarters and Group Executive of Quality Management Headquarters
Managing Director	Masahiro Osawa	Group Executive of Finance & Accounting Headquarters
Managing Director	Shigeyuki Matsumoto	Group Executive of Device Technology Development Headquarters and Deputy Group Executive of Core Technology Development Headquarters
Managing Director	Katsuichi Shimizu	Chief Executive of Inkjet Products Operations
Managing Director	Ryoichi Bamba	Managing Director President of Canon Europa N.V. and President of Canon Europe Ltd.
Managing Director	Toshio Homma	Chief Executive of L Printer Products Operations
Managing Director	Masaki Nakaoka	Chief Executive of Office Imaging Products Operations
Managing Director	Haruhisa Honda	Group Executive of Production Engineering Headquarters
Director	Shunichi Uzawa	Executive Vice President of Canon U.S.A., Inc.
Director	Toshiyuki Komatsu	Deputy Group Executive of Corporate Planning Development Headquarters
Director	Tetsuro Tahara	Group Executive of Global Manufacturing & Logistics Headquarters
Director	Seijiro Sekine	Group Executive of Information & Communication Systems Headquarters
Director	Shunji Onda	Group Executive of Global Procurement Headquarters

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Director	Kazunori Fukuma	President & Representative Director of SED Inc.
Director	Hideki Ozawa	President of Canon (China) Co., Ltd.
Director	Masaya Maeda	Group Executive of Image Communication Products Operations

Position	Name	Business in Charge or Representatives of other Organizations
Corporate Auditor	*Keijiro Yamazaki	
Corporate Auditor	Kunihiro Nagata	
Corporate Auditor	Tadashi Ohe	Attorney
Corporate Auditor	Yoshinobu Shimizu	Certified Public Accountant
Corporate Auditor	Minoru Shishikura	

- Notes: 1. Mr. Fujio Mitarai, Mr. Tsuneji Uchida and Mr. Toshizo Tanaka are Representative Directors.
2. Corporate Auditor with asterisk was newly elected at the Ordinary General Meeting of Shareholders for the 107th Business Term held on March 28, 2008, and assumed his office.
3. Corporate Auditors Mr. Tadashi Ohe, Mr. Yoshinobu Shimizu and Mr. Minoru Shishikura are Outside Corporate Auditors defined by

Item 16,  
Article 2 of the  
Corporation  
Law.

4. Corporate Auditor  
Mr. Kunihiro Nagata had experienced accounting operation at the Company for many years and has a wealth of expertise in finance and accounting.
5. Corporate Auditor  
Mr. Yoshinobu Shimizu is a Certified Public Accountant and has a wealth of expertise in finance and accounting.
6. Corporate Auditor  
Mr. Minoru Shishikura had experienced financial operation at an insurance company for many years and has a wealth of expertise in finance.
7. Business in Charge or Representatives of other Organizations of Directors  
Mr. Akiyoshi Moroe and Mr. Shigeyuki Matsumoto, as of January 1,

2009, have been  
changed as  
follows.

Akiyoshi Moroe	Group Executive of External Relations Headquarters, Group Executive of General Affairs Headquarters and Group Executive of Human Resources Management & Organization Headquarters
Shigeyuki Matsumoto	Group Executive of Device Technology Development Headquarters

(2) Remuneration and Other Amounts to Directors and Corporate Auditors

Directors	27 persons	1,586 million yen
Corporate Auditors	6 persons	108 million yen

(including 54 million yen for 3 Outside Corporate Auditors)

- Notes: 1. The above  
persons include  
2 Directors and  
1 Corporate  
Auditor who  
have retired at  
the conclusion  
of the Ordinary  
General  
Meeting of  
Shareholders for  
the 107th  
Business Term  
held on  
March 28, 2008.
2. Directors  
remuneration  
and other  
amounts do not  
include amount  
paid as salary  
for employees  
to those  
Directors who  
are also  
employees.
3. Directors  
remuneration  
and other  
amounts include  
provisions for  
directors  
bonuses for this  
term in the  
amount of  
244 million yen.

4. Directors remuneration and other amounts include expenses related to the share options issued pursuant to the resolution of the 107th Ordinary General Meeting of Shareholders, held on March 28, 2008, in the amount of 145 million yen.

5. The above remuneration and other amounts include an increased amount of accrued directors retirement benefits for this term (Directors 310 million yen, Corporate Auditors 13 million yen (including 6 million yen for Outside Corporate Auditors)).

6. In addition to the above, Directors and Corporate Auditors received the following remuneration and other amounts.

Directors allowance paid pursuant to the resolution of the Ordinary General Meeting of Shareholders for the 107th Business Term held on March 28, 2008

Directors	2 persons	118 million yen
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Corporate Auditor

1 person

18 million yen

Each amount includes increased amount of accrued directors retirement benefits, disclosed in the business report for this business term and in prior business terms.

49

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(3) Outside Directors and Outside Corporate Auditors

**Important Concurrent Post**

Name	Concurrent Post	Company Name
Tadashi Ohe	Outside Corporate Auditor	Marui Group Co., Ltd.
	Outside Corporate Auditor	Kao Corporation
Yoshinobu Shimizu	Outside Corporate Auditor	Mitsubishi UFJ Trust and Banking Corporation
	Outside Corporate Auditor	Canon Electronics Inc.
Minoru Shishikura	Outside Corporate Auditor	Canon Marketing Japan Inc.
	Outside Corporate Auditor	Canon Finetech Inc.

**Principal Activities**

Name	Principal Activities
Tadashi Ohe	Attended 10 out of 13 Board of Directors meeting and all 16 of the Board of Corporate Auditors meeting held during this term, and provided expert input as an attorney when necessary.
Yoshinobu Shimizu	Attended all 13 of Board of Directors meeting and all 16 of the Board of Corporate Auditors meeting held during this term, and provided expert input as a Certified Public Accountant when necessary.



Minoru Shishikura

Attended 12 out of 13 Board of Directors meeting and all 16 of the Board of Corporate Auditors meeting held during this term, and provided input based on his insight in financial operation when necessary.

**Remuneration and Other Amounts Received by Outside Directors and Outside Corporate Auditors from the Company's Subsidiaries**

Remuneration and other amounts received during this term by Outside Corporate Auditors from the Company's subsidiaries for their services as Outside Corporate Auditors amounted to 11 million yen.

50

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## 5. Accounting Auditor

(1) Name of Accounting Auditor

Ernst & Young ShinNihon LLC

(2) Remuneration and Other Amounts to Accounting Auditor for This Term

	Amount
(i) Remuneration and other amounts payable by the Company for the services defined in Paragraph 1, Article 2 of the Certified Public Accountants Act	608 million yen
(ii) Total amount of cash and other financial benefits payable by the Company and its subsidiaries to the Accounting Auditor	1,032 million yen

- Notes:
1. In the audit agreement between the Company and the Accounting Auditor, remuneration amounts are determined on a lump-sum without breakdown into a separate remuneration amount for auditing in accordance with the Corporation Law and in accordance with the Financial Instruments and Exchange Law. Accordingly, the amounts shown in (i) above represent total amounts of remuneration and other amounts for both of these auditing services.
  2. The Company pays remuneration to the Accounting Auditor for their advice and instruction concerning the development, operation and assessment pertaining to the internal control on financial reports and financial due diligence in addition to the services defined in Paragraph 1, Article 2 of the Certified Public Accountants Act.
  3. Among the Company's principal subsidiaries, Asia Pacific System Research Co., Ltd. is audited by KPMG AZSA & Co., Canon U.S.A., Inc. is audited by Ernst & Young LLP and Canon Europa N.V. is audited by Ernst & Young Accountants LLP.

### (3) Policy Regarding Decision to Either Dismiss or Not Reappoint Accounting Auditor

The Board of Corporate Auditors, by unanimous agreement, will dismiss the Accounting Auditor when confirmed that the Accounting Auditor falls under any Item of Paragraph 1, Article 340 of the Corporation Law.

In addition to the above, should anything occur to negatively impact the qualifications or independence of the Accounting Auditor, making it unlikely that the Accounting Auditor will be able to properly perform an audit, the Directors will propose, with the agreement of the Board of Corporate Auditors, or as requested by the Board of Corporate Auditors, not to reappoint the Accounting Auditor at a general meeting of shareholders.

## 6. Systems for Ensuring Propriety of Operations

As systems for ensuring the propriety of the Company's operations, the Board of Directors has adopted a resolution as follows:

- (1) System for Ensuring the Performance of Duties by Directors and Employees to Comply with Laws and Articles of Incorporation
  - (i) Based on the spirit of the Three Selfs (self-motivation, self-management, and self-awareness) a Canon universal principle dating back to the Company's founding the Company established the Canon Group Code of Conduct as a standard to which Directors, Executive Officers and employees must adhere when performing their work. A Committee that manages and oversees this initiative promotes compliance activities to develop law-abiding, independent and strong individuals with a high sense of ethics.
  - (ii) Policies and measures set forth by the Committee above are implemented throughout the Company with the assistance of compliance staff assigned to each division.
  - (iii) Each division establishes internal rules and guidelines to help ensure that all Directors, Executive Officers and employees thoroughly understand the laws and regulations of Japan and other countries.
  - (iv) The Company ensures Directors, Executive Officers and employees the implementation of the basic policy that provides not to have any relation with antisocial forces under any circumstances, and also maintains and improves the cooperation structure with external institutions such as police by establishing a department in charge.
  - (v) The Company's internal auditing, legal, and other divisions work to strengthen compliance through law-abidance guidance and monitoring on its business activities.
  - (vi) An in-house hotline system is employed to promote internal self-checks to prevent illegal or unethical activities and help prevent improprieties.
- (2) System for Maintaining and Managing Information Relating to the Performance of Duties by Directors
  - (i) Information relating to the performance of duties by Directors is maintained and managed in accordance with the Company's basic rules for document management addressing the creation, sending and receiving, storage, retention, and destruction of documents, and other in-house rules.
  - (ii) A system is established that enables Directors, Corporate Auditors, and internal auditing to access this information anytime.

(3) Rules and Other Systems Regarding Management of Risk of Loss

- (i) Important matters are carefully deliberated at the Executive Committee and in other Management Committees on specific action plans to eliminate or reduce business risks.
- (ii) Business processes are specified and risks are evaluated based on guidelines set forth by a committee that oversees financial risk management to ensure the accuracy and reliability of financial reporting. This must be documented in writing, and the status of control activity is regularly confirmed to make risk management effectively work.
- (iii) A risk management system is created through the formulation and observance of various in-house rules to protect the Company from diversifying risks (quality, environmental, disaster, information-related, export management, etc.) and maintain public faith. In particular, Basic Policies Regarding Product Safety have been established, which govern efforts in supplying customers with safe products that will allow comfortable and satisfactory use.
- (iv) Wide-ranging audits of various types and promotion of the in-house hotline system by internal auditing are carried out for the early detection and resolution of risks.

(4) System for Assuring Directors' Efficient Execution of Duties

- (i) The Executive Committee and Management Committees are established and important matters are carefully deliberated in advance by Directors, Executive Officers and relevant managers to promote prompt and appropriate decision making by Directors.
- (ii) Based on explanation of management policies in long-term management plans, the Company goals are given concrete shape in medium-term plans, and each division is thoroughly informed of the content of these plans. Furthermore, annual and quarterly short-term plans and monthly budgetary control are used to monitor performance progress, through which the Company makes optimum use of management resources.

- (5) System for Ensuring Appropriate Operations of the Corporate Group Comprised of Corporation, its Parent Companies and Subsidiaries
- (i) Based on the Canon Group Code of Conduct, the Company promotes Groupwide compliance and infuses an awareness of compliance and corporate ethics to share as a set of common values for the Group.
  - (ii) Policies and measures set forth by the Committee managing and overseeing the Canon Group Code of Conduct are implemented at each Group company by compliance staff assigned to it.
  - (iii) The internal auditing, legal, and other divisions enhance compliance by providing guidance and monitoring with regard to the observance of laws in the business activities of all Group companies.
  - (iv) The soundness and efficiency of the Group's business activities are ensured through the formulation of Groupwide medium-term plans and deliberations in the Management Committee.
- (6) Matters Regarding Employees Who Assist the Duties of Corporate Auditors When Corporate Auditors Request Assignment of Such Employees
- (i) A division is established specifically to assist Corporate Auditors with their duties.
  - (ii) Full-time employees of a requisite number are assigned to the division.
- (7) Matters Regarding Independence of the Employees in (6) Above From Directors
- (i) The division is an organization independent of the Board of Directors.
  - (ii) Changes in the division's personnel require the prior consent of the Board of Corporate Auditors.

- (8) System for Directors and Employees to Report to Corporate Auditors and System for Other Types of Reporting to Corporate Auditors
- (i) Directors promptly report to Corporate Auditors matters that may have a significant impact on the Company when such matters emerge or are likely to emerge.
  - (ii) Directors, Executive Officers and employees deliver reports periodically to Corporate Auditors regarding matters Directors and the Corporate Auditors have previously agreed upon in consultations.
  - (iii) Corporate Auditors attend the Executive Committee and other important meetings.
  - (iv) An in-house hotline system is adopted to allow Corporate Auditors to receive information from employees.
- (9) Other Systems for Securing the Effectiveness of Auditing by Corporate Auditors
- (i) Corporate Auditors periodically receive reports from accounting auditors.
  - (ii) The Company establishes the systems for providing cooperation and allowing field audits of internal divisions and affiliates to be performed efficiently by Corporate Auditors.

Consolidated Financial Statements  
[Consolidated Balance Sheets](#)

**ASSETS**

Millions of yen

	<b>As of Dec. 31, 2008</b>	<b>As of Dec. 31, 2007</b>
<b>Current assets:</b>		
Cash and cash equivalents	679,196	944,463
Short-term investments	7,651	20,499
Trade receivables, net	595,422	794,240
Inventories	506,919	563,474
Prepaid expenses and other current assets	275,660	286,111
<b>Total current assets</b>	<b>2,064,848</b>	<b>2,608,787</b>
Noncurrent receivables	14,752	15,239
Investments	88,825	90,086
Property, plant and equipment, net	1,357,186	1,364,702
Intangible assets	119,140	112,516
Other assets	325,183	321,295
<b>Total assets</b>	<b>3,969,934</b>	<b>4,512,625</b>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Millions of yen

	<b>As of Dec. 31, 2008</b>	<b>As of Dec. 31, 2007</b>
<b>Current liabilities:</b>		
Short-term loans and current portion of long-term debt	5,540	18,317
Trade payables	406,746	514,226
Accrued income taxes	69,961	150,726
Accrued expenses	277,117	357,525
Other current liabilities	184,636	215,911
<b>Total current liabilities</b>	<b>944,000</b>	<b>1,256,705</b>
Long-term debt, excluding current installments	8,423	8,680
Accrued pension and severance cost	110,784	44,710
Other noncurrent liabilities	55,745	57,324
<b>Total liabilities</b>	<b>1,118,952</b>	<b>1,367,419</b>

<b>Minority interests</b>	<b>191,190</b>	<b>222,870</b>
<b>Commitment and contingent liabilities</b>		
<b>Stockholders' equity:</b>		
Common stock	174,762	174,698
[Authorized shares] (share)	[3,000,000,000]	[3,000,000,000]
[Issued shares] (share)	[1,333,763,464]	[1,333,636,210]
Additional paid-in capital	403,790	402,991
Legal reserve	53,706	46,017
Retained earnings	2,876,576	2,720,146
Accumulated other comprehensive income (loss)	(292,820)	34,670
Treasury stock, at cost	(556,222)	(456,186)
[Treasury shares] (share)	[99,275,245]	[72,588,428]
<b>Total stockholders' equity</b>	<b>2,659,792</b>	<b>2,922,336</b>
<b>Total liabilities and stockholders' equity</b>	<b>3,969,934</b>	<b>4,512,625</b>

## &lt;Notes to Consolidated Balance Sheets&gt;

1. Allowance for doubtful receivables: 9,318 million yen
2. Accumulated depreciation: 1,635,601 million yen
3. Accumulated other comprehensive income (loss) includes foreign currency translation adjustments, net unrealized gains and losses on securities, net gains and losses on derivative financial instruments and pension liability adjustments.
4. Guarantee obligations for bank loans taken out by employees: 22,308 million yen.

## &lt;Note to Per Share Information&gt;

Stockholders' equity per share 2,154.57 yen



## Consolidated Statements of Income

	Millions of yen	
	Year ended Dec. 31, 2008	Year ended Dec. 31, 2007
<b>Net sales</b>	<b>4,094,161</b>	<b>4,481,346</b>
Cost of sales	2,156,153	2,234,365
<b>Gross profit</b>	<b>1,938,008</b>	<b>2,246,981</b>
<b>Operating expenses:</b>		
Selling, general and administrative expenses	1,067,909	1,122,047
Research and development expenses	374,025	368,261
	<b>1,441,934</b>	<b>1,490,308</b>
<b>Operating profit</b>	<b>496,074</b>	<b>756,673</b>
<b>Other income (deductions):</b>		
Interest and dividend income	19,442	32,819
Interest expense	(837)	(1,471)
Other, net	(33,532)	(19,633)
	<b>(14,927)</b>	<b>11,715</b>
<b>Income before income taxes and minority interests</b>	<b>481,147</b>	<b>768,388</b>
Income taxes	160,788	264,258
<b>Income before minority interests</b>	<b>320,359</b>	<b>504,130</b>
Minority interests	11,211	15,798
<b>Net income</b>	<b>309,148</b>	<b>488,332</b>
<Note to Per Share Information>		
Net income per share		
Basic		246.21 yen
Diluted		246.20 yen
		57

## Consolidated Statement of Stockholders' Equity

	Millions of yen						
	Common stock	Additional paid-in capital	Legal reserve	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total stockholders' equity
<b>Balance at December 31, 2007</b>	<b>174,698</b>	<b>402,991</b>	<b>46,017</b>	<b>2,720,146</b>	<b>34,670</b>	<b>(456,186)</b>	<b>2,922,336</b>
Conversion of convertible debt and other	64	824					888
Cash dividends				(145,024)			(145,024)
Transfers to legal reserve			7,689	(7,689)			-
Comprehensive income:							
Net income				309,148			309,148
Other comprehensive income (loss), net of tax							
Foreign currency translation adjustments					(258,764)		(258,764)
Net unrealized gains and losses on securities					(5,152)		(5,152)
Net gains and losses on derivative instruments					2,342		2,342
Pension liability adjustments					(65,916)		(65,916)
<b>Total comprehensive income</b>							<b>(18,342)</b>
Repurchase of treasury stock, net		(25)		(5)		(100,036)	(100,066)
<b>Balance at December 31, 2008</b>	<b>174,762</b>	<b>403,790</b>	<b>53,706</b>	<b>2,876,576</b>	<b>(292,820)</b>	<b>(556,222)</b>	<b>2,659,792</b>

&lt;Note to Consolidated Statement of Stockholders' Equity&gt;

Pension liability adjustments include actuarial loss, prior service credit and net transition obligation.

58

## Notes to Consolidated Financial Statements

### <Notes to Basic Significant Matters Regarding Preparation of Consolidated Financial Statements>

#### Significant Accounting Policies

##### 1. Group Position

The number of consolidated subsidiaries was 245, and the number of affiliated companies accounted for by the equity method was 18.

##### 2. Basis of Presentation

The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles ( US GAAP ) pursuant to the provision of Section 1, Article 148 of the Company Accounting Regulations. However, certain disclosures required under US GAAP are omitted pursuant to the same provision.

##### 3. Cash Equivalents

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

##### 4. Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at the rate of exchange in effect at the balance sheet date. Exchange differences are charged or credited to income. Assets and liabilities of subsidiaries located outside Japan are translated into Japanese yen at the rates of exchange in effect at the balance sheet date and income and expense items are translated at the average exchange rates prevailing during the year. The resulting translation adjustments are reported in other comprehensive income (loss).

##### 5. Inventories

Inventories are stated at the lower of cost or market value. Cost is determined by the average method for domestic inventories and principally the first-in, first-out method for overseas inventories.

##### 6. Marketable Securities

Canon accounts for its debt and marketable equity securities in accordance with Statement of Financial Accounting Standards No.115, Accounting for Certain Investments in Debt and Equity Securities. Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, on available for-sale securities are excluded from earnings and are reported in other comprehensive income (loss) until realized. Realized gain and losses are determined on the average cost method.

7. Property, Plant and Equipment

Property, plant and equipment are depreciated principally by the declining-balance method.

8. Goodwill and Other Intangible Assets

Goodwill and other intangible assets with indefinite useful lives are not amortized, but are instead tested for impairment at least annually in accordance with Statement of Financial Accounting Standards No.142, Goodwill and Other Intangible Assets. Intangible assets with estimated useful lives are amortized over the respective estimated useful lives. Software is amortized on a straight-line basis over the period of three to five years.

9. Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No.144, Accounting for the Impairment or Disposal 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. If the carrying amount of the asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset.

10. Basis of Recording Allowances

(Allowance for doubtful accounts)

An allowance for doubtful accounts is provided based on credit loss history and an evaluation of any specific doubtful accounts.

(Accrued pension and severance cost)

In accordance with Statement of Financial Accounting Standards No.87, Employer's Accounting for Pensions and Statement of Financial Accounting Standards No.158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, pension and severance cost is accrued based on the projected benefit obligations and the fair value of plan assets at the balance sheet date. Unrecognized actuarial loss is recognized by amortizing a portion in excess of a corridor (i.e., 10% of the greater of the projected benefit obligations or the fair value of plan assets) by the straight-line method over the average remaining service period of employees. Unrecognized prior service cost is amortized by the straight-line method over the average remaining service period of employees.

11. Taxes collected from customers and remitted to governmental authorities are excluded from revenues, cost and expenses in consolidated statements of income.

12. Stock Based Compensation

Canon measures stock-based compensation cost at the grant date, based on the fair value of the award, and recognizes the cost on a straight-line basis over the requisite service period.

13. 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 and all stock options were exercised.

14. New Accounting Standard

Canon adopted SFAS No. 157, Fair Value Measurements in the first quarter beginning January 1, 2008. The adoption of SFAS 157 had no effect on the consolidated statement of income for the year ended December 31, 2008.

15. Reclassification

Time deposits and marketable securities, which had been previously disclosed separately in the consolidated balance sheets, have been reclassified to short-term investments.

Intangible assets, which were previously included in Other assets, have been reclassified in the consolidated balance sheets.

<Note to Significant Subsequent Events>

There is no significant subsequent event.

Accounting Audit Report of Accounting Auditor on Consolidated Financial Statements  
Report of Independent Auditors

February 9, 2009  
The Board of Directors  
Canon Inc.

Ernst & Young ShinNihon LLC

Hideo Kojima  
Certified Public Accountant  
Designated and Engagement  
Partner

Naomitsu Hirayama  
Certified Public Accountant  
Designated and Engagement  
Partner

Yuichiro Munakata  
Certified Public Accountant  
Designated and Engagement  
Partner

Hiroki Suzuki  
Certified Public Accountant  
Designated and Engagement  
Partner

Pursuant to Article 444, Section 4 of the Corporation Law, we have audited the consolidated balance sheet, the consolidated statement of income, the consolidated statement of stockholders' equity and the notes to consolidated financial statements of Canon Inc. (the Company) applicable to the fiscal year from January 1, 2008 through December 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position and results of operations of the Canon Group, which consisted of the Company and consolidated subsidiaries, applicable to the fiscal year ended December 31, 2008 in conformity with accounting principles generally accepted in the United States under Article 148, Section 1 of the Corporation Accounting Regulations (refer to Note 2 of notes to basic significant matters regarding preparation of consolidated financial statements in the notes to consolidated financial statements).

We have no interest in the Company which should be disclosed in compliance with the Certified Public Accountants Act.

Audit Report of Board of Corporate Auditors on Consolidated Financial Statements

Audit Report on Consolidated Financial Statements

Regarding the consolidated financial statements (consolidated balance sheet, consolidated statement of income, consolidated statements of changes in stockholders' equity, and notes to consolidated financial statements) for the 108th business term from January 1, 2008, to December 31, 2008, we have prepared this Audit Report upon deliberation based on the audit reports prepared by each Corporate Auditor and hereby report as follows:

1. Auditing Methods Employed by the Corporate Auditors and Board of Corporate Auditors and Details of Such Methods

We established auditing policies, allocation of duties, and other relevant matters, and received reports from each Corporate Auditor regarding their execution of audits and results thereof, as well as reports from the Directors and the Accounting Auditor regarding performance of their duties, and sought explanations as necessary.

Following the auditing policies and allocation of duties established by the Board of Corporate Auditors, each Corporate Auditor received reports from such as the Directors and employees regarding consolidated financial statements and sought explanations as necessary. Furthermore, we monitored and verified whether the Accounting Auditor maintained their independence and implemented appropriate audits, and received reports from the Accounting Auditor regarding the performance of their duties and sought explanations as necessary. In addition, we received notice from the Accounting Auditor that System for ensuring that duties are performed properly (matters set forth in each item of Article 159 of the Company Accounting Regulations) is organized in accordance with the Quality Management Standards Regarding Audits (Business Accounting Council, October 28, 2005) and other relevant standards, and sought explanations as necessary. Based on the above methods, we examined the consolidated financial statements for this business term.



2. Audit Results

We confirm that the methods and results of the audit employed by the Accounting Auditor, Ernst & Young ShinNihon LLC, are proper.

February 10, 2009

Board of Corporate Auditors, Canon Inc.

Corporate Auditor	Keijiro Yamazaki
Corporate Auditor	Kunihiro Nagata
Corporate Auditor	Tadashi Ohe
Corporate Auditor	Yoshinobu Shimizu
Corporate Auditor	Minoru Shishikura

Note: Corporate Auditors, Tadashi Ohe, Yoshinobu Shimizu and Minoru Shishikura are Outside Corporate Auditors, as provided in Item 16, Article 2, and Paragraph 3, Article 335, of the Corporation Law.

Non-Consolidated Financial Statements  
Non-Consolidated Balance Sheets

ASSETS	Millions of yen	
	As of Dec. 31, 2008	As of Dec. 31, 2007
<b>Current assets</b>	<b>1,138,932</b>	<b>1,356,510</b>
Cash and deposits	10,674	5,676
Notes receivable	176,449	233,775
Accounts receivable	431,598	604,547
Marketable securities	93,899	75,920
Finished goods	107,375	110,168
Work in process	109,933	112,051
Raw materials and supplies	4,360	4,731
Deferred tax assets	68,123	52,989
Short-term loans receivable	51,512	49,735
Other current assets	85,010	106,926
Allowance for doubtful receivables	(1)	(8)
<b>Fixed assets</b>	<b>1,480,066</b>	<b>1,434,382</b>
<b>Property, Plant And Equipment, net</b>	<b>929,217</b>	<b>912,986</b>
Buildings	510,730	465,680
Machinery	185,710	172,863
Vehicles	696	399
Tools and equipment	47,548	55,167
Land	137,987	138,165
Construction in progress	46,546	80,712
<b>Intangible fixed assets</b>	<b>40,431</b>	<b>42,497</b>
Software	37,469	39,205
Other intangibles	2,962	3,292
<b>Investments and other assets</b>	<b>510,418</b>	<b>478,899</b>
Marketable securities-noncurrent	15,427	28,471
Investments in affiliated companies	411,247	367,132
Long-term loans receivable	3,911	6,767
Long-term pre-paid expenses	12,529	12,957
Deferred tax assets-noncurrent	62,402	57,381
Guarantees	1,535	1,787
Other noncurrent assets	3,425	4,465
Allowance for doubtful receivables-noncurrent	(58)	(61)
<b>Total assets</b>	<b>2,618,998</b>	<b>2,790,892</b>

<Notes to Non-Consolidated Balance Sheets>

1. Accumulated depreciation of property, plant and equipment	988,205 million yen
Accumulate impairment losses of property, plant and equipment	10,197 million yen
2. Guarantees	
Mortgage bank loans for employees	19,323 million yen
3. Receivables and Payables for affiliated companies	
Receivables	692,310 million yen
Payables	431,659 million yen
<Notes to the per share information>	
Net assets per share	1,510.75 yen
66	

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LIABILITIES AND NET ASSETS	Millions of yen	
	As of Dec. 31, 2008	As of Dec. 31, 2007
<b>Current liabilities</b>	<b>715,501</b>	<b>854,642</b>
Notes payable	1,871	2,440
Accounts payable	322,109	419,444
Short-term loans payable	156,148	94,465
Other payables	99,325	109,473
Accrued expenses	64,610	79,992
Accrued income taxes	47,825	115,668
Deposits	9,690	10,576
Accrued warranty expenses	6,077	4,705
Accrued bonuses for employees	4,972	5,194
Accrued directors' bonuses	244	360
Other current liabilities	2,630	12,325
<b>Noncurrent liabilities</b>	<b>38,492</b>	<b>45,684</b>
Convertible debentures	-	128
Accrued pension and severance cost	34,456	41,713
Accrued directors' retirement benefits	1,576	1,368
Reserve for environmental provision	1,300	2,475
Accrued long service rewards for employees	1,160	-
<b>Total liabilities</b>	<b>753,993</b>	<b>900,326</b>
<b>Stockholders' Equity</b>	<b>1,865,955</b>	<b>1,886,784</b>
<b>Common stock</b>	<b>174,762</b>	<b>174,698</b>
<b>Capital surplus</b>	<b>306,288</b>	<b>306,250</b>
Additional paid-in capital	306,288	306,225
Other capital surplus	-	25
<b>Retained earnings</b>	<b>1,941,127</b>	<b>1,862,022</b>
Legal reserve	22,114	22,114
Other retained earnings	1,919,013	1,839,908
Reserve for special depreciation	4,664	7,694
Reserve for deferral of capital gain on property	2,578	1,255
Special reserves	1,249,928	1,249,928
Retained earnings brought forward	661,843	581,031
<b>Treasury stock</b>	<b>(556,222)</b>	<b>(456,186)</b>
<b>Valuation and translation adjustments</b>	<b>(1,196)</b>	<b>3,782</b>
<b>Net unrealized gains (losses) on Securities</b>	<b>(1,048)</b>	<b>5,028</b>
<b>Net deferred gains (losses) on hedges</b>	<b>(148)</b>	<b>(1,246)</b>
<b>Subscription rights to shares</b>	<b>246</b>	<b>-</b>

<b>Total net assets</b>	<b>1,865,005</b>	<b>1,890,566</b>
<b>Total liabilities and net assets</b>	<b>2,618,998</b>	<b>2,790,892</b>

67

## Non-Consolidated Statements of Income

Millions of yen

	Year ended Dec. 31, 2008	Year ended Dec. 31, 2007
<b>Net Sales</b>	<b>2,721,094</b>	<b>2,887,912</b>
<b>Cost of Sales</b>	<b>1,801,801</b>	<b>1,793,613</b>
<b>Gross Profit</b>	<b>919,293</b>	<b>1,094,299</b>
<b>Selling, general and administrative expenses</b>	<b>560,587</b>	<b>560,458</b>
<b>Operating profit</b>	<b>358,706</b>	<b>533,841</b>
<b>Other Income</b>	<b>117,797</b>	<b>108,956</b>
Interest income	1,419	2,054
Dividend income	13,512	16,816
Rental income	66,150	49,310
Royalty income	25,180	30,709
Miscellaneous income	11,536	10,067
<b>Other Expense</b>	<b>117,417</b>	<b>89,954</b>
Interest expense	3,844	1,285
Depreciation of rental assets	59,121	43,226
Loss on disposal and write-off of inventories	38,873	7,128
Foreign exchange loss	5,678	28,440
Miscellaneous loss	9,901	9,875
<b>Ordinary profit</b>	<b>359,086</b>	<b>552,843</b>
<b>Non-Ordinary Income</b>	<b>71</b>	<b>898</b>
Gain on sales of fixed assets	39	407
Gain on sales of marketable securities-noncurrent	32	90
Gain on sales of investments in affiliated companies	-	401
<b>Non-Ordinary Loss</b>	<b>26,155</b>	<b>4,368</b>
Loss on sales and disposal of fixed assets	4,969	3,869
Loss on impairment of fixed assets	12,508	499
Loss on sales of marketable securities - noncurrent	8,678	-
<b>Income before income taxes</b>	<b>333,002</b>	<b>549,373</b>
Income taxes    Current	125,704	202,198
Deferred	(16,837)	(19,798)
<b>Net income</b>	<b>224,135</b>	<b>366,973</b>

<Notes to Non-Consolidated Statements of Income>

Transactions with affiliated companies

	2,644,587 million
Sales	yen
	1,705,182 million
Purchase	yen
	131,489 million
Other transactions	yen

<Notes to the per share information>

Net income per share	178.50 yen
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68

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## Non-Consolidated Statement of changes in Net Assets

		Stockholders' equity		Retained earnings	
	Common Stock	Capital surplus			
		Additional paid-in capital	Other capital surplus	Legal reserve	Reserve for special depreciation
Balance at December 31, 2007	174,698	306,225	25	22,114	7,694
Changes in the term					
Conversion of convertible debentures	64	63			
Transfer to reserve for special depreciation					632
Reversal of reserve for special depreciation					(3,662)
Transfer to reserve for deferral of capital gain on property					
Reversal of reserve for deferral of capital gain on property					
Dividends from surplus					
Net income					
Repurchase of treasury stock					

Disposal of treasury stock (25)

Net change of items other than stockholders equity

Total changes in the term	64	63	(25)	-	(3,030)
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Balance at December 31, 2008	174,762	306,288	-	22,114	4,664
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1. Number of issued shares as of December 31, 2008	1,333,763,464
2. Classes and number of treasury stock	shares (Shares)

Classes of stock	Balance as of December 31, 2007	Increase	Decrease	Balance as of December 31, 2008
common stock	72,588,428	26,701,146	14,329	99,275,245

(Reason for change)

The increase of 26,701,146 shares reflects the acquisition of 26,673,000 shares as approved by the resolution of the board of directors meeting, and the purchase of 28,146 shares based on the shareholders request for purchase of shared less-than-one-unit.

The decrease reflects the sale of 14,329 shares based on the shareholders request for the sale of shares less-than-one-unit.

70

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Millions of yen								
Stockholders' equity					Valuation and translation adjustments		Subscription rights to shares	Total net assets
Retained earnings		Retained earnings brought forward	Treasury stock	Total stockholders equity	Net unrealized gains (losses) on securities	Net Deferred gains (losses) on hedges		
Reserve for deferral of capital gain on property	Special reserves							
1,255	1,249,928	581,031	(456,186)	1,886,784	5,028	(1,246)	-	1,890,566
				127				127
		(632)		-				-
		3,662		-				-
1,396		(1,396)		-				-
(73)		73		-				-
		(145,024)		(145,024)				(145,024)
		224,135		224,135				224,135
			(100,122)	(100,122)				(100,122)
		(5)	86	56				56
				-	(6,076)	1,098	246	(4,732)
1,323	-	80,812	(100,036)	(20,829)	(6,076)	1,098	246	(25,561)
2,578	1,249,928	661,843	(556,222)	1,865,955	1,048	(148)	246	1,865,005

## 3. Dividends from surplus

(1) Amount of dividends paid

Decision	Classes of stock	Cash dividend (Millions of yen)	Dividend per share (yen)	Base date	Effective date
March 28, 2008 Annual meeting of stockholders	common stock	75,663	60.00	December 31, 2007	March 31, 2008
July 24, 2008 Board of directors meeting	common stock	69,361	55.00	June 30, 2008	August 26, 2008

- (2) Dividends whose record date is included in the current fiscal year-end and effective date is after the current fiscal year-end.

Scheduled	Classes of stock	Cash dividend (Millions of yen)	A source of dividend	Dividend per share (yen)	Base date	Effective date
March 27, 2009 Annual meeting of stockholders	common stock	67,897	Retained earnings	55.00	December 31, 2008	March 30, 2009

Notes to Non-Consolidated Financial Statements

<Notes to Significant Accounting Policies>

1. Valuation of Securities

(1) Securities of subsidiaries and affiliates----stated at cost based on the moving average method.

(2) Other securities:

Securities with quotation----stated at fair value (unrealized holdings gains and losses are reported in net assets, when sold, the cost is based on the moving average method.) Securities without quotation----stated at cost based on the moving average method.

2. Valuation of Inventories

(1) Finished goods; work in process----valued at cost based on the periodic average method.

(2) Raw materials and supplies----valued at cost based on the moving average method.

3. Depreciation Method of Fixed Assets

(1) Property, plant and equipment----calculated by declining-balance method. For buildings (excluding fixtures) acquired after April 1, 1998, depreciation is calculated by straight-line method.

<Additional information>

Due to the amendment of Japanese Corporate Tax Law in 2007, for Property, Plant and equipment acquired before March 31, 2007, 5% of acquisition cost and reminder cost variance is calculated by straight-line for 5 years, next year of which it was 5% of acquisition cost. The changes in accounting for depreciation did not have a material impact on the statements of income.

- (2) Intangible fixed assets----calculated by straight-line method. With regard to software for sale, calculated based on the estimated marketable period in consideration of marketing plan etc. of the relevant products (3 years), and with regard to internal-use software, calculated based on the estimated useful period in the Company (5 years).
4. Deferred Charges----The items which can be deferred under the Corporation Law charged to operations as incurred.
5. Basis of Recording Allowances
- (1) Allowance for doubtful accounts----provided as a general provision for uncollectible receivables  
---- General accounts  
Allowances are provided using a rate determined by past debt experience.
- Allowance for accounts considered to be uncollectible and accounts in bankruptcy filing are provided for individual estimated uncollectible amount, primarily determined based on the respective customer's financial conditions.
- (2) Accrued warranty expenses----provides as general provision for product after-sales service expenses and no charge repair cost on an estimated amount based on the historical performance.
- (3) Accrued bonuses for employees----provided as a general provision for bonus to employees for this term based on an amount expected to pay.
- (4) Accrued directors' bonuses----provided as general provision for bonus to directors for this term based on an amount expected to pay.
- (5) Accrued pension and severance cost----provided as general provision for employee retirement and severance benefits based on projected benefits obligation and expected plan asset. Prior service cost and actuarial variance are amortized by straight-line method with average remaining service periods.

- (6) Accrued directors' retirement benefits----provision for directors' retirement benefits based on the necessary amount at the fiscal year-end in accordance with management policy.
  - (7) Reserve for environmental provision----provided as general provision for the future environmental-related cost, such as construction costs to prevent the proliferation of soil pollution, and also clean up costs of hazardous substances based on the related regulations.
  - (8) Accrued long service rewards for employees----provided as general provision for reward for employees in accordance with management policy for long service employees for this term based on an amount expected to pay.
6. Hedge accounting
- (1) Hedge accounting----deferral hedge accounting has been applied.
  - (2) Hedging instrument and hedged assets / liabilities  
  
Hedging instrument----derivative transaction (foreign exchange contract) Hedged assets / liabilities----accounts receivables denominated in foreign currency for forecasted transaction.
  - (3) Hedge policy----derivative financial instruments are comprised principally of foreign exchange contracts to manage currency risk. The Company does not hold derivative financial instrument for trading purpose.
  - (4) Assessment of hedge effectiveness----foreign exchange forward contracts due to the same currency of the same underlying at the same period are concluded to cover foreign currency fluctuation risk in the market based on the hedging policy, and thus is effective.
7. Consumption Taxes----excluded from the statements of income and are accumulated in other receivables or other payables.

<Notes to Change in Accounting Policies>

(Accrued long service rewards for employees)

The Company has a byelaw for Refresh Leave to grant long service reward and refresh leave at a regular period to the employees who have been serving the Company for long years in order to refresh mind and body as well as generating new energy. As the significance of amounts rose due to the increase in numbers of employees, and reinforcement of attendance record systems enabled to estimate the rational amounts of reward payable, the Company changed the accounting policy for long service reward from the expense of the term in which the reward was paid, to recognition of accrued long service reward based on expected amounts under the byelaw from this accounting period, in order to calculate periodical profit and loss more appropriately. As a result, operating profit, ordinary profit and income before income taxes have decreased by 1,160 million yen, and net income has decreased by 696 million yen for the accounting period ended December 31, 2008.

75



## &lt;Note to Deferred Income Tax&gt;

## 1. Significant components of deferred tax assets

	23,191	million
Employees pension and retirement benefits		yen
	25,056	million
Devaluation loss on inventories		yen
	19,508	million
Loss on disposal and write-off of inventories		yen
	3,805	million
Outstanding enterprise tax		yen
	9,335	million
Depreciation of fixed assets in excess of limit		yen
	15,626	million
Excess in amortization of software		yen
	9,794	million
Amortization of deferred charges in excess of limit		yen
	698	million
Unrealized gains (losses) on securities		yen
	33,713	million
Other		yen
	140,726	million
Subtotal deferred tax assets		yen
	(5,350)	million
Valuation reserve		yen
	135,376	million
Total deferred tax assets		yen
2. Significant components of deferred tax liabilities		
	(3,109)	million
Reserve for special depreciation		yen
	(1,742)	million
Reserve for deferral of capital gain on property		yen
	(4,851)	million
Total deferred tax liabilities		yen
	130,525	million
Net deferred tax assets		yen

## &lt;Notes to Finance lease transactions&gt; (As of December 31, 2008)

	452	million
1. Acquisition costs		yen
	312	million
2. Accumulated depreciation		yen
3. Future minimum lease payments	141	

million  
yen

Note: Acquisition costs and future minimum lease payments include interest expense since the balance of future minimum lease payments accounts for only a small percentage of tangible fixed assets as of the balance sheet date.

76

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## &lt;Notes to Transaction with Related Parties&gt;

Status	Company name	Ratio of voting rights held by the company	Relationship with the Company	Transaction details	Transaction amount (millions of yen)	Item	Balance at December 31, 2008
Subsidiary	Canon Marketing Japan Inc.	(Possession) Direct: 55.2% Indirect: 0.0%	Sales of the Company's products Interlocking directorate	Sales of the Company's products	337,510	Accounts receivable	89,551
Subsidiary	Oita Canon Inc.	(Possession) Direct: 100%	Sales of the Company's products Interlocking directorate	Purchase of products, components and others	426,865	Accounts payable	95,541
Subsidiary	Canon U.S.A., Inc.	(Possession) Direct: 100%	Sales of the Company's products Interlocking directorate	Sales of the Company's products	788,186	Notes receivable	176,295
						Accounts receivable	6,649
				Borrowings of funds	13,437	Short-term loans payable	81,927
Subsidiary	Canon Europa N.V.	(Possession) Direct: 100%	Sales of the Company's products Interlocking directorate	Sales of the Company's products	931,002	Accounts receivable	183,448
Subsidiary	Canon Singapore Pte. Ltd.	(Possession) Direct: 100%	Sales of the Company's products Interlocking directorate	Sales of the Company's products	241,970	Accounts receivable	57,122

Conditions of transactions and policy regarding determination of conditions of transaction.

(Note 1) The transactions above are determined on a fair price basis.

(Note 2) Consumption taxes are excluded from the transaction amount, however, included in the balance at December 31, 2008.

(Note 3) The loans payable from Canon U.S.A., Inc. are intended to make best use of the funding in the Canon Group. Transaction amount shows net loan and repayment. The interests are determined reasonably based on market interest rate.

(Note 4) Ratio of voting rights held by the Company for Indirect of Canon Marketing Japan Inc. shows 0.0% because the value is a fraction amount.

<Note to Significant Subsequent Event>

There is no significant subsequent event.



Accounting Audit Report of Accounting Auditor

Report of Independent Auditors

February 9, 2009  
The Board of Directors  
Canon Inc.

Ernst & Young  
ShinNihon LLC

Hideo Kojima  
Certified Public  
Accountant  
Designated and  
Engagement  
Partner

Naomitsu Hirayama  
Certified Public  
Accountant  
Designated and  
Engagement  
Partner

Yuichiro Munakata  
Certified Public  
Accountant  
Designated and  
Engagement  
Partner

Hiroki Suzuki  
Certified Public  
Accountant  
Designated and  
Engagement  
Partner

Pursuant to Article 436, Section 2, Paragraph 1 of the Corporation Law, we have audited the non-consolidated balance sheet, the non-consolidated statement of income, the non-consolidated statement of changes in net assets, the notes to non-consolidated financial statements and the related supplementary schedules of Canon Inc. (the Company ) applicable to the 108th fiscal year from January 1, 2008 through December 31, 2008. These non-consolidated financial statements and the related supplementary schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these non-consolidated financial statements and the related supplementary schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the non-consolidated financial statements and the related supplementary schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the non-consolidated financial statements and the related supplementary schedules. An audit also includes assessing the accounting principles used and significant

estimates made by management, as well as evaluating the overall presentation of the non-consolidated financial statements and the related supplementary schedules. We believe that our audit provides a reasonable basis for our opinion.

78

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In our opinion, the non-consolidated financial statements and the related supplementary schedules referred to above present fairly, in all material respects, the financial position and results of operations of Canon Inc. applicable to the 108th fiscal year ended December 31, 2008 in conformity with accounting principles generally accepted in Japan.

We have no interest in the Company which should be disclosed in compliance with the Certified Public Accountants Act.

79

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Audit Report of Board of Corporate Auditors

Audit Report

Regarding the performance of duties by the Directors for the 108th business term from January 1, 2008, to December 31, 2008, we have prepared this Audit Report upon deliberation based on the audit reports prepared by each Corporate Auditor and hereby report as follows:

1. Auditing Methods Employed by the Corporate Auditors and Board of Corporate Auditors and Details of Such Methods

We established auditing policies, allocation of duties and other relevant matters, and received reports from each Corporate Auditor regarding their execution of audits and results thereof, as well as reports from the Directors, other relevant personnel, and the Accounting Auditor regarding performance of their duties, and sought explanations as necessary.

Each Corporate Auditor complied with the auditing standards of Corporate Auditors established by the Board of Corporate Auditors, followed the auditing policies, allocation of duties, and other relevant matters, communicated with such as the Directors, the internal auditing and other employees, and made efforts to establish the environment for collecting information and auditing, and participated in the meetings of the Board of Directors and other important meetings, received reports from such as the Directors and employees regarding performance of their duties, sought explanations as necessary, examined important authorized documents and associated information, and studied the operations and status of assets at the head office and principal offices. In addition, we monitored and verified the system for ensuring that the performance of duties by the Directors conforms to the related laws and regulations and Articles of Incorporation, as well as the resolution of the Board of Directors regarding the organization of the system stipulated in item 1 and item 3, Article 100, of the Enforcement Regulations of the Corporation Law and the status of the system based on such resolution (Internal Control System), which are necessary for ensuring propriety of company's operations. With respect to subsidiaries, we communicated and exchanged information with Directors and Corporate Auditors of subsidiaries, and received business reports from subsidiaries as necessary. Based on the above methods, we examined the business report and the accompanying detailed statements for this business term.

Furthermore, we monitored and verified whether the Accounting Auditor maintained their independence and implemented appropriate audits, and we received reports from the Accounting Auditor regarding the performance of their duties and sought explanations as necessary. In addition, we received notice from the Accounting Auditor that

System for ensuring that duties are performed properly (matters set forth in each item of Article 159 of the Company Accounting Regulations) is organized in accordance with the Quality Management Standards Regarding Audits (Business Accounting Council, October 28, 2005) and other relevant standards, and sought explanations as necessary. Based on the above methods, we examined the non-consolidated financial statements (non-consolidated balance sheet, non-consolidated statement of income, non-consolidated statements of changes in net assets, and notes to non-consolidated financial statements) and the accompanying detailed statements for this business term.

## 2. Audit Results

### (1) Results of Audit of Business Report and Other Relevant Documents

1. We confirm that the business report and the accompanying detailed statements fairly represent the Company's conditions in accordance with the related laws and regulations and Articles of Incorporation.
2. We have found no significant evidence of wrongful act or violation of related laws and regulations, nor the Articles of Incorporation with regard to the performance of duties by the Directors.
3. We confirm that the content of the resolution of the Board of Directors regarding the Internal Control System is proper. In addition, we have found no matters on which to remark in regard to the performance of duties by the Directors regarding the Internal Control System.

### (2) Results of Audit of non-consolidated financial statements and the accompanying detailed statements

We confirm that the methods and results of the audit employed by the Accounting Auditor, Ernst & Young ShinNihon LLC, are proper.

February 10, 2009

Board of Corporate Auditors, Canon Inc.

Corporate Auditor	Keijiro Yamazaki
Corporate Auditor	Kunihiro Nagata
Corporate Auditor	Tadashi Ohe
Corporate Auditor	Yoshinobu Shimizu
Corporate Auditor	Minoru Shishikura

Note: Corporate Auditors, Tadashi Ohe, Yoshinobu Shimizu and Minoru Shishikura are Outside Corporate Auditors, as provided in Item 16, Article 2, and Paragraph 3, Article 335, of the Corporation Law.

(For Reference)

Information on Shares

**Business term:**

From January 1 to December 31 of each year

**Ordinary general meeting of shareholders:**

March of each year

**Record date for above:**

December 31 of each year

**Record date for interim dividends:**

June 30 of each year

**Manager of the register of shareholders / Account management institution for the special account (*tokubetsu koza*)**

Mizuho Trust & Banking Co., Ltd.  
2-1, Yaesu 1-chome, Chuo-ku, Tokyo

**Business handling place:**

Stock Transfer Agency Department, Head Office  
Mizuho Trust & Banking Co., Ltd.

\* Please inquire at your securities company etc. about procedures pertaining to shares of the Company, such as change of address.

\* Please inquire at Mizuho Trust & Banking Co., Ltd. about the payment of accrued dividends, procedures for the issuance of a statement of payment or procedures related to shares recorded in the special account.

**Mailing address and telephone number:**

Stock Transfer Agency Department  
Mizuho Trust & Banking Co., Ltd.  
8-4, Izumi 2-Chome, Suginami-ku, Tokyo 168-8507  
Telephone: 0120-288-324 (toll free)

**Number of shares constituting one unit:**

100 shares

**Newspaper in which public notices are inserted:**

The Nihon Keizai Shimbun

**Stock exchange listings:**

Tokyo, Osaka, Nagoya, Fukuoka, Sapporo and New York

**Securities code:**

7751

Canon Inc., Headquarters  
30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501  
Telephone: 03(3758)2111  
URL

Canon Inc.                      canon.jp  
Canon Worldwide Network    www.canon.com

82



