CANON ANNUAL REPORT 2006

Fiscal Year Ended December 31, 2006

Canon

CORPORATE PROFILE

Canon develops, manufactures and sells a wide lineup of copying machines, printers, cameras, optical products, industrial equipment and other products to meet a diverse range of customer needs. The Company has developed its business activities on a global scale. Canon is a registered trademark in over 180 countries and regions around the world.

Canon first began implementing its Excellent Global Corporation Plan in 1996, and has since delivered a series of strong performances. In fiscal 2006, the inaugural year of Phase III of the Plan, Canon achieved record earnings and marked its seventh consecutive year of growth in both sales and net income.

With the spread of globalization and broadband networks, Canon stands poised to lead a new era in digital imaging and highly effective communication. In addition to strengthening business results for enhanced corporate value, the Company engages in a number of environmental and social contribution activities and focuses on fulfilling its duties to investors and society by stressing good corporate governance.

CORPORATE PHILOSOPHY: *Kyosei*

The corporate philosophy of Canon is *kyosei*. A concise definition of this word would be "Living and working together for the common good," but our definition is broader: "All people, regardless of race, religion or culture, harmoniously living and working together into the future." Unfortunately, the presence of imbalances in our world in such areas as trade, income levels and the environment hinders the achievement of *kyosei*.

Addressing these imbalances is an ongoing mission, and Canon is doing its part by actively pursuing *kyosei*. True global companies must foster good relations, not only with their customers and the communities in which they operate, but also with nations and the environment. They must also bear the responsibility for the impact of their activities on society. For this reason, Canon's goal is to contribute to global prosperity and people's well-being, which will lead to continuing growth and bring the world closer to achieving *kyosei*.

CORPORATE GOAL

In fiscal 2007, Canon's 70th year in business, the Company aims to strengthen existing businesses and identify next-generation business domains to assure sustained growth beyond 2010, while maintaining a high profit margin structure. Canon will make every effort to join the ranks of the global top 100 companies by 2010 in terms of key performance indicators. The Company's goals for 2010 include net sales of ¥5.5 trillion and a return on net sales ratio of 10% or higher.

CONTENTS

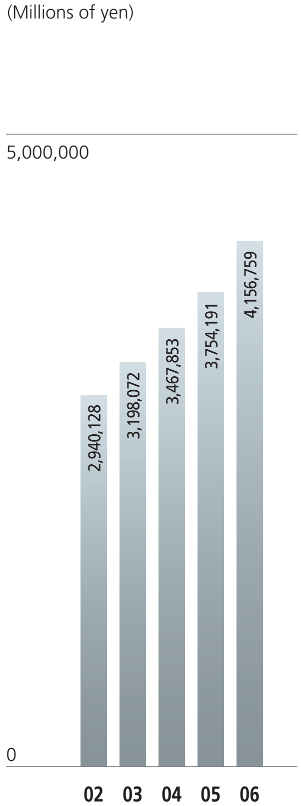
Cover Photos:
Aiming to expand its business areas to achieve sound growth in Phase III, Canon has entered the print-on-demand market and strengthened its large-format printer business. The Company will leverage its exceptional imaging technologies to increase its presence in these markets.

FINANCIAL HIGHLIGHTS

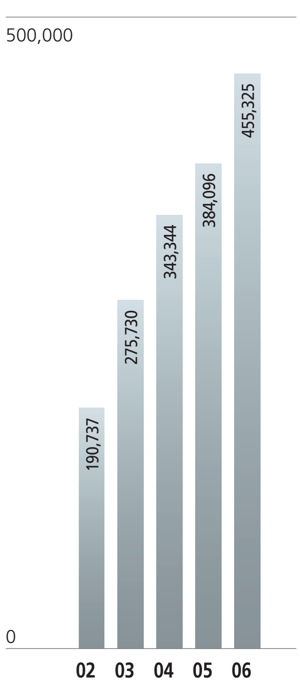
	Millions of yen (except per share amounts)			Thousands of U.S. dollars (except per share amounts)
	2006	2005	Change (%)	**2006**
Net sales	**¥4,156,759**	3,754,191	+10.7	**$34,930,748**
Operating profit	**707,033**	583,043	+21.3	**5,941,454**
Income before income taxes and minority interests	**719,143**	612,004	+17.5	**6,043,218**
Net income	**455,325**	384,096	+18.5	**3,826,261**
Net income per share:				
-Basic	**¥ 341.95**	288.63	+18.5	**$ 2.87**
-Diluted	**341.84**	288.36	+18.5	**2.87**
Total assets	**¥4,521,915**	4,043,553	+11.8	**$37,999,286**
Stockholders' equity	**¥2,986,606**	2,604,682	+14.7	**$25,097,529**

Notes:
1. Canon's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles.
2. U.S. dollar amounts are translated from yen at the rate of JPY119=U.S.$1, the approximate exchange rate on the Tokyo Foreign Exchange Market as of December 29, 2006, solely for the convenience of the reader.
3. Canon has made a three-for-two stock split on July 1, 2006. All per share information has been adjusted to reflect the stock split.

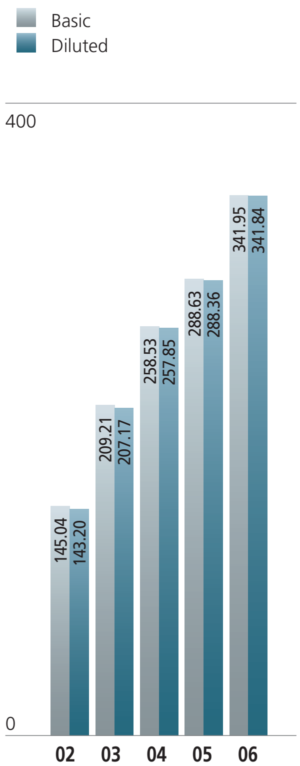
Net Sales
(Millions of yen)



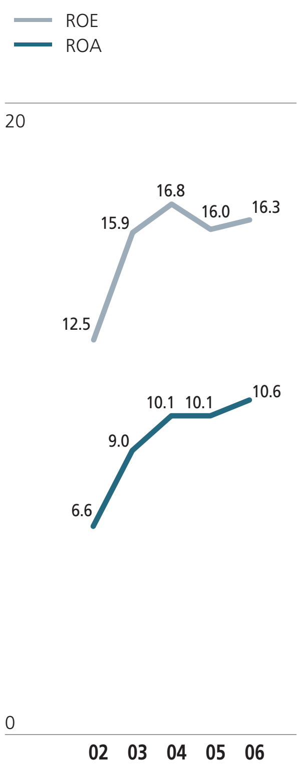
Net Income
(Millions of yen)



Net Income per Share
(Yen)



ROE / ROA
(%)



Continuing Our Upward Journey with Innovation and Sound Growth

Overview of Fiscal 2006

Canon hit the ground running in fiscal 2006, the inaugural year of Phase III of its Excellent Global Corporation Plan aimed at attaining sound growth. The Company achieved record earnings and posted its seventh consecutive year of sales and profit growth, as well as increased sales across all major product categories and all operating regions.

The global economy continued on a steady course in 2006 in spite of concerns over sharp rises in raw material and fuel costs, along with tense geopolitical conditions. Personal consumption and capital investment increased in the United States while the European economy recovered steadily. The Asian economy continued to hum along, driven by China and ASEAN countries, and the economy in Japan saw moderate but stable growth.

Canon again enjoyed strong results in digital cameras, color network multifunction devices (MFDs) and laser beam printers (LBPs). Consolidated net sales in fiscal 2006 grew 10.7% to ¥4,156.8 billion (US$34,931 million), income before income taxes and minority interests jumped 17.5% to ¥719.1 billion (US$6,043 million), and net income rose 18.5% to ¥455.3 billion (US$3,826 million). The gross profit ratio improved 1.1 percentage points to 49.6%, owing to major cost reductions.

Return to Stockholders

With the goal of expanding its base of individual investors, Canon executed a three-for-two stock split in July 2006. The Company will continue taking an active approach to stockholder returns in the future, primarily in the form of dividends, after careful consideration of investment plans and cash flows in the context of consolidated performance results. Over the mid to long term, the Company intends to raise its stockholder return ratio to a level of approximately 30% on a consolidated basis. For the fiscal year ended December 31, 2006, Canon set its full-year dividend per share at ¥100, which would equal ¥125 on a pre-stock-split basis, marking a real increase of ¥25 over the previous fiscal year.

Toward the Achievement of Phase III Targets

In Phase III of our Excellent Global Corporation Plan, we will strengthen existing businesses and cultivate new businesses while maintaining a high profit structure. In addition, we will work toward further accelerating innovation across all business activities.

Through reforms carried out in Phase I and Phase II, Canon made major improvements in productivity and solidified its financial foundation to enhance corporate value. Moreover, aggressive investments in infrastructure over the past 10 years have led to expanded sales and enabled us to focus on cultivating new businesses over the mid-term.

We view the five years of Phase III as an expansion period and, with the aim of joining the ranks of the global top 100 companies, have set consolidated performance targets of ¥5.5 trillion in net sales and a return on net sales of 10% or higher in 2010.

A Truly Excellent Global Corporation

In 2007, as we celebrate the 70th anniversary of Canon's founding, I envision the Company continuing on a long journey of 100 or even 200 years of sustained development and prosperity. As we take up fresh challenges in our drive to increase the level of admiration and respect the Company earns worldwide, we will continue to follow our philosophy of *kyosei* and act as a responsible corporate citizen to protect the natural environment and make positive contributions to society.

In May 2006, I was appointed Chairman of Nippon Keidanren (Japan Business Federation), and will work in this capacity to contribute to the development of Japanese society, in addition to my responsibilities at Canon. I have assumed the post of Chairman and CEO, while Mr. Tsuneji Uchida has been appointed President and COO. Under this new management framework, we will press ahead toward our primary goal of accomplishing our Phase III objectives.

Fujio Mitarai
Chairman and CEO
Canon Inc.

Steady Advances for Sound Growth

Under Phase III, Canon aims to enter the ranks of the global top 100 companies by 2010 in terms of key performance indicators. The Company has set targets for 2010 of ¥5.5 trillion in consolidated net sales and a net income to sales ratio of 10% or higher.

At GRAPH EXPO 2006 in Chicago, U.S.A., Canon exhibited the "imagePRESS" brand production printer to bolster its presence in the field of commercial printing

Canon has its sights firmly set on achieving the 2010 targets established for Phase III of its Excellent Global Corporation Plan. When the Company embarked on Phase I of the Plan in 1996, its initial aim was to strengthen its financial health. Indicators that testify to Canon's success include the stockholder equity ratio, which climbed from 35.1% in 1995 to 66.0% at the end of 2006, and retained earnings, which expanded nearly 5.5 times from ¥433.5 billion to ¥2,368.0 billion over the same period.

In Phase II, launched in 2001, the Company set the ambitious goal of becoming No. 1 in the world in all of its major areas of business, with an emphasis on product competitiveness. Building on this goal, Canon kicked off Phase III in fiscal 2006 under the theme of "Innovation and Sound Growth." Capitalizing on global trends, specifically the diffusion of broadband networks and the continued advance of globalization as economic development spreads to more nations around the world led by the BRIC economies (Brazil, Russia, India, and China), Canon is taking steps to fortify its existing businesses while creating new business domains.

External Ratings

- **Financial Times Global 500** (June 10, 2006 issue)
  Market value ranking: 102
  (9th in the Technology Hardware and Equipment category)
- **FORTUNE Global 500** (July 24, 2006 issue)
  Revenues ranking: 170
  (6th in the Computers, Office Equipment category)
  Profits ranking: 114
  (3rd in the Computers, Office Equipment category)
- **BusinessWeek "Best Global Brands" of 2006** (August 7, 2006 issue)
  Ranking: 35
  (4th among all Japanese companies)

FORTUNE Global 500 is a registered trademark of FORTUNE Magazine, a division of Time Inc. in the United States of America.

I will do everything in my power to steer Canon toward the achievement of new innovation and boldly push forward with measures to realize our Phase III objectives.

Tsuneji Uchida

Tsuneji Uchida
President and COO
Canon Inc.

1 Achieve the overwhelming No. 1 position in existing core businesses and develop three new display businesses

Canon displayed a full-HD SED 55-inch panel prototype at CEATEC JAPAN 2006

Canon has achieved global No. 1 market positions for such core products as copying machines, LBPs and digital cameras, and will strive not only to maintain these positions but also to further its market leadership.

Furthermore, Canon is generally already among the top three in other sectors and has given the highest priority to attaining the top position for all of its core businesses. For example, in line with growing demand for color output in the office, Canon is applying proprietary technology to copying machines and LBPs to actively launch competitive new products that are differentiated by their performance capabilities. The Company aims to get a jump on the competition with the development of a new-concept multifunction office system that maximizes the functionality of each device connected to a network. By leveraging its strengths in digital cameras and photo printers, Canon aspires to become No. 1 in home photo printing. In semiconductor-production equipment, the Company is aiming to raise competitiveness by developing state-of-the-art exposure equipment that employs leading-edge technology such as liquid immersion lithography. In today's environment where production volume has dramatically increased, Canon recognizes quality as an extremely important issue. Quality problems have the potential to severely impact the brand image that has been carefully cultivated through decades of effort. Therefore, Canon will review and reinforce its quality-control systems.

Canon's three new display businesses are surface-conduction electron-emitter displays (SEDs), organic light-emitting diode (OLED) displays, and rear projection displays. The Company is speeding up the development of these businesses and reinforcing their support systems. Canon is forging ahead with measures to realize commercial opportunities in SEDs, and has also intensified development of OLED displays, which Canon plans to use for monitors in digital cameras.


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

2 Establish new production systems to maintain international competitiveness

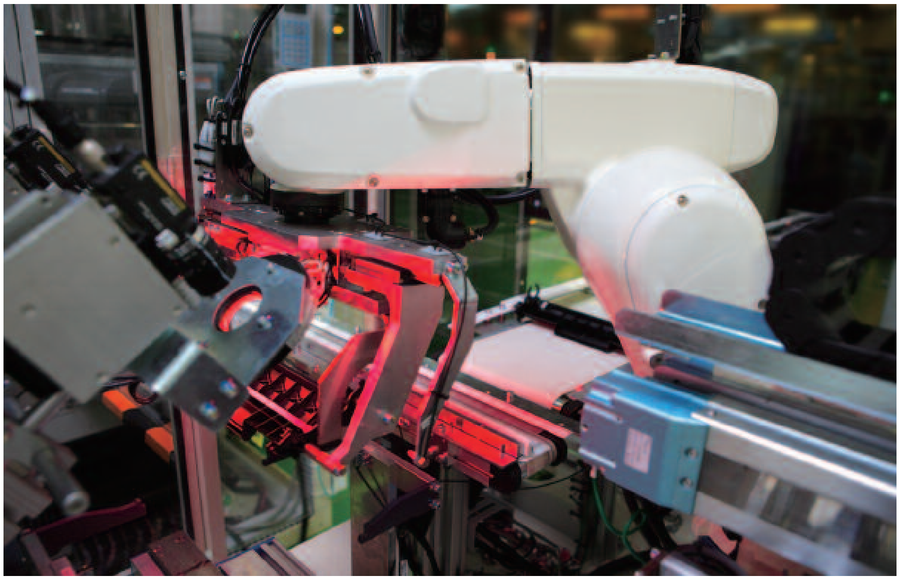
Canon will continue to promote production innovation initiatives

For Canon to compete with the world's top companies, it must raise production efficiency to even higher levels. Therefore, the Company has set a Phase III performance target for the cost-to-sales ratio of 45% in 2010. To attain this goal, Canon is implementing Companywide initiatives targeting in-house production, automation and procurement reforms.

In-house production of key devices and components is one of the most important aspects of efforts to increase product competitiveness and reduce costs. Canon is also strengthening in-house production of parts and production equipment.

The Company has introduced automated production lines using automated assembly systems and robots in order to meet growing demand for Canon products, as well as to reinforce competitiveness on a global scale and to boost production. In Japan, the Company is promoting the automated production of such products as toner and ink cartridges, for which there is a sharp increase in demand. Canon will take active steps to realize a "three-in-one" foundation for manufacturing that integrates development, production technology, and manufacturing know-how. As a step in this direction, the Company is planning the construction of a new production-engineering center in Japan to accelerate the strengthening of production technology capabilities. Also, Canon Machinery Inc., a company with expertise in automated machinery that was added to the Group in 2005, will construct a new plant for production of automated machinery for toner and ink cartridge assembly.

In the field of procurement reforms, Canon works to secure more reliable parts and components with a focus on environment, quality, cost and delivery (EQCD). At the same time, the Company is making significant progress in reducing costs by raising efficiency in procurement operations.



Canon is now establishing fully automated toner cartridge production

3 Expand operations through diversification and strengthen the Three Regional Headquarters system

Canon is strengthening its large-format printer business, expanding the potential of inkjet printers

Canon recognizes that new business is crucial to succeed in reaching the 2010 net sales target of ¥5.5 trillion and increasing corporate value.

Regarding business diversification, the Company is expanding its large-format printer business for graphic arts and a range of corporate uses. The L Printer division, for which the Company holds high expectations, became Canon's seventh product operations segment in 2007. Canon also entered the growing print-on-demand (POD) market with the introduction of the imagePRESS series of production color printing systems for such commercial printing needs as the creation of catalogs and brochures.

In an aim to increase revenues from independent business, Group companies are being encouraged to pursue business activities outside of Canon's established fields.

Canon is focusing on strengthening its Three Regional Headquarters system. Canon U.S.A., Inc., Canon Europe Ltd., and Canon Europa N.V. have made steady progress in implementing structural reforms and new businesses. These companies will be encouraged to apply their human and capital resources in order to expand their areas of business and become companies that provide exports to the rest of the world.

4 Identify next-generation business domains and obtain necessary technological capabilities

Canon works tirelessly to stay ahead of changing trends in order to launch next-generation products. To this end, the Company established the New Business Domain Committee, which explores new fields to ensure significant growth from 2010. Canon aims to establish a core business in medical-related fields in the future by cultivating and expanding applications in its imaging technologies. To compile and develop the technologies required for this area, the Company launched a joint project with Kyoto University in Japan during 2006 and began joint research with Stanford University in the United States in the field of medical imaging.

In addition, efforts are underway to strengthen collaboration between academia and industry through joint research with other world-renowned universities and research institutes. For example, Canon strengthened its ties with the Tokyo Institute of Technology in 2006 through continued joint research in the areas of advanced materials and imaging technologies.

To meet the future needs of society, the Company aims to develop platform technologies in the areas of intelligent robots and safety. Aiming to create breakthrough technologies for next-generation businesses, Canon will bolster research capabilities across the Group.

Canon is conducting collaborative research with leading research institutions such as the Massachusetts Institute of Technology

5 Nurture truly autonomous individuals

Canon's guiding principles are epitomized in its "*San-Ji*" spirit: self-motivation, self-management and self-awareness. The Company believes that putting the *San-Ji* spirit into practice on a daily basis cultivates individual autonomy and an internalized sense of duty and ethics, which provides a basis for thorough compliance and internal controls.

In an era of intense shifts in the business environment, it is becoming ever more important to anticipate changes early on and to continue to innovate proactively. It will be the truly autonomous individuals who will carry the responsibility of achieving further innovation.

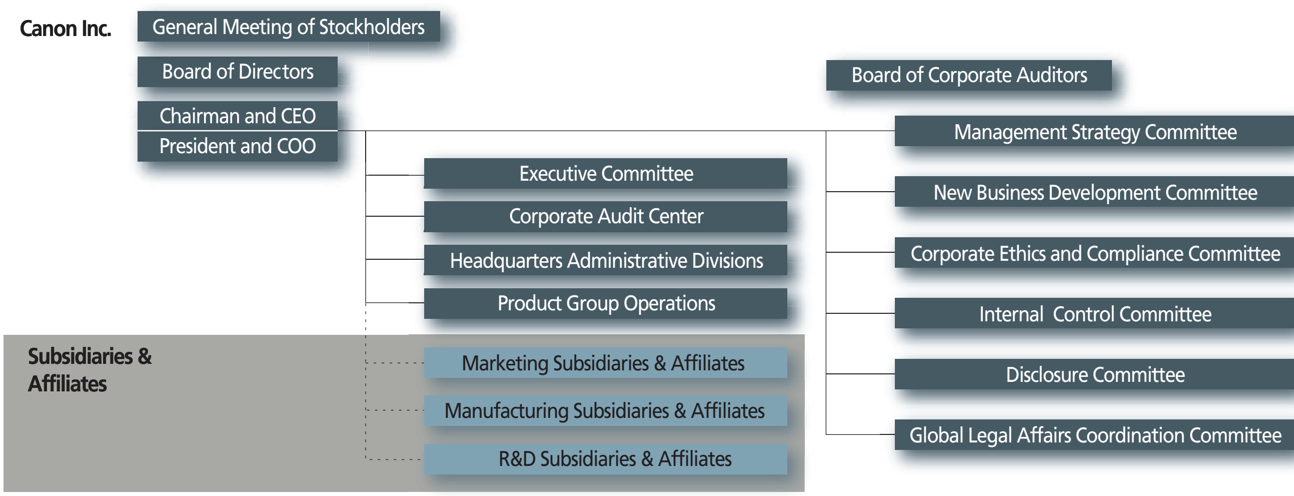
To cultivate a new generation of employees who display a strong *San-Ji* spirit, the Company opened the Canon Global Management Institute in Tokyo in May 2006. It will function as a development center for future leaders and executives of the Group worldwide.

Canon aims to become a company that produces human resources that play supporting roles in the world of business and industry as well as the global economy.

Sales staff training at the Suzhou Training Academy of Canon (China) Co., Ltd.

For 70 years Canon has nurtured a vibrant compliance culture based on the guiding principles of the *San-Ji* spirit.

Governance Structure (as of December 31, 2006)



Boards of Directors & Corporate Auditors (as of December 31, 2006)

Chairman & CEO

Fujio Mitarai

President & COO

Tsuneji Uchida

Senior Managing Directors

Toshizo Tanaka
Group Executive, Finance & Accounting Headquarters; in charge of Internal Control Committee and Disclosure Committee

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

Junji Ichikawa
Chief Executive, Optical Products Operations

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

Managing Directors

Akiyoshi Moroe
Group Executive, General Affairs Headquarters; Group Executive, External Relations Headquarters; in charge of Corporate Ethics and Compliance Committee

Kunio Watanabe
Group Executive, Corporate Planning Development Headquarters; in charge of Management Strategy Committee and New Business Development Committee

Hironori Yamamoto
Group Executive, Global Environment Promotion Headquarters; Group Executive, Production Engineering Headquarters

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

Yasuo Mitsuhashi
Chief Executive, Peripheral Products Operations

Directors

Katsuichi Shimizu
Chief Executive, Inkjet Products Operations

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

Tomonori Iwashita
Chief Executive, Image Communication Products Operations

Toshio Homma
Group Executive, L Printer Business Promotion Headquarters

Shigeru Imaiida
Senior Managing Director, Canon ANELVA Corporation

Masahiro Osawa
Group Executive, Global Procurement Headquarters

Keijiro Yamazaki
Group Executive, Human Resources Management & Organization Headquarters

Shunichi Uzawa
Group Executive, Core Technology Development Headquarters

Masaki Nakaoka
Chief Executive, Office Imaging Products Operations

Toshiyuki Komatsu
Group Executive, Leading-Edge Technology Research Headquarters

Shigeyuki Matsumoto
Group Executive, Device Technology Development Headquarters

Haruhisa Honda
Chief Executive, Chemical Products Operations

Tetsuro Tahara
Group Executive, Global Manufacturing & Logistics Headquarters

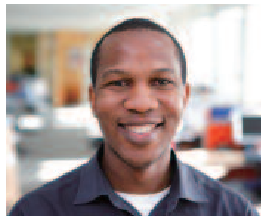
Seijiro Sekine
Group Executive, Information & Communication Systems Headquarters; Deputy Group Executive, Global Manufacturing & Logistics Headquarters

Shunji Onda
Deputy Group Executive, Finance & Accounting Headquarters

Corporate Auditors

Teruomi Takahashi
Kunihiro Nagata
Tadashi Ohe
Yoshinobu Shimizu
Minoru Shishikura





Basic Policy and Corporate Governance Structure

Canon recognizes that strengthening management supervision functions and maintaining management transparency are vital to improving its corporate governance structure and raising corporate value. Canon's basic governance structure comprises the General Meeting of Stockholders, the Board of Directors and the Board of Corporate Auditors. Furthermore, the Executive Committee and management committees are dedicated to key issues. All of these bodies work together to ensure appropriate management of the Group through an independent internal auditing structure centered on the Corporate Audit Center, and an information disclosure system for management activities.

Board of Directors

Important business matters are discussed and ratified during meetings of the Board of Directors and Executive Committee, which are attended, in principle, by all directors. As of December 31, 2006, the Board consisted of 26 directors. In order to realize a more streamlined and efficient management decision-making process, Canon has not adopted an outside director system. The main reason why directors are chosen from among Canon personnel is that they have followed these same codes of behavior and have been subject to close scrutiny within the Group over many years.

Auditing System

Canon is working to bolster its auditing framework. In 2006, Canon increased the membership of its Board of Corporate Auditors to five, including three external auditors who have no personal, capital or business affiliations with Canon. Auditor duties include attending meetings of the Board of Directors, Executive Committee and various management committees, listening to business reports from directors, carefully examining documents related to important decisions, and conducting strict audits of the Group's business and assets. Corporate auditors also work closely with accounting auditors and the Corporate Audit Center, which monitors compliance, risk management and internal control systems, and provides assessments and recommendations. Relevant administrative divisions collaborate with the Center to oversee such areas as quality, environmental issues, export control management and information security.

Internal Control Committee

The Internal Control Committee, established in 2004, ensures the reliability of financial reporting. It also conducts reviews of the Group's internal controls in order to gauge the true efficiency of business operations, supports compliance with all related laws and internal regulations, and implements sound internal controls. In response to the Sarbanes-Oxley Act, including Article 404 that came into force during 2006, Canon continues to reinforce internal control systems and implement all appropriate measures.

In order to strengthen internal controls, Canon is documenting and assessing material business processes at all related divisions throughout the Group, and proceeding with reform initiatives. Canon has formed working groups to conduct comprehensive evaluations of internal controls across areas including accounting, management oversight, legal compliance, IT systems, and promotion of corporate ethics.

Internal controls over financial reporting as of December 31, 2006, have been assessed as effective by the management and the independent registered public accounting firm. (Please refer to p.89 and p.91)

Other Corporate Governance Committees

Canon's management committees are integral to its overall governance system. Key among these are the Corporate Ethics and Compliance Committee, which discusses and approves compliance and corporate ethics policies; the Global Legal Affairs

Coordination Committee, which analyzes trends in legal developments and works to raise the level of employee awareness regarding important legal issues facing the Group; and the Disclosure Committee, which is dedicated to ensuring the dissemination of accurate and thorough information.

Compliance

Since its founding, employee education has been based on the guiding principles of the *San-Ji*, or "Three Selfs" spirit, namely "self-motivation," or taking the initiative and being proactive in all things; "self-management," or conducting oneself responsibly and being accountable for all one's actions; and "self-awareness," or understanding one's situation and role in it. Based upon these principles, the Canon Group Code of Conduct was established as a standard for executives and employees.

Canon holds a Compliance Week twice per year to give employees a chance to discuss issues related to compliance and corporate ethics that may arise in actual operations, and to recognize the importance of their individual actions in the workplace.

Disclosure

Canon makes every effort to disclose information on its management and business strategies as well as its performance results to stockholders, investors and all other stakeholders in an accurate, fair and timely manner. To this end, Canon holds regular briefings and posts the latest information on its Website together with a broad range of disclosure materials. Canon has established its own Disclosure Guidelines, in addition to a Disclosure Committee that serves to ensure strict compliance with disclosure regulations prescribed by stock exchanges.

With 46.9% of Canon's shares owned by non-Japanese investors as of December 31, 2006, the Group goes to great lengths to promote close relations with non-Japanese institutional investors, maintaining IR bases in Europe and the United States and working to ensure that investors inside and outside of Japan have access to the same information. Recognizing the growing influence of individual investors in capital markets, Canon has also initiated IR briefings at which the Chairman and CEO or a Group executive from the Finance & Accounting Headquarters presents the Group's strategies and answers questions that arise. Canon will continue to promote transparency and understanding of its activities by practicing thoroughgoing disclosure.

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

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

1. Directors

Currently, the Company's board of directors does not have any director who could be regarded as an "independent director" under the NYSE Corporate Governance Rules for U.S. listed companies. Unlike the NYSE Corporate Governance Rules, the Corporation Law of Japan (the "Corporation Law") does not require Japanese companies with a board of corporate auditors such as the Company, to appoint independent directors as members of the board of directors. The NYSE Corporate Governance Rules require non-management directors of U.S. listed companies to meet at regularly scheduled executive sessions without the presence of management. Unlike the NYSE Corporate Governance Rules, however, the Corporation Law does not require companies to implement an internal corporate organ or committee comprised solely of independent directors. Thus, the Company's board of directors currently does not include any non-management directors.

2. Committees

Under the Corporation Law, the Company may choose to:
(i) have an audit committee, nomination committee and compensation committee and abolish the post of corporate auditors; or
(ii) have a board of corporate auditors.

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

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

3. Audit Committee

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

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

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

Under the Corporation Law, more than half of a company's corporate auditors must be "outside" corporate auditors. These are individuals who are prohibited to have ever been a director, executive officer, manager, or employee of the Company or its subsidiaries. There are five members on the Company's board of auditors, three of whom are outside corporate auditors. The Company's current corporate auditor system meets these requirements. The qualifications for an "outside" corporate auditor under the Corporation Law are different from the audit committee independence requirement under the NYSE Corporate Governance Rules.

4. Shareholder Approval of Equity Compensation Plans

The NYSE Corporate Governance Rules require that shareholders be given the opportunity to vote on all equity compensation plans and any material revisions of such plans, with certain limited exceptions. Under the Corporation Law, a Company is required to obtain shareholder approval regarding the detail of an equity-compensation plan. Stock acquisition rights to be issued to directors and corporate auditors are recognized as part of remuneration of directors and corporate auditors, and the issuance of stock acquisition rights must be approved by shareholders as part of their approval regarding remuneration of directors and corporate auditors. The Company currently has not adopted any stock option compensation plans.


MENU
SELECT
DISPLAY
Canon
FOLDER
FILE
WB
CLEAR
ON
OFF

CORPORATE FUNCTIONS

Photo:
To celebrate the 100th anniversary of the Beijing Zoo, Canon cosponsored a photography and essay competition entitled "The Beijing Zoo and me," focusing on the themes of protecting wildlife and bringing harmony between people and nature.

RESEARCH & DEVELOPMENT

Canon's engineers around the world are improving upon existing capabilities and pursuing next-generation technologies to drive business growth.

Canon is conducting joint research with the Tokyo Institute of Technology aimed at developing thin-film transistors

R&D Expenditure and Patents

Canon is dedicated to maintaining its competitive edge through a strong emphasis on cutting-edge research and development, which is reflected in the high percentage of net sales that Canon allots to such activities. In 2006, R&D expenses increased ¥21.8 billion from the previous fiscal year to ¥308.3 billion, accounting for 7.4% of net sales. Looking at spending by segment, ¥113.8 billion, or 36.9%, went to business machines, and ¥41.1 billion, or 13.3%, to cameras. Investment in optical and other products was ¥29.9 billion, or 9.7% of the total, and basic R&D that does not belong to any one business segment was ¥123.5 billion, or 40.1%.

Canon's extensive and highly advanced R&D activities have produced a wealth of intellectual property. In 2006, the Company newly acquired 2,385 patents in the United States, third* among all corporations, marking the 15th consecutive year Canon has placed among the top three. The Company will continue to pursue R&D themes targeting sustainable growth and endeavor to strengthen its R&D capabilities that lead to the gain of major and basic patents.

*Source: U.S. Patent and Trademark Office; Calculated based upon announcements of weekly totals.

Next-Generation Business Domains

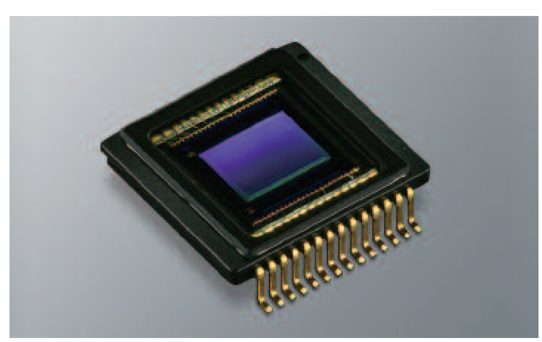
Canon is pursuing the development of innovative technologies that will support its push into new business domains. The Company is working to leverage its expertise in imaging to pioneer advances in such fields as healthcare. Canon researchers and engineers are actively engaged in joint research with leading institutes and universities. For example, in 2006 the Company teamed up with several departments from Kyoto University, Japan, to conduct studies in medical imaging, aiming to revolutionize diagnostic imaging in order to enable the early detection of illnesses.

Canon conducts research in nanotechnology, the science and control of matter and light on the nanometer scale, including research into nanostructural material, to develop key components and core devices.

In life sciences, Canon has applied inkjet technology to fabricate reliable DNA chips able to detect genetic mutations that cause cancer and other maladies, and to realize treatments optimized for each individual patient by accurately identifying types of diseases and stages of progress. Moreover, Canon is working to develop a new device for administering medication through a mist sprayed into the mouth, providing an alternative to injections.

Bolstering Product Competitiveness

Canon strives to be No. 1 in the world in each of its core business areas by boosting product competitiveness. Toward this end, the Company cultivates the



New HD CMOS sensor incorporated in Canon HD camcorders produces full high-definition video

Canon's color management technology allows for consistent color reproduction in both input and output devices

following five "imaging engines," a group of technologies that support Canon product businesses.

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

These engines support product performance and are the source of Canon's competitive advantage. Canon continues to cultivate these engines and explore the fusion of various technologies, which in turn leads to the development of key devices and innovative product features.

An example of an Image Capturing Engine is the DIGIC imaging processor. In 2006, DIGIC III was introduced with advanced Face Detection Technology that properly adjusts focus and exposure based on the detection of people's faces. Canon has also developed a new HD CMOS sensor for video camcorders that enables the high-speed reading of images in full HD (1,920 x 1,080 pixels).

Canon believes that shared-platform technologies are vital for accelerating and reinforcing product development. The Company has established its unique color management technology that unifies color reproduction for Canon input and output products. In addition, Canon is proceeding further with its advanced color management system, called "Kyuanos." Part of this technology has been incorporated into Windows Vista™*.

In addition to reinforcing its measuring, analysis and simulation technologies, Canon uses 3D-CAD systems to shorten product-development times and to reduce trial times and costs.

*Windows Vista is a trademark of Microsoft Corporation.

3D-CAD design systems have enabled fewer prototypes, shorter development times and effective information sharing

PRODUCTION

As a further step toward production reform, Canon is aiming to reduce its cost-to-sales ratio to 45% in 2010.

Producing color LBPs and copying machines through the cell production system at Canon (Suzhou) Inc. in China

Toward the Establishment of New Production Methods

The introduction of the cell production system, which replaced conveyor belt lines with small teams of workers, or "cells," who assemble products from start to finish, marked a major step forward in production reforms at Canon. With ingenuity, effort, and the experience-based knowledge of each individual worker as driving forces, cell production is employed at all of Canon's production bases worldwide. Cell production supports just-in-time production—the manufacture of products only when and in the amounts needed—while also enabling highly accurate supply chain management (SCM) in response to market demands. As a next step to further production reform, the Company is boosting in-house production, establishing automated production systems and reforming its procurement operations. Canon has targeted a cost-to-sales ratio of 45% for 2010.

In-House Production and Procurement Innovations

The in-house production of key parts and components as well as production equipment represents one of Canon's most important efforts to increase competitiveness and reduce costs. As an example of the Company's endeavors, Canon made Igari Mold Co., Ltd. a wholly owned subsidiary in 2004 to increase in-house mold production. Mold-making operations across the entire Group were consolidated into this manufacturer of precision plastic molds, which was renamed Canon Mold Co., Ltd. in January 2007.

In the area of procurement innovations, Canon is carrying out sweeping structural reforms of its current system while consolidating suppliers. In addition, the Company is improving collaboration between procurement and development divisions in order to reduce the cost of parts, beginning at the development stage.

Building Integrated Production Systems and Increasing Production Capacity

In order to further reduce lead times, Canon is building a production system for fully integrating the manufacture of materials and key components, as well as assembly and logistics operations. For example, construction of a new lens plant at Oita Canon Inc. has been completed and operations will begin in spring 2007, enabling the integration of interchangeable SLR camera lens production with camera manufacturing operations.

At the same time, the Company is stepping up production capacity in order to meet growing demand. Oita Canon Materials Inc. completed construction of a new toner and toner cartridge facility in 2006, and has begun construction of

Manufacturing high-precision molds at Canon Mold Co., Ltd. to bolster in-house production and product competitiveness

Oita Canon Inc. is constructing a wholly integrated system for production of digital cameras and lenses

another new facility for the manufacture of print heads and ink cartridges for inkjet printers.

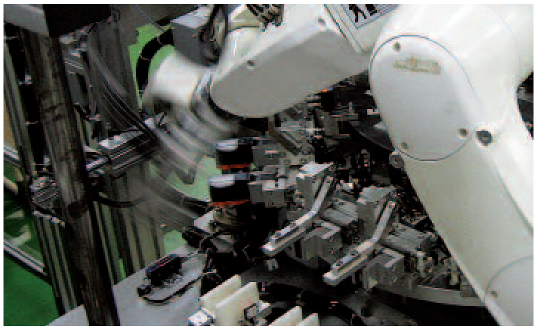
Canon is building a second inkjet printer factory in Hanoi, Vietnam, in order to expand production capacity by approximately 50%. Scheduled for completion in spring 2007, the new facility will integrate aspects of production from parts processing to assembly. The Company also commenced production of LBPs at its facility in Que Vo, Hanoi, Vietnam, during 2006.

Efforts toward Full Automation

Canon aims to achieve fully automated manufacturing as a means of boosting productivity and enhancing its competitive position in global markets, while responding to increasing demand for Canon products. To bolster this effort, the Company will establish automated production systems through "three-in-one" foundation integrating development, production technology and manufacturing know-how. Canon is working to realize round-the-clock, unmanned manufacturing in its toner cartridge operations, and is also promoting the automated assembly of inkjet cartridges.

IT Revolution for Optimal SCM

Canon seeks to construct a highly advanced integrated IT system to achieve optimal SCM across development, procurement, production, logistics, sales and service processes. The Company has already introduced 3D-CAD systems across the organization for product development and, as a next step, intends to standardize 3D-CAD systems throughout the Group to create a comprehensive system that integrates all business processes through 3D data. The system will link the production data system, used to coordinate sales and production, with the sales data system.



Canon is promoting automated production of inkjet cartridges at Fukushima Canon Inc. in Japan

SALES & MARKETING

Canon is implementing a number of region-specific strategies to reinforce its leading position in global markets.

Canon Concerto held in Moscow in 2006—Canon will expand its presence in Russia

Greater Global Diversification

In today's world of constantly evolving information networks, Canon sales and marketing companies around the world work tirelessly to provide tailor-made solutions to satisfy a diverse range of unique customer needs, and to advance Canon's reputation as a highly trusted brand. Regional marketing headquarters oversee operations in each area: Canon U.S.A., Inc. in North and South America; Canon Europe Ltd. and Canon Europa N.V. in Europe, Russia, Africa and the Middle East; Canon (China) Co., Ltd. in Asia outside Japan; Canon Australia Pty. Ltd. in Oceania; and Canon Marketing Japan Inc. in Japan.

The Americas

In the Americas, Canon continues to turn out strong performances, with sales in 2006 increasing 12.0% to ¥1,283.6 billion, representing 30.9% of Canon's consolidated net sales.

Aiming to spur more dynamic business expansion in North America, Canon U.S.A. is strengthening collaboration in sales and marketing with Canon Canada, Inc. and Canon Mexicana, S. de R.L. de C.V. In Latin America, the quality of business operations is being enhanced, with careful analysis of economic trends and consideration of potential risk, in order to expand sales and secure profits.

Canon U.S.A. plans to make its full-fledged entry into such new markets as POD, and bolster its large-format printer business. Furthermore, by reinforcing the supply chain to ensure the timely and accurate delivery of products to customers, the Company aims to significantly reduce inventory management-related costs.

Europe

In Europe, sales reached ¥1,314.3 billion in 2006, up 11.3% from the previous year, representing 31.6% of consolidated net sales. This strong performance was made possible through structural reform efforts to lower fixed costs and boost productivity.

Buoyed by the introduction of new products in autumn 2006, the business products segment enjoyed improved conditions and sales. In an effort to foster closer ties with end-users, the consumer imaging products segment is developing a Web-based communication system to promote healthy dialogue. Canon has been working to standardize and unify its IT system infrastructure across Europe by mid-2007, enabling all Group sales companies in Europe to access Group data online. The Company is strengthening its sales networks in areas with strong growth potential such as Russia, Eastern Europe, the Middle

Based upon their high performance, Canon HD broadcasting lenses are in use at the studios of ABC, Inc. in the United States

Using a security card, Canon's MFD solutions made it possible for Interpolis, a Dutch insurance company, to realize their flexible "Crystal Clear" concept with no IT boundaries

East and Africa. Canon aims to increase year-on-year sales and profits in Europe for 2007 to mark its 50th anniversary in Europe.

Japan, Asia and Oceania

Sales in Japan reached a record ¥932.3 billion, up 8.9% year on year, marking the fourth consecutive year of sales and profit growth. Sales in Japan accounted for 22.4% of consolidated net sales.

Canon Sales Co., Inc. changed its name to Canon Marketing Japan, Inc. in April 2006 to reflect the company's strengthened focus on providing value-creating information services that meet customer needs. Canon Marketing Japan is bolstering its presence in the solutions and services business, and continues to strengthen its customer-focused operations.

Sales in China, Oceania and Asian countries excluding Japan increased 9.8% year on year to ¥626.5 billion, representing 15.1% of consolidated net sales. The Company recorded outstanding sales increases of more than 30% in the high-growth markets of China, India, Vietnam, and Thailand, with growth in China in particular topping 36%.

Canon is working actively to attain greater customer satisfaction in Asian markets by improving education among its staff in sales, services and call center operations. Canon is also promoting the expansion of its solutions business and high-value-added products for professionals, such as large-format printers and digital SLR cameras. Moreover, the Company is implementing region-specific strategies to raise awareness and enhance the image of the Canon brand throughout Asia.

Canon opened a showroom in Beijing to enhance communication with customers and provide personalized service

CORPORATE SOCIAL RESPONSIBILITY

Canon's corporate philosophy of *kyosei* embodies the very essence of CSR and demonstrates the Company's commitment to creating a better world.

As part of its policy of Green Procurement, Canon conducts on-site verification at a hexavalent chromium-free plating factory in Shanghai

Canon's Basic Approach to CSR

Canon's corporate philosophy is *kyosei*, which can be defined as "Living and working together for the common good." In addition to the basic principle of returning a portion of profits to society, Canon believes that involvement in environmental conservation and social contribution activities is the natural responsibility of an Excellent Global Corporation. Aiming to become a company worthy of admiration and respect worldwide, Canon is engaged in such activities on many fronts.

Environmental Activities

Life Cycle Assessment

Canon conducts its environmental activities from the standpoint of life cycle assessment (LCA) to ensure that products are environmentally friendly at every stage, from procurement and production to use and recycling. The Company promotes energy and resource conservation as well as the elimination of hazardous substances in all of its business operations.

Factor 2

Canon's mid-to long-term environment-management plan, known as Vision 2010, centers on "Factor 2," which targets the doubling of resource efficiency across all of the Group's business operations by 2010, using 2000 as the baseline date. The "Factor" is calculated as the ratio of net sales to life cycle CO_2 emissions (CO_2 emissions throughout the entire life cycle of all Canon Group Products).

Production Stage

Working on a collaborative basis, Canon and its suppliers have adopted the Canon Green Procurement Standards, which favor materials and products that reduce environmental impact.

In the design stage, Canon's use of 3D-CAD systems has reduced the amount of waste generated from the creation of prototypes. The Company makes every effort to develop and manufacture lighter and smaller products that use less material and thereby consume fewer resources. Canon was among the first companies to develop alternative technologies for regulated hazardous substances in anticipation of the European Union's RoHS Directive. Furthermore, the Company promotes energy conservation in its production activities through such measures as the installation of energy efficient technologies and facilities, and the purification and reuse of water used in manufacturing processes. Canon has also achieved zero landfill waste at all manufacturing sites. In the area of distribution, the Company is actively implementing a worldwide modal shift, switching from trucks to ships and railway

Lenses are cleaned at Oita Canon with purified and reused wastewater from the plant

The PIXMA MP600 cuts power consumption by nearly 90% compared to earlier models thanks to energy-saving technologies

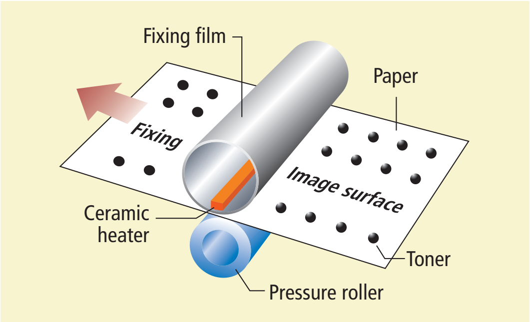
transport to reduce burden on the environment. Canon has also instituted a number of measures to lessen the environmental impact of packaging materials, including cutting down on the number of materials used as a means of reducing CO_2 emissions.

Usage Stage

When considered in terms of product life cycle, the burden on the environment from copying machines and inkjet printers is at its highest during the usage stage. Canon's on-demand fixing technology and improved copying machine controller have made it possible for the imageRUNNER C3380 (iR C3380 in some areas) MFD to achieve an 80% reduction in power consumption compared with previous models. Although energy consumption during camera use is comparatively low, the CMOS sensor and DIGIC image processor enable Canon cameras to not only achieve higher image quality, but also help lower power consumption.

Recycling Stage

Canon is active in recycling and remanufacturing its products. For instance, the Company pioneered the recycling of toner cartridges from copying machines and



Fixing film enables toner fixing with localized warming to eliminate warm-up times and save energy

Reusable parts and recycled plastics are employed in Canon copying machines, MFDs and printers

Charity auction for *The Other Side of Fashion*. All proceeds go to Red Cross youth projects across Europe

LBPs in 1990, and has been remanufacturing copying machines on a global scale since 1992. In 2007, Canon released its first remanufactured color MFD in Japan. While maintaining the same level of reliability and performance as a new machine, the remanufactured MFDs employ reused components accounting for up to 83% of their weight. Moreover, CO_2 emissions during the production stage are reduced by upwards of 76% in comparison to new products.

Material Flow Cost Accounting

Canon introduced material flow cost accounting in 2001, and plans to implement it at all major manufacturing sites by the end of fiscal 2007. Material flow cost accounting involves calculating and managing quantity and cost data from losses incurred in the manufacturing process. Using this method, Canon has successfully reduced the amount of resources used, waste generated, and costs incurred. Canon achieved resource savings of 1,200 tons in 2006.

Contributing to Society

In line with its corporate philosophy, *kyosei*, Canon makes social contributions around the world. The following are just a few of the Company's many ongoing activities.

The Other Side of Fashion

In 2006, Canon launched a photography campaign entitled *The Other Side of Fashion*, putting Canon cameras in the hands of 100 of the world's most influential style icons for them to capture images reflecting their relationship with the world of fashion. The collection was exhibited across Europe and published as a magazine. All proceeds from the sales of the magazine and charity auctions of the prints went to Red Cross youth projects across Europe.

Eyes on Yellowstone

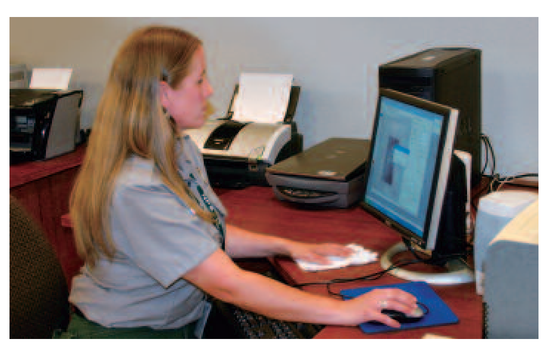
An educational and research program made possible by Canon, Eyes on Yellowstone (a national park in the United States) assists with scientific research and breaks new ground in conservation, endangered species protection and the application of cutting-edge technology essential to managing park wildlife and ecosystems.

Canon Envirothon

The Canon Envirothon is North America's largest high school environmental education competition. More than 500,000 teenagers are involved in a year-long learning process that combines in-class curriculum with hands-on field experiences.

Canon Cup Junior Soccer

Canon has been supporting Canon Cup Junior Soccer, a competition for primary school boys and girls in Japan,



Canon supports the Heritage and Research Center at Yellowstone National Park in digitizing its priceless archives

©WWF-Canon / Martin HARVEY

Canon has been supporting the WWF, the global wildlife conservation organization, as a Conservation Partner in Europe, the Middle East and Africa since 1998

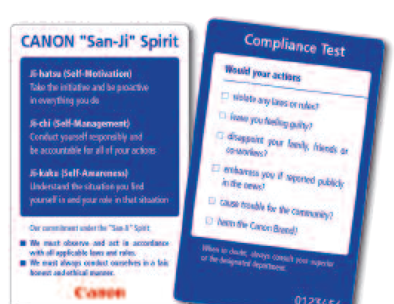
since 2001. The aim is to provide boys and girls with an opportunity to experience the excitement of sports and international exchange through various programs.

Training and Nurturing Employees

Striving to achieve the objectives of its Excellent Global Corporation Plan, Canon has redoubled its efforts in educating personnel and offering specialized training at all levels, including management and administrative levels.

Since the Company's founding, employee education has been based on the guiding principles of the *San-Ji*, or "Three Selfs" spirit. Future innovation at Canon depends on the strength and autonomy of each and every employee. They express their commitment to the Three Selfs principle through excellence in their day-to-day responsibilities.

Canon employs a merit-based pay system that fairly rewards employees who work hard to expand their skills and reach their performance targets. Canon supports recognition and award programs to honor employees for their outstanding achievements. Under the Canon Expert System, employees involved in cell production are evaluated and recognized based on such factors as the number of processes handled by a single worker, specialized knowledge, and skills. Similarly, Canon's Master Craftsman System recognizes employees for their superlative manufacturing skills in areas including lens polishing and high-precision processing, as well as for passing on their know-how to the next generation. Canon also certifies researchers and engineers who are experts in particular technologies as Members of the Canon Academy of Technology. Academy members enhance technical research, mentor younger engineers, and bring Canon's technological superiority to the global forefront.



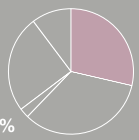
Canon Compliance Cards defining the *San-Ji* spirit are provided to Group employees


HERE
ER, PLEASE SWIPE YOUR
CARD IN THE SLOT ABOVE.
GBCblue
To begin, swipe your credit card o
Welcome to the GBC
There is a $1.25 minimum fee

PRODUCT GROUPS

Business Machines
OFFICE IMAGING PRODUCTS 28-29

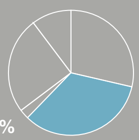
- Office network digital multifunction devices (MFDs)
- Color network digital MFDs
- Office copying machines
- Personal-use copying machines
- Full-color copying machines, etc.



28.5%

Business Machines
COMPUTER PERIPHERALS 30-31

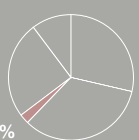
- Laser beam printers (LBPs)
- Single-function inkjet printers
- Inkjet multifunction peripherals
- Image scanners, etc.



33.6%

Business Machines
BUSINESS INFORMATION PRODUCTS

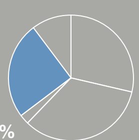
- Computer information systems
- Document scanners
- Personal information products, etc.



2.6%

CAMERAS 32-33

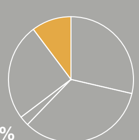
- Single lens reflex (SLR) cameras
- Compact cameras
- Digital cameras
- Digital video camcorders, etc.



25.1%

OPTICAL AND OTHER PRODUCTS 34-35

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



10.2%

Share of Consolidated Sales

Photo:
Canon solutions using MEAP technology made it possible for the Omni Hotel Business Center in Atlanta to enhance their operational efficiency and provide an around-the-clock self copying service by credit card payment for customer convenience.

Office network color multifunction device

OFFICE IMAGING PRODUCTS

Canon is strengthening its solutions business and working to boost sales of color products.

Masaki Nakaoka

Chief Executive, Office Imaging Products Operations

The market for office imaging products is seeing an overall shift toward color models. While color models have largely become the norm in offices in Japan, there remains ample room for greater expansion in Europe and the United States. In response, Canon plans to introduce high-value-added color products to reinforce competitiveness. At the same time, demand is on the rise for multifunction devices (MFDs) in the SOHO markets of Europe and Asia, and Canon expects significant growth still to come. The Company is steadily expanding sales of high-performance, low-end MFDs to SOHO markets. By introducing competitively priced models to high-growth emerging markets, we aim to expand underlying demand and increase market share. In the Asian market for office machines, led by China, Canon is working to establish its service and maintenance systems.

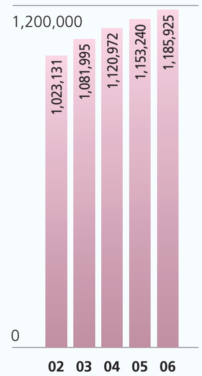
Canon is forging ahead with efforts to strengthen its proposal-style solutions business in order to bring greater efficiency to customers' businesses and contribute to enhancing their performance. While leveraging our Multifunctional Embedded Application Platform (MEAP) technology, which enables the customization of network digital MFDs, we are improving the training of solutions and sales staff to provide optimal solutions that reduce total costs in offices. Canon will actively extend its solutions business worldwide.

Holding high expectations for its imagePRESS digital color printing systems, Canon is entering the POD market with a view toward expanding its office imaging business. The imagePRESS addresses the needs of customers to create outstanding color catalogs, brochures and all kinds of documents. We foresee significant potential for this business in 2007 and beyond, and will continue to expand our product lineup to increase market share in the commercial printing industry.

The year 2007 marks the 30th anniversary of Canon color copying machines and 20th anniversary of digital color models, demonstrating the instrumental role Canon has played in opening new frontiers for color copying machines. Expecting growth of the market for color models to continue, we will work vigorously to boost sales of our color products and make 2007 a truly memorable year.

Fiscal 2006 Review

Sales Results:
Office Imaging Products
(Millions of yen)



Sales in the Office Imaging Products business during fiscal 2006 amounted to ¥1,185.9 billion, up 2.8% over the previous fiscal year. Strong sales in the fourth quarter of the year mitigated the impact of a slight drop in unit sales, leading to an overall sales increase for the year.

Sales of color MFDs rose sharply, owing to the launch of new models including the mid- to high-speed Color imageRUNNER C5180 series (iR C5180 series in some areas) and the energy-saving Color imageRUNNER C3380 series (iR C3380 series in some areas). Among monochrome network digital MFDs, the unveiling of the high-speed imageRUNNER iR 7105 (iR 7105 in some areas) helped to maintain year-on-year sales levels in the United States. However, sales of monochrome models decreased in other markets as users revealed preferences for color models. Low-end models targeting the SOHO market proved popular and contributed to overall sales growth.

Sales in all regions were up compared to the previous fiscal year. Sales in the U.S. market rose on a unit basis and in monetary value, while Canon posted record unit sales in Latin America. In Europe, expanded sales of color models offset a drop in sales of monochrome models resulting from the impact of geopolitical tensions in the Middle East. In Asia, although price declines spurred by increasing competition grew more severe, Canon recorded increased unit sales of low-end models in emerging economies. In Japan, the introduction of new color models during the second half of the year led to strong fourth-quarter sales and an increase for the full year.

Color imageRUNNER C5180 (iR C5180 in some areas)

Color imageRUNNER C3380 (iR C3380 in some areas)

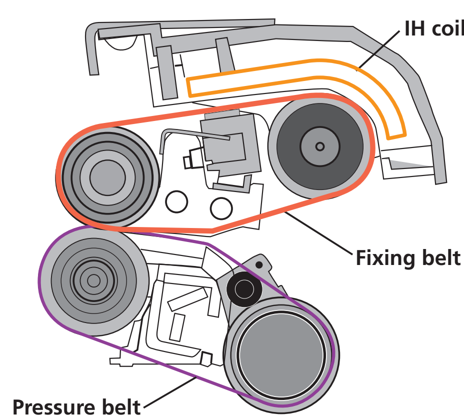
Innovative Technology

Twin Belt Fixing

In response to increasing demands for higher speed output of color documents in office environments, Canon continuously seeks to enhance the speed and consistency of its MFDs for greater productivity. One such example is Canon's Twin Belt Fixing (TBF) technology. In electrophotographic printing, toner is transferred to paper by heat and fused to the paper by adding pressure. Canon's TBF technology uses a fixing belt and a pressure belt to replace the two rollers conventionally used for adding heat and pressure. The fixing belt is heated by a highly efficient induction-heating (IH) coil similar to those used in cooking devices, and the pressure belt adds pressure from the backside of the paper. Using belts instead of the rollers found in conventional machines allows the toner to be fixed over a wide contact area. This enables faster, more consistent printing even for color documents that utilize large amounts of toner.

Utilizing materials with low thermal capacity for the fixing belt also improves heat efficiency by 20% in comparison with conventional models.

The new TBF technology has been incorporated into Canon's new iR C5180 and Color imageRUNNER iR C4580 (iR C4580 in some areas) MFDs, which have been received favorably by customers for their reduced warm-up time and consistent image reproduction.



Twin Belt Fixing
TBF employs a fixing belt and a pressure belt for fast, consistent image reproduction, and an IH coil for a significant reduction in warm-up time.

Inkjet multifunction printer

COMPUTER PERIPHERALS

Canon will expand the market for home photo printing by cultivating its FINE technology and providing enhanced functions.

Katsuichi Shimizu

Chief Executive, Inkjet Products Operations

Canon maintains an unwavering commitment to producing photo-quality inkjet printers. FINE (Full-photolithography Inkjet Nozzle Engineering) is Canon's key inkjet printing technology for precise ejection of ultra-fine ink droplets up to one-picoliter*, resulting in images of high resolution. Incorporated into all of the Company's inkjet printers, FINE technology supports the photo-quality printing abilities that have given Canon printers a solid brand reputation around the globe. It is this commitment to photo quality that continues to drive sales growth in inkjet printers.

The volume market continues to shift from single-function printers (SFPs) toward multifunction printers (MFPs) capable of printing, copying, scanning and faxing. While the overall market for inkjet printers showed signs of leveling off in 2006, Canon recorded a steady year-on-year sales increase. In the year under review, we introduced a new, popular operation method for our MFPs in the form of an Easy-Scroll Wheel, which enables users to select functions with greater simplicity for improved operability. Canon also developed Dual Color Gamut Processing Technology to control the hue and brightness of an MFP's copy function for faithful reproduction of original photos and documents. In addition, we are continuing to pursue improvements in printer design.

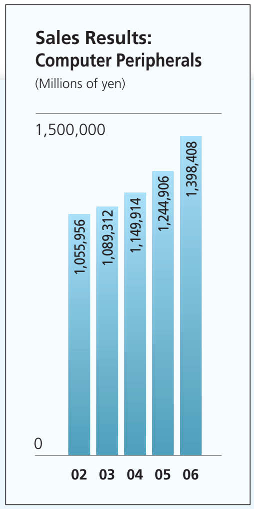
While continually cultivating FINE and other key technologies for superior images, Canon will actively move to expand the market for home photo printing by improving user-friendliness and promoting the cost merits of home printing. In addition, we will equip our printers with greater network functions to enhance compatibility with TV-based home networks.

We are also bolstering our lineup of inkjet printers for professional and advanced amateur photographers. Key strategies in this area include launching products with refined monotone printing capabilities that appeal to professionals.

*One picoliter = one trillionth of a liter

PIXMA iP4300

Fiscal 2006 Review



Sales in the Computer Peripherals business during fiscal 2006 amounted to ¥1,398.4 billion, a year-on-year increase of 12.3%, resulting from the aggressive introduction of new models.

Amidst increasingly severe price competition, the worldwide printer market saw growth in demand for laser beam printers (LBPs), while demand for inkjet printers shifted rapidly from single-function to multifunction models.

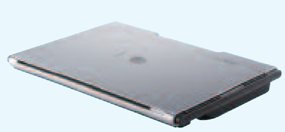
Canon saw record sales of LBPs, with results of color models in terms of units sold rising more than 50% over the previous year, and monochrome models achieving unit growth of more than 10%. Through color on-demand fixing, the color LBP5000 realizes zero warm-up time and was well received in the Asian market.

Canon also posted sales increases for inkjet printers. Among the Company's leading new products were the PIXMA MP600, a high-speed MFP featuring outstanding ease of use, and the PIXMA iP4300, an SFP that gained popularity in North America, Europe and Asia. In addition to raising the appeal of its product design, Canon also equipped new inkjet models with the Easy-Scroll Wheel for enhanced user convenience.

PIXMA MP600

Despite shrinking overall demand for flatbed scanners, Canon scanner sales declined only slightly in comparison with the overall market owing to superior product features. Sales remained strong in the United States, Russia, China, Japan, Canada and Australia. In addition to low-end models, the mid-range CanoScan LiDE 600F is seeing increased sales in Japan and the United States.

LBP5300



CanoScan LiDE 600F

Innovative Technology

For Professional Photo Quality

With the dramatic advances in image quality and speed in recent years, demand for inkjet printers is on the rise among professional and advanced amateur photographers who use digital SLR cameras.

To follow the PIXMA Pro9000 that was released in 2006, Canon is preparing to launch the PIXMA Pro9500 professional-quality inkjet printer. The Pro9500 features a 10-color pigment-ink system to meet the most demanding commercial photographic requirements and deliver high-resolution prints with exceptional color stability for exhibitions, art sales, quality samples and other commercial uses.

In addition to generating outstanding color prints, the ink system includes gray, black and matte black ink tanks that create monochrome photographs of incomparable quality. The printer also supports a wide range of fine art papers, and is equipped with a flat paper path to enable such papers to be fed straight into the printer without the risk of bending or curling.

Intended for use in professional studio environments, PIXMA Pro series printers provide faster and simpler results when used with digital SLR cameras. The printers are compatible with features of Canon's EOS-series of digital SLR cameras. With the increasing popularity of digital SLR cameras, Canon aims to contribute to the further evolution of photo culture and reinforce its leading position in the professional market.

PIXMA Pro 9500
The PIXMA Pro9500 allows for seamless connectivity to EOS digital SLR cameras, and improved workflow from image capturing and processing to editing and printing.

Digital SLR camera

CAMERAS

We will leverage our 70 years of accumulated know-how to expand the camera market and lead the creation of a more abundant imaging culture.

Tomonori Iwashita

Chief Executive, Image Communication Products Operations

In fiscal 2006, Canon further reinforced its overwhelming No. 1 position in the global market for compact digital cameras and digital single lens reflex (SLR) cameras. Total sales volume of the Company's digital still cameras surpassed 20 million units in 2006.

Canon shipped a record 2.5 million digital SLR cameras in 2006 and can boast the largest share of a market that continues to expand. In compact cameras, 2006 was a year that saw further evolution of our photography culture, with Canon not only offering such conventional improvements as increased pixel counts and boosted optical zoom performance, but also focusing on enhancements that allow anyone to easily shoot winning photos for greater enjoyment of the picture-taking experience. In video camcorders, the Company released the high-definition HV10, leveraging Canon's imaging strengths.

As we move into the high-definition television (HDTV) age, Canon will continue to pursue the ultimate in image quality, from still images to movies for both input and output devices. Specifically, Canon will forge ahead with the independent development of all key components for digital SLR cameras, including lenses, imaging sensors, and image processors. We will utilize this strength to spur technological innovation in the basic capabilities of cameras and create value-added products. Canon will raise productivity and cost competitiveness through in-house production and the utilization of IT networks. To increase the sales volume of digital cameras, we will expand our push into the BRIC and other emerging economies to complement existing operations in Japan, Western Europe and the United States. In addition, Canon intends to boost sales and profits in such new business areas as compact photo printers, LCD projectors and network cameras.

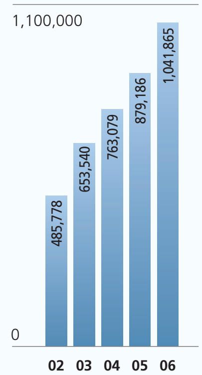
Images will always have a major influence in shaping our culture and are constantly changing. Marking our 70th anniversary in 2007, we will draw from the know-how accumulated over our history to contribute to the further expansion of the camera market and to take a leading role in creating a more abundant imaging culture. We will work tirelessly to be the overwhelming No. 1 brand in all of our existing camera products.

Fiscal 2006 Review

Sales in the Camera segment increased 18.5 % year on year to ¥1,041.9 billion.

Supported by rapid growth in emerging markets, compact digital camera unit sales climbed over 20% to 18.6 million units in 2006. Canon has further strengthened its competitive advantage by releasing models such as the PowerShot SD800 IS DIGITAL ELPH (DIGITAL IXUS 850 IS in some areas), equipped with the DIGIC III imaging processor featuring Face Detection Technology.

Sales Results: Cameras
(Millions of yen)



Canon's worldwide sales of digital SLR cameras on a unit basis were extremely impressive, jumping approximately 30% over the previous year. Canon, with its formidable lineup, maintained its commanding lead in the market. This lineup includes the EOS Digital Rebel XTi (EOS 400D in some areas) entry-level model, the EOS 5D for advanced amateurs, and the EOS-1Ds Mark II and the EOS-1D Mark II N for professional photographers. In line with the sales growth for digital SLR cameras, the Company also achieved record sales of interchangeable lenses.

Canon launched the high-definition HV10 digital video camcorder in 2006. With a full HD CMOS sensor for moving images and a DIGIC DV II imaging processor built into a compact body, this camcorder realizes vivid high-definition images that are tops in the industry.

Canon expanded its SELPHY series of compact digital photo printers with the release of the SELPHY ES1, featuring an integrated ink and paper cassette. With the built-in DIGIC imaging processor for simple operation and high-quality photo prints, this model has generated robust sales growth.

Canon reinforced its lineup of LCD projectors with the introduction of such models as the SX6 and SX60, both of which are equipped with a liquid crystal on silicon (LCOS) panel and Canon's exclusive Aspectual Illumination System (AISYS) optical system.

PowerShot SD800 IS DIGITAL ELPH
(DIGITAL IXUS 850 IS in some areas)

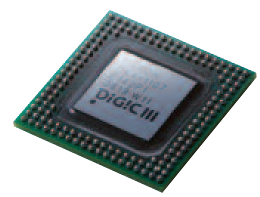
HV10

REALiS SX6
(XEED SX6 in some areas)

Innovative Technology

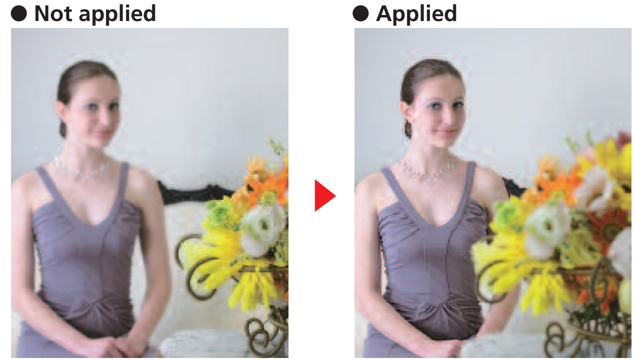
Face Detection Technology

Canon developed Face Detection Technology to facilitate clearer pictures of people's faces. Face Detection Technology is able to detect faces and then optimize focus and exposure accordingly. Face Detection AF finds faces within the frame and sets the optimal focus. For group shots, the AF system can detect up to nine faces in the frame and sets the most suitable focus accordingly. Canon's AE system automatically adjusts the exposure and flash to ensure proper illumination of both the faces and the overall scene, eliminating the common problem of darkened or overexposed faces. This leading-edge technology enhances user-friendliness and the pleasure of picture taking. The evolution of the DIGIC imaging processor has enabled the addition of this new function to Canon digital cameras.



DIGIC III

● **Not applied** ● **Applied**



Face Detection Technology
Canon's Face Detection technology helps camera users to capture crisp, clear shots of human subjects to eliminate blurred or overexposed faces.

Semiconductor exposure equipment

OPTICAL AND OTHER PRODUCTS

Canon provides highly advanced LCD-panel and semiconductor-production equipment that rapidly contributes to customers' profitability.

Junji Ichikawa

Chief Executive, Optical Products Operations

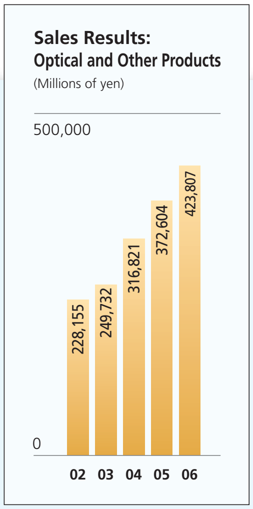
Major products in Canon's Optical and Other Products segment include semiconductor-production equipment and LCD-panel production equipment. Major factors affecting the return on investment for customers that purchase such equipment include productivity and installation time. By enhancing the quality of our products from the design stage, we are working to boost throughput to contribute to greater productivity of customers' operations, while aiming to reduce the installation time required for equipment.

Canon concentrated on sales of MPA-8800 mirror projection aligners for seventh- and eighth-generation panels during 2006. Though demand for LCD exposure equipment dipped in 2006 owing to previous robust investment by panel manufacturers, the trend toward larger glass substrates for production of larger LCD televisions has fueled demand for exposure equipment in recent years. Accordingly, Canon will launch new-concept LCD exposure equipment during 2007 for the production of next-generation panels.

As for semiconductor exposure equipment in 2007, Canon will commence shipments of new ArF excimer laser dry-type and immersion lithography-type scanning steppers. This will give us a full lineup of products to provide memory manufacturers with a combination of steppers best suited to their fabrication systems. Another key concept in Canon semiconductor equipment is "upward compatibility," which stresses the importance of delivering platform products, or "base machines," that can be used for several product generations. Investing in completely new systems with each successive innovation in the industry requires a tremendous amount of time and resources. We are working to create base machines that only require new key components to be developed in order to meet the latest market needs.

Canon will work closely with customers to provide highly advanced LCD-panel and semiconductor-production equipment that matches their needs and rapidly contributes to their profitability. With an emphasis on quality and low-cost production methods, including in-house production, Canon will make every effort to bolster sales and earnings results in this segment.

Fiscal 2006 Review

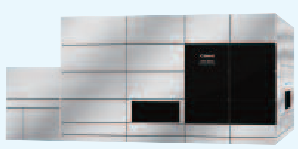


Sales in the Optical and Other Products segment in fiscal 2006 totaled ¥423.8 billion, up 13.7% from the previous fiscal year.

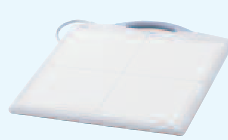
In the LCD market, oversupply in the first half of 2006 triggered a steep decrease in prices, and earnings at panel manufacturers dropped accordingly. This led to a slowdown in demand for exposure equipment that impacted overall segment sales. In contrast, unit sales of semiconductor-production equipment increased steadily. Canon enhanced the competitiveness of its FPA-6000ES5a and other KrF excimer laser systems, as well as its FPA-5500iZa and i-line series lineup, by improving product performance and quality. In addition, the Company shortened lead-times to successfully deliver products in line with customer time demands. These factors contributed to significant growth in revenues that exceeded forecasts at the beginning of 2006.

In X-ray digital radiography, competition grew more severe between CR-, CCD- and FPD-based still-image X-ray digital cameras. Led by the CXDI-50G, overall year-on-year sales increased significantly. Against a backdrop of greater use of digital images in patient diagnosis, sales of non-mydriatic retinal cameras decreased. However, sales of CF-60DSi digital mydriatic retinal cameras and TX-F non-contact tonometers offset the decrease. As a result, overall sales of ophthalmic equipment remained largely unchanged from the previous year.

Spurred by strong growth of HDTV lenses for studios and live broadcasts, as well as professional ENG lenses, Canon posted record sales of broadcast lenses on double-digit percentage growth.



MPA-8800



CXDI-50G

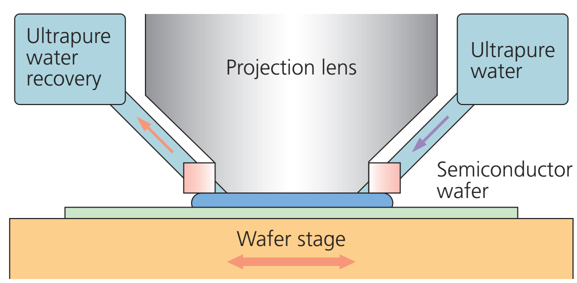
DIGISUPER 100AF

Innovative Technology

Immersion Lithography Technology

Making narrower circuit linewidths on a semiconductor chip enables a greater number of transistors or other components per chip. To achieve increasingly narrow circuit linewidths, Canon is pursuing advances in immersion lithography technology utilizing ArF excimer lasers as a light source. The technology involves filling the space between the projection lens and the wafer with ultrapure water, which has a higher refractive index than air, to increase the numerical aperture (NA) of the lens for greater precision. As a light source, ArF excimer lasers offer the shortest wavelength—193 nanometers (nm)—used in current lens optics. Using an ArF excimer laser light source, the limit for circuit linewidths was previously thought to be 65nm. Applying immersion lithography technology, however, enables circuit linewidths to be reduced down to 45nm. Immersion lithography enables customers to shrink circuit linewidths using current equipment, potentially leading to a significant reduction in investment costs.

In 2007, Canon will introduce the FPA-7000AS7 immersion lithography scanning stepper incorporating this immersion lithography technology. Canon will continue exploring further possibilities and applications for immersion technology by searching for liquids with high refractive indexes to increase numerical apertures.



Liquid Film Immersion Method Using Ultrapure Water
Immersion lithography involves replacing the air normally found between the projection lens and wafer with ultrapure water, enabling circuit linewidths down to 45nm.

MAJOR CONSOLIDATED SUBSIDIARIES

(As of December 31, 2006)

MANUFACTURING

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

RESEARCH & DEVELOPMENT

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

MARKETING & OTHER

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

TABLE OF CONTENTS

GENERAL

The following discussion and analysis provides information that management believes to be relevant to understanding Canon's consolidated financial condition and results of operations. References in this discussion to the "Company" are to Canon Inc. and, unless otherwise indicated, references to the financial condition or operating results of "Canon" refer to Canon Inc. and its consolidated subsidiaries.

OVERVIEW

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

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

Economic Environment

Looking back at the global economy in 2006, in the United States, despite a decrease in housing investment, the economy continued to display growth with healthy employment conditions and continued growth in consumer spending, along with an increase in corporate capital investment. In Europe, while exports appeared somewhat sluggish due to the appreciation of the euro, the region indicated a trend toward moderate recovery as domestic demand expanded in major European countries, boosted by such factors as increased consumer spending owing to improvements in the employment environment. Within Asia, the Chinese economy maintained a high growth rate while other economies in the region also enjoyed generally favorable conditions. In Japan, although consumer spending has yet to fully regain its strength, the economy maintained a trend toward recovery amid increased capital spending fueled by strong corporate performances.

Market Environment

With respect to the markets in which the Canon Group operates, within the camera segment demand for digital single-lens reflex (SLR) cameras and compact digital cameras continued to realize healthy growth during the term. Within the office imaging product market, demand for network digital multifunction devices (MFDs) remained solid as the office market moved toward color and multifunctionality. As for computer peripherals, including printers, although demand grew for color as well as monochrome laser beam printers, and shifted rapidly within the inkjet printer market from single-function to multifunction models, the segment suffered amid severe price competition. In the optical equipment segment, although demand for projection aligners, which are used to produce liquid crystal display (LCD) panels, declined due to restrained investment by LCD manufacturers, demand for steppers, used in the production of semiconductors, was strong, supported by increased investment by manufacturers. The average value of the yen for the year was ¥116.43 to the U.S. dollar and ¥146.51 to the euro, representing year-on-year decreases of about 5% against the U.S. dollar, and 7% against the euro.

Summary of Operations

In 2006, the first year of a new five-year management plan—Phase III of Canon's Excellent Global Corporation Plan—Canon achieved record highs in both consolidated net sales and net income, and a seventh consecutive year of sales and profit growth, mainly due to a solid rise in sales of digital cameras and color network digital MFDs, and laser beam printers, along with the positive effects of the depreciation of the yen. In fiscal 2006, Canon achieved 10.7% growth in net sales, to ¥4,156,759 million (U.S.$34,931 million), and an 18.5% increase in net income, to ¥455,325 million (U.S.$3,826 million). Canon's gross profit increased by 13.3%, to ¥2,060,480 million (U.S.$17,315 million).

Key Performance Indicators

Following are the key performance indicators (KPIs) that Canon uses in managing its business. The changes from year to year in these KPIs are set forth in the table shown on page 39.

Revenues

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

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

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

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

Cash Flow Management

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

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

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

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

KEY PERFORMANCE INDICATORS	2006	2005	2004	2003	2002
Net sales (Millions of yen)	**¥4,156,759**	3,754,191	3,467,853	3,198,072	2,940,128
Gross profit to net sales ratio	**49.6%**	48.5%	49.4%	50.3%	47.6%
R&D expense to net sales ratio	**7.4%**	7.6%	7.9%	8.1%	7.9%
Operating profit to net sales ratio	**17.0%**	15.5%	15.7%	14.2%	11.8%
Inventory turnover within days	**45 days**	47 days	49 days	49 days	51 days
Debt to total assets ratio	**0.7%**	0.8%	1.1%	3.1%	5.0%
Stockholders' equity to total assets ratio	**66.0%**	64.4%	61.6%	58.6%	54.1%

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles, and based on the selection and application of significant accounting policies which require management to make significant estimates and assumptions. Canon believes that the following are the more critical judgment areas in the application of its accounting policies that currently affect its financial condition and results of operations.

Revenue Recognition

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

For arrangements with multiple elements, which may include any combination of equipment, installation and maintenance, Canon allocates revenue to each element based on its relative fair value if such element meets the criteria for treatment as a separate unit of accounting as prescribed in the Emerging Issues Task Force Issue 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables." Otherwise, revenue is deferred until the undelivered elements are fulfilled as a single unit of accounting.

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

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

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

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

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

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

Allowance for Doubtful Receivables

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

Valuation of Inventories

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

Environmental Liabilities

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

Valuation of Deferred Tax Assets

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

Employee Retirement and Severance Benefit Plans

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

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

In preparing its financial statements for fiscal 2006, Canon estimated a discount rate of 2.7% and an expected long-term rate of return on plan assets of 4.8%. In estimating the discount rate, Canon uses available information about rates of return on high-quality fixed-income governmental and corporate bonds currently available and expected to be available during the period to the maturity of the pension benefits. Canon establishes the expected long-term rate of return on plan assets based on management's expectations of the long-term return of the various plan asset categories in which it invests. Management develops expectations with respect to each plan asset category based on actual historical returns and its current expectations for future returns.

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

Decrease in expected return on plan assets may increase net periodic benefit cost by decreasing expected return amounts, while differences between expected value and actual fair value of those assets could affect pension expense in the following years, and vice versa. For fiscal 2007, if a change of 50 basis points in the expected long-term rate of return on plan assets is to occur, that may cause a change of approximately ¥3,040 million in net periodic benefit cost. Canon multiplies management's expected long-term rate of return on plan assets by the value of its plan assets, to arrive at the expected return on plan assets that is included in pension income (expense). Canon defers recognition of the difference between this expected return on plan assets and the actual return on plan assets. The net deferral affects the value of plan assets in future fiscal years and, ultimately, future pension income (expense).

On December 31, 2006, Canon adopted the recognition and disclosure provisions of SFAS 158. SFAS 158 required Canon to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plans in the December 31, 2006 consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income (loss), net of tax.

Effective January 1, 2007, Canon and certain of its domestic subsidiaries have amended their defined benefit pension plans, and the projected benefit obligation has decreased by ¥101,620 million (U.S.$853,950 thousand). This decrease will be amortized as a reduction of net periodic benefit cost over the employees' average remaining service period. The amount will be approximately ¥5,834 million (U.S.$49,025 thousand) per year. In conjunction therewith, Canon and certain of its domestic subsidiaries have implemented a defined contribution pension plan for certain future pension benefits attributable to employees' future services.

CONSOLIDATED RESULTS OF OPERATIONS

SUMMARY OF OPERATIONS

	Millions of yen 2006	Change	2005	Change	2004	Thousands of U.S. dollars 2006
Net sales	**¥4,156,759**	**+10.7%**	3,754,191	+8.3%	3,467,853	**$34,930,748**
Operating profit	**707,033**	**+21.3**	583,043	+7.2	543,793	**5,941,454**
Income before income taxes and minority interests	**719,143**	**+17.5**	612,004	+10.8	552,116	**6,043,218**
Net income	**455,325**	**+18.5**	384,096	+11.9	343,344	**3,826,261**

Sales

Canon's consolidated net sales in fiscal 2006 totaled ¥4,156,759 million (U.S.$34,931 million). This represents a 10.7% increase from the previous fiscal year, reflecting solid rises in sales of digital cameras and color network digital MFDs, and laser beam printers, along with the positive effects of the depreciation of the yen.

Overseas operations are significant to Canon's operating results and generated approximately 75% of total net sales in fiscal 2006. Such sales are denominated in the applicable local currency and are subject to fluctuations in the value of the yen in relation to such other currencies. Despite efforts to reduce the impact of currency fluctuations on operating results, including localizing some manufacturing and procuring parts and materials from overseas suppliers, Canon believes such fluctuations have had and will continue to have a significant effect on results of operations.

The average value of the yen in fiscal 2006 was ¥116.43 to the U.S. dollar, and ¥146.51 to the euro, representing depreciation of about 5% against the U.S. dollar, and 7% against the euro, compared with the previous year. The effects of foreign exchange rate fluctuations favorably impacted net sales by approximately ¥138,700 million. This favorable impact was comprised of approximately ¥67,800 million for U.S. dollar denominated sales, ¥65,900 million for euro-denominated sales and ¥5,000 million for other foreign currency-denominated sales.

Cost of Sales

Cost of sales principally reflects the cost of raw materials, parts and labor used by Canon in the manufacture of its products. A portion of the raw materials used by Canon is imported or includes imported materials. Such raw materials are subject to fluctuations in world market prices and exchange rates that may affect Canon's cost of sales. Other components of cost of sales include depreciation expenses from plants, maintenance expenses, light and fuel expenses and rent expenses. The ratio of cost of sales to net sales for fiscal 2006, 2005 and 2004 was 50.4%, 51.5% and 50.6%, respectively.

Gross Profit

Canon's gross profit in fiscal 2006 increased by 13.3% to ¥2,060,480 million (U.S.$17,315 million) from fiscal 2005. The gross profit ratio improved 1.1 points year on year to reach 49.6%. The improved gross profit ratio was mainly the result of such factors as the introduction of automated production lines, and the in-house manufacturing of key components and key devices, in addition to cost-reduction efforts realized through ongoing production-reform and procurement-reform activities, which absorbed the negative effects of severe price competition in the consumer product market.

Operating Expenses

The major components of operating expenses are payroll, R&D, advertising expenses and other marketing expenses. Although R&D expenditures grew 7.6% in fiscal 2006 from the previous year to ¥308,307 million (U.S.$2,591 million), the operating expenses to net sales ratio improved 0.4 points. This was achieved by limiting growth in selling, general and administrative expenses, with the exception of a temporary increase in expenses related to the relocation of operation bases, below the growth rate for net sales. In general, Canon maintains a high level of R&D expenditure to strengthen its R&D capabilities. R&D expenditures grew in fiscal 2006 from the previous year, resulting from increased R&D activities.

Operating Profit

Operating profit in fiscal 2006 increased by 21.3% to ¥707,033 million (U.S.$5,941 million) from fiscal 2005. Operating profit in fiscal 2006 was 17.0% of net sales, compared with 15.5% in fiscal 2005.

Other Income (Deductions)

Other income (deductions) declined ¥16,851 million (U.S.$142 million), attributable to an increase of currency exchange losses and a decrease in gains on sales of securities, although interest income grew in line with the rise in the interest rate.

Income Before Income Taxes and Minority Interests

Income before income taxes and minority interests in fiscal 2006 was ¥719,143 million (U.S.$6,043 million), a 17.5% increase from fiscal 2005, and constituted 17.3% of net sales.

Income Taxes

Provision for income taxes increased by ¥35,448 million (U.S.$298 million) from fiscal 2005, primarily as a result of the increase in income before income taxes and minority interests. The effective tax rate during fiscal 2006 declined by 0.3% compared with fiscal 2005.

Net Income

As a result of the factors offerings above, net income in fiscal 2006 increased by 18.5% to ¥455,325 million (U.S.$3,826 million), which exceeds the growth rate of income before income taxes and minority interests. This represents an 11.0% return on net sales.

Product Information

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

- **The business machines product group** includes office imaging products, computer peripherals and business information products.
  Office imaging products include office network digital MFDs, color network digital MFDs, office copying machines, personal-use copying machines and full-color copying machines.
  Computer peripherals include laser beam printers, inkjet printers, inkjet multifunction peripherals and image scanners.
  Business information products include micrographic equipment, personal computers and calculators.
- **The cameras product group** includes single lens reflex ("SLR") cameras, compact cameras, digital cameras and digital video camcorders.
- **The optical and other products product group** includes steppers for semiconductor chip production, mirror projection mask aligners used in the production of LCDs, television broadcasting lenses and medical equipment.

Sales by Product

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

SALES BY PRODUCT

	Millions of yen 2006	Change	2005	Change	2004	Thousands of U.S.dollars 2006
Business machines:						
Office imaging products	**¥1,185,925**	**+2.8%**	1,153,240	+2.9%	1,120,972	**$ 9,965,756**
Computer peripherals	**1,398,408**	**+12.3**	1,244,906	+8.3	1,149,914	**11,751,328**
Business information products	**106,754**	**+2.4**	104,255	–10.9	117,067	**897,092**
	2,691,087	**+7.5**	2,502,401	+4.8	2,387,953	**22,614,176**
Cameras	**1,041,865**	**+18.5**	879,186	+15.2	763,079	**8,755,168**
Optical and other products	**423,807**	**+13.7**	372,604	+17.6	316,821	**3,561,404**
Total	**¥4,156,759**	**+10.7**	3,754,191	+8.3	3,467,853	**$34,930,748**

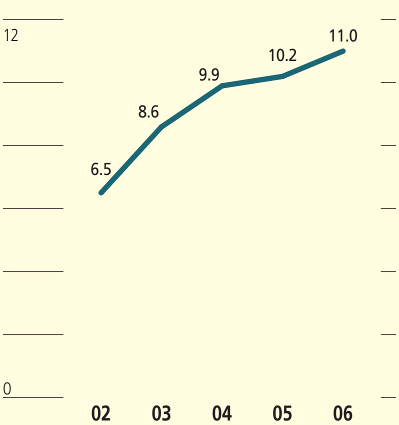
Sales of business machines, constituting 64.7% of consolidated net sales, increased 7.5%, to ¥2,691,087 million (U.S.$22,614 million) in fiscal 2006.

Sales of office imaging products increased 2.8% in fiscal 2006, to ¥1,185,925 million (U.S.$9,966 million). In the business machine segment, sales of color network digital MFDs, which are grouped in the office imaging products sub-segment, recorded significant growth with the launch of such new models as the mid to high-speed office-use iR C5180 series, the low-power-consumption iR C3380 series, and the high-image-quality imagePRESS C1 for commercial printing. Among monochrome network digital MFDs, while sales increased in the Asian market, sales of monochrome models declined in other markets as demand shifted toward color models. Color office imaging products accounted for 31% and 28% and monochrome office imaging products accounted for 52% and 56% of office imaging products sales in fiscal 2006 and 2005, respectively. Sales of facsimiles and information system business accounted for 17% and 16% of sales of office imaging products in both fiscal 2006 and 2005, respectively.

Sales of computer peripherals increased 12.3% in fiscal 2006 to ¥1,398,408 million (U.S.$11,751 million). Laser beam printers enjoyed a year-on-year increase in unit sales, with color models growing more than 50% and monochrome machines, particularly low-end models, also recording healthy growth of over 10%. Sales in value terms also rose significantly. As for inkjet printers, despite a decline in demand for single-function models and severe price competition in the market, sales in value terms increased along with unit sales. Sales performance was boosted by the introduction of 24 new models—13 single-function models and 11 multifunction models-including the high-speed user-friendly PIXMA MP600 and overseas entry-

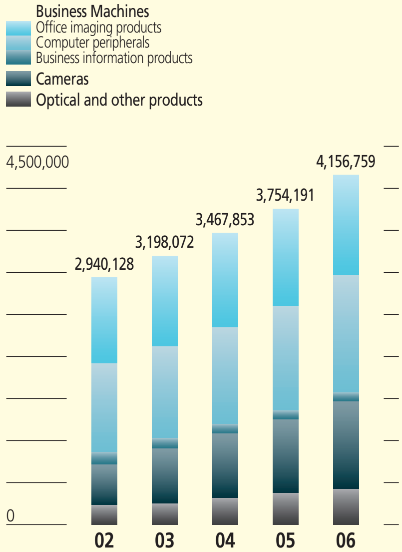
Return on Sales

(%)



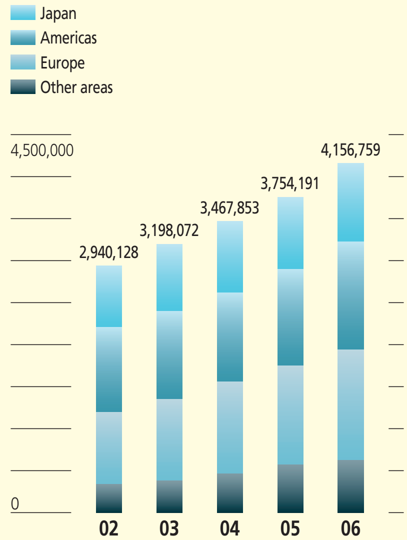
Sales by Product

(Millions of yen)



Sales by Region

(Millions of yen)



level-model PIXMA MP160 all-in-ones, which contributed to a stronger product lineup while also supporting favorable sales growth for consumables.

Sales of business information products increased 2.4%, to ¥106,754 million (U.S.$897 million) in fiscal 2006, mainly due to the growth in the demand for document scanner.

Sales of cameras continued to achieve significant sales growth of 18.5% in fiscal 2006, totaling ¥1,041,865 million (U.S.$8,755 million). The continued strong demand for digital SLR cameras has fueled continued growth with particularly strong sales for the advanced-amateur-model EOS 30D, launched in the first half of 2006, and the EOS DIGITAL REBEL XTi, launched in the second half. This, in turn, led to expanded sales of interchangeable lenses for SLR cameras. Sales of compact digital cameras also continued to expand steadily with the introduction of 16 new models in 2006, including six stylish ELPH-series models and 10 PowerShot-series models that cater to a diverse range of shooting styles. As a result, unit sales of digital cameras grew by more than 20% compared with the previous year. Digital cameras accounted for 75% and 72% and conventional film cameras accounted for 15% and 16% of camera sales in fiscal 2006 and 2005, respectively. In the field of digital video camcorders, the launch of consumer-market HDV models equipped with Canon HD CMOS sensors contributed to expanded sales, filling out the company's digital camcorder lineup along with MiniDV and DVD models. Video camcorders accounted for the remaining 10% and 12% of camera sales in fiscal 2006 and 2005, respectively. Sales of cameras constituted 25.1% of consolidated net sales in fiscal 2006.

Sales of optical and other products increased 13.7% in fiscal 2006, to ¥423,807 million (U.S.$3,561 million). In the optical and other products segment, while steppers, used in the production of semiconductors, enjoyed steady demand due to a significant increase in investment by manufacturers, sales of optical products decreased amid declining demand for aligners, used to produce LCD panels, due to restrained investment by LCD manufacturers. As for the other products included in the segment, the newly consolidated subsidiaries last year contributed to significant sales growth. Sales of optical and other products constituted 10.2% of consolidated net sales in fiscal 2006.

Sales by Region

A geographical analysis indicates that net sales in fiscal 2006 increased in every region.

In Japan, net sales increased by 8.9% in fiscal 2006 from fiscal 2005. The results were mainly attributable to increased sales of digital cameras and steppers, used in the production of semiconductors and the significant sales growth of the newly consolidated subsidiaries acquired last year.

In the Americas, net sales increased by 6.6% on a local currency basis, mainly due to increased sales of digital cameras and laser beam printers. Sales of digital cameras experienced continued strong demand and benefited from the effect of newly-launched products such as the EOS 30D, advanced-amateur-model, and the EOS DIGITAL REBEL XTi. On a yen basis, after accounting for the depreciation of the yen against the U.S. dollar, net sales in the Americas increased by 12.0%.

In Europe, net sales increased by 4.3% on a local currency basis mainly due to increased sales of digital cameras and laser beam printers. On a yen basis, after accounting for the depreciation of the yen against the euro, net sales in Europe grew 11.3% in fiscal 2006.

Sales in other areas increased by 9.8% on a yen basis in fiscal 2006, reflecting overall sales growth, particularly in digital cameras.

A summary of net sales by region is provided below:

SALES BY REGION

	Millions of yen					Thousands of U.S.dollars
	2006	Change	2005	Change	2004	**2006**
Japan	**¥ 932,290**	**+8.9%**	856,205	+0.8%	849,734	**$ 7,834,370**
Americas	**1,283,646**	**+12.0**	1,145,950	+8.2	1,059,425	**10,786,941**
Europe	**1,314,305**	**+11.3**	1,181,258	+8.0	1,093,295	**11,044,580**
Other areas	**626,518**	**+9.8**	570,778	+22.6	465,399	**5,264,857**
Total	**¥4,156,759**	**+10.7**	3,754,191	+8.3	3,467,853	**$34,930,748**

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

SEGMENT INFORMATION BY PRODUCT

Millions of yen		Business Machines	Cameras	Optical and Other Products	Corporate and Eliminations	Consolidated
2006:	Net sales:					
	Unaffiliated customers	**¥2,691,087**	**1,041,865**	**423,807**	**—**	**4,156,759**
	Intersegment	**—**	**—**	**190,687**	**(190,687)**	**—**
	Total	**2,691,087**	**1,041,865**	**614,494**	**(190,687)**	**4,156,759**
	Operating cost and expenses	**2,091,858**	**773,127**	**573,019**	**11,722**	**3,449,726**
	Operating profit	**¥ 599,229**	**268,738**	**41,475**	**(202,409)**	**707,033**
	Assets	**¥1,617,198**	**542,866**	**501,008**	**1,860,843**	**4,521,915**
	Depreciation and amortization	**127,873**	**28,756**	**37,018**	**68,647**	**262,294**
	Capital expenditure	**154,259**	**31,517**	**36,272**	**157,609**	**379,657**
2005:	Net sales:					
	Unaffiliated customers	¥2,502,401	879,186	372,604	—	3,754,191
	Intersegment	—	—	158,114	(158,114)	—
	Total	2,502,401	879,186	530,718	(158,114)	3,754,191
	Operating cost and expenses	1,960,373	705,480	491,898	13,397	3,171,148
	Operating profit	¥ 542,028	173,706	38,820	(171,511)	583,043
	Assets	¥1,427,277	480,957	517,527	1,617,792	4,043,553
	Depreciation and amortization	123,037	27,662	28,011	47,231	225,941
	Capital expenditure	201,887	57,678	15,955	108,264	383,784
2004:	Net sales:					
	Unaffiliated customers	¥2,387,953	763,079	316,821	—	3,467,853
	Intersegment	—	—	138,419	(138,419)	—
	Total	2,387,953	763,079	455,240	(138,419)	3,467,853
	Operating cost and expenses	1,866,869	632,281	426,408	(1,498)	2,924,060
	Operating profit	¥ 521,084	130,798	28,832	(136,921)	543,793
	Assets	¥1,338,817	399,207	418,418	1,430,579	3,587,021
	Depreciation and amortization	115,830	21,880	24,895	30,087	192,692
	Capital expenditure	134,128	39,783	52,264	92,555	318,730

Thousands of U.S.dollars		Business Machines	Cameras	Optical and Other Products	Corporate and Eliminations	Consolidated
2006:	Net sales:					
	Unaffiliated customers	**$22,614,176**	**8,755,168**	**3,561,404**	**—**	**34,930,748**
	Intersegment	**—**	**—**	**1,602,411**	**(1,602,411)**	**—**
	Total	**22,614,176**	**8,755,168**	**5,163,815**	**(1,602,411)**	**34,930,748**
	Operating cost and expenses	**17,578,638**	**6,496,865**	**4,815,286**	**98,505**	**28,989,294**
	Operating profit	**$ 5,035,538**	**2,258,303**	**348,529**	**(1,700,916)**	**5,941,454**
	Assets	**$13,589,899**	**4,561,899**	**4,210,151**	**15,637,337**	**37,999,286**
	Depreciation and amortization	**1,074,563**	**241,647**	**311,076**	**576,865**	**2,204,151**
	Capital expenditure	**1,296,294**	**264,849**	**304,807**	**1,324,445**	**3,190,395**

Notes:
1. General corporate expenses of ¥202,328 million (U.S.$1,700 million), ¥171,522 million and ¥136,929 million in the years ended December 31, 2006, 2005 and 2004, respectively, are included in "Corporate and Eliminations." For the fiscal year ended December 31, 2004, a gain of ¥17,141 million is also included, which relates to the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities.
2. Corporate assets of ¥1,860,933 million (U.S.$15,638 million), ¥1,239,255 million and ¥1,430,599 million as of December 31, 2006, 2005 and 2004, respectively, which mainly consist of cash and cash equivalents, marketable securities, investments and corporate properties, are included in "Corporate and Eliminations."
3. The segments are defined under Japanese GAAP. In grouping of segment information by product, Japanese GAAP requires that consideration be given to similarities of product types and characteristics, manufacturing methods, sales markets, and other factors that are similar.

SEGMENT INFORMATION BY GEOGRAPHIC AREA

Millions of yen		Japan	Americas	Europe	Others	Corporate and Eliminations	Consolidated
2006:	Net sales:						
	Unaffiliated customers	**¥1,037,657**	**1,277,867**	**1,313,919**	**527,316**	**—**	**4,156,759**
	Intersegment	**2,311,482**	**4,764**	**3,586**	**792,018**	**(3,111,850)**	**—**
	Total	**3,349,139**	**1,282,631**	**1,317,505**	**1,319,334**	**(3,111,850)**	**4,156,759**
	Operating cost and expenses	**2,558,685**	**1,236,138**	**1,272,463**	**1,275,817**	**(2,893,377)**	**3,449,726**
	Operating profit	**¥ 790,454**	**46,493**	**45,042**	**43,517**	**(218,473)**	**707,033**
	Assets	**¥2,644,116**	**432,001**	**682,381**	**339,314**	**424,103**	**4,521,915**
2005:	Net sales:						
	Unaffiliated customers	¥ 979,748	1,139,784	1,178,672	455,987	—	3,754,191
	Intersegment	2,046,173	7,424	2,206	646,530	(2,702,333)	—
	Total	3,025,921	1,147,208	1,180,878	1,102,517	(2,702,333)	3,754,191
	Operating cost and expenses	2,362,019	1,110,415	1,147,658	1,071,155	(2,520,099)	3,171,148
	Operating profit	¥ 663,902	36,793	33,220	31,362	(182,234)	583,043
	Assets	¥2,419,012	406,101	569,750	312,472	336,218	4,043,553
2004:	Net sales:						
	Unaffiliated customers	¥ 919,153	1,057,066	1,090,712	400,922	—	3,467,853
	Intersegment	1,882,973	8,863	4,161	591,677	(2,487,674)	—
	Total	2,802,126	1,065,929	1,094,873	992,599	(2,487,674)	3,467,853
	Operating cost and expenses	2,206,141	1,025,628	1,071,552	965,080	(2,344,341)	2,924,060
	Operating profit	¥ 595,985	40,301	23,321	27,519	(143,333)	543,793
	Assets	¥1,793,679	341,616	533,865	271,566	646,295	3,587,021

Thousands of U.S.dollars		Japan	Americas	Europe	Others	Corporate and Eliminations	Consolidated
2006:	Net sales:						
	Unaffiliated customers	**$ 8,719,807**	**10,738,378**	**11,041,336**	**4,431,227**	**—**	**34,930,748**
	Intersegment	**19,424,218**	**40,034**	**30,135**	**6,655,613**	**(26,150,000)**	**—**
	Total	**28,144,025**	**10,778,412**	**11,071,471**	**11,086,840**	**(26,150,000)**	**34,930,748**
	Operating cost and expenses	**21,501,554**	**10,387,715**	**10,692,967**	**10,721,151**	**(24,314,093)**	**28,989,294**
	Operating profit	**$ 6,642,471**	**390,697**	**378,504**	**365,689**	**(1,835,907)**	**5,941,454**
	Assets	**$22,219,462**	**3,630,261**	**5,734,294**	**2,851,378**	**3,563,891**	**37,999,286**

Notes:
1. General corporate expenses of ¥202,328 million (U.S.$1,700 million), ¥171,522 million and ¥136,929 million in the years ended December 31, 2006, 2005 and 2004, respectively, are included in "Corporate and Eliminations." For the fiscal year ended December 31, 2004, a gain of ¥17,141 million is also included, which relates to the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities.
2. Corporate assets of ¥1,860,933 million (U.S.$15,638 million), ¥1,239,255 million and ¥1,430,599 million as of December 31, 2006, 2005 and 2004, respectively, which mainly consist of cash and cash equivalents, marketable securities, investments and corporate properties, are included in "Corporate and Eliminations."
3. Segment information by geographic area is determined by the location of the Company or its relevant subsidiary making the sale. The segments are defined under Japanese GAAP. In grouping of segment information by geographic area, Japanese GAAP requires that consideration be given to geographic proximity, as well as similarities of economic activities, interrelationships of business activities and other similar factors.

Operating Profit by Product

Operating profit for business machines in fiscal 2006 increased ¥57,201 million (U.S.$481 million) to ¥599,229 million (U.S.$5,036 million). The gross profit ratio improved compared to the previous year, due to cost reduction efforts, and the sales-to-expense ratio declined, contributing to an increase in operating profit.

Operating profit for cameras increased ¥95,032 million (U.S.$799 million) to ¥268,738 million (U.S.$2,258 million). The gross profit ratio for the camera segment improved, due to such factors as increased sales of new products and cost reduction efforts.

Operating profit for optical and other products in fiscal 2006 increased ¥2,655 million (U.S.$22 million) to ¥41,475 million (U.S.$349 million). The gross profit ratio increased compared to the previous year, due to an increase in sales of steppers.

FOREIGN OPERATIONS AND FOREIGN CURRENCY TRANSACTIONS

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

The return on foreign operation sales is usually lower than that from domestic operations because foreign operations consist mainly of marketing activities. Return on foreign operation sales is calculated by dividing net income of foreign subsidiaries, after factoring in consolidation adjustments between foreign subsidiaries, by net sales of foreign subsidiaries. Marketing activities are generally less profitable than production activities, which are mainly conducted by the Company and its domestic subsidiaries. The returns on foreign operation sales in fiscal 2006, 2005 and 2004 were 3.7%, 3.0% and 2.8%, respectively. This compares with returns of 11.0%, 10.2% and 9.9% on total operations for the respective years.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents in fiscal 2006 increased ¥150,673 million (U.S.$1,266 million) to ¥1,155,626 million (U.S.$9,711 million), compared with ¥1,004,953 million in fiscal 2005 and ¥887,774 million in fiscal 2004. Canon's cash and cash equivalents are typically denominated in Japanese yen, with the remainder denominated in foreign currencies such as the U.S. dollar.

Net cash provided by operating activities in fiscal 2006 increased by ¥89,563 million (U.S.$753 million) from the previous year to ¥695,241 million (U.S.$5,842 million), reflecting the substantial growth in sales and increased cash proceeds from sales, combined with a substantial increase in net income. Cash flow from operating activities consisted of the following components: the major component of Canon's cash inflow is cash received from customers, while the major components of Canon's cash outflow are payments for parts and materials, selling, general and administrative expenses, and income taxes.

For fiscal 2006, cash inflow from cash received from customers increased, due to the increase in net sales. This increase in cash inflow was within the range of the increase in net sales, as there were no significant changes in Canon's collection rates. Cash outflow for payments for parts and materials also increased, as a result of an increase in net sales. However, this increase was less than the increase in net sales, due to the effects of cost reduction. Cost reduction reflects a decline in unit prices of parts and raw materials, as well as a streamlining of the process of using these parts and materials through promoting efficiency in operations. Cash outflow for payroll payments increased, due to the increase in the number of employees. The employees in the Asian region increased, due to the expansion of production in the regions. Cash outflow for payments for selling, general and administrative expenses increased, but the increase was within the range of the increase in net sales, due to cost-cutting efforts. Cash outflow for payments of income taxes increased, due to the increase in taxable income.

Net cash used in investing activities in fiscal 2006 was ¥460,805 million (U.S.$3,872 million), compared with ¥401,141 million in fiscal 2005 and ¥252,967 million in fiscal 2004, consisting primarily of capital expenditures. Capital expenditures in fiscal 2006 totaled ¥424,862 million (U.S.$3,570 million), which was used mainly to expand production capabilities in Japan and overseas regions and to strengthen the Company's R&D-related infrastructure. As a result, free cash flow, or cash flow from operating activities minus cash flow from investing activities, totaled ¥234,436 million (U.S.$1,970 million) for fiscal 2006 as compared to ¥204,537 million for fiscal 2005.

Net cash used in financing activities totaled ¥107,487 million (U.S.$903 million) in fiscal 2006, mainly resulting from a decrease in loan repayments accompanying the company's strengthened financial position despite a large increase in the dividend payout. The Company paid dividends in fiscal 2006 of ¥83.33 (U.S.$0.70) per share, which was an increase of ¥16.66 (U.S.$0.14) per share over the prior year (after adjusting for the effect of 3 for 2 stock split in 2006).

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

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

Short-term loans (including current portion of long-term debt) amounted to ¥15,362 million (U.S.$129 million) at December 31, 2006 compared to ¥5,059 million at December 31, 2005. Long-term debt (excluding current portion) amounted to ¥15,789 million (U.S.$133 million) at December 31, 2006 compared to ¥27,082 million at December 31, 2005.

Canon's long-term debt generally consists of lease obligations, as well as fixed-rate notes and convertible debentures which Canon has issued in the domestic market with original maturities of ten to fifteen years.

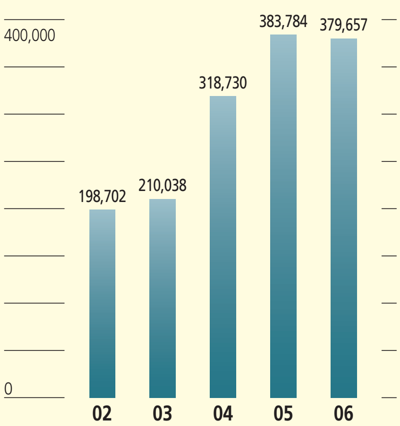
In order to facilitate access to global capital markets, Canon obtains credit ratings from two rating agencies, Moody's Investors Services, Inc. ("Moody's") and Standard and Poor's Rating Services ("S&P"). In addition, Canon maintains a rating from Rating and Investment Information, Inc. ("R&I"), a rating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

As of February 28, 2007, Canon's debt ratings are: Moody's: Aa2 (long-term); S&P: AA (long-term), A-1+ (short-term); and R&I: AA+ (long-term). Canon does not have any rating downgrade triggers that would accelerate the maturity of a material amount of its debt. A downgrade in Canon's credit ratings or outlook could, however, increase the cost of its borrowings.

Capital expenditure in fiscal 2006 amounted to ¥379,657 million (U.S.$3,190 million) compared with ¥383,784 million in fiscal 2005 and ¥318,730 million in fiscal 2004. In fiscal 2005, capital expenditures were mainly used to expand production capabilities in both domestic and overseas regions, and to bolster the Company's R&D-related infrastructure. In addition, Canon has been continually investing in tools and dies for business machines, in which the amount invested is generally the same each year. For fiscal 2007, Canon projects its capital expenditures will be approximately ¥480,000 million (U.S.$4,034 million). The capital expenditures include investments in new production plants and new facilities of Canon.

Employer contributions to Canon's worldwide defined benefit pension plans were ¥44,981 million (U.S.$378 million) in fiscal 2006, ¥40,059 million in fiscal 2005, ¥31,018 million in fiscal 2004. During fiscal 2007, Canon expects to make cash contributions of approximately ¥17,369 million (U.S.$146 million) to its defined benefit pension plans.

Capital Expenditure
(Millions of yen)



Working capital in fiscal 2006 increased ¥239,101 million (U.S.$2,009 million), to ¥1,619,042 million (U.S.$13,605 million), compared with ¥1,379,941 million in fiscal 2005 and ¥1,248,987 million in fiscal 2004. This increase was primarily a result of an increase in cash and cash equivalents. Canon believes its working capital will be sufficient for its requirements for the foreseeable future. Canon's capital requirements are primarily dependent on management's business plans regarding the levels and timing of capital expenditures and investments. The working capital ratio (ratio of current assets to current liabilities) for fiscal 2006 was 2.39 compared to 2.28 for fiscal 2005 and 2.27 for fiscal 2004.

Return on assets (Net income divided by the average of total assets as of December 31, 2006, 2005 and 2004) recorded 10.6% in fiscal 2006, compared to 10.1% in fiscal 2005 and 10.1% in fiscal 2004.

Return on stockholders' equity was 16.3% in fiscal 2006 compared with 16.0% in fiscal 2005 and 16.8% in fiscal 2004.

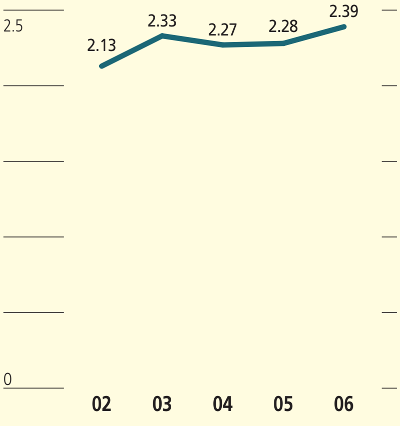
Debt to total assets ratio was 0.7%, 0.8% and 1.1% as of December 31, 2006, 2005 and 2004, respectively. Canon had short-term loans and long-term debt of ¥31,151 million as of December 31, 2006, ¥32,141 million as of December 31, 2005 and ¥38,530 million as of December 31, 2004.

OFF-BALANCE SHEET ARRANGEMENTS

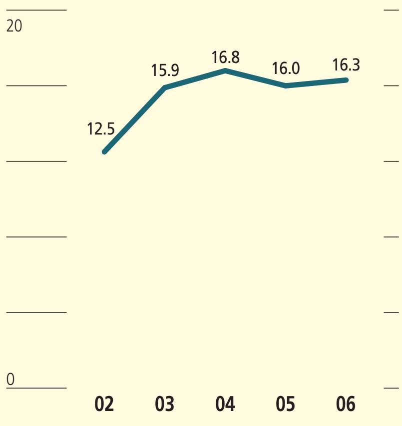
As part of its ongoing business, Canon does not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating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

Canon provides guarantees to third parties of bank loans of its employees, affiliates and other companies. Canon would have to perform under a guarantee, if the borrower defaults on a payment within the contract periods of 1 year to 30 years in the case of employees with housing loans, and of 1 year to 10 years in the case of affiliates and other companies. The maximum amount of undiscounted payments Canon would have had to make in the event of default by all borrowers was ¥30,051 million (U.S.$253 million) at December 31, 2006. The carrying amounts of the liabilities recognized for Canon's obligations as a guarantor under those guarantees are insignificant.

Working Capital Ratio



Return on Stockholders' Equity
(%)



CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following summarizes Canon's contractual obligations at December 31, 2006.

Millions of yen

		Payments Due By Period			
	Total	Less than 1 year	1–3 years	3–5 years	More than 5 years
Contractual obligations:					
Long-term debt					
Capital lease obligations	¥ 10,585	5,263	4,850	465	7
Other long-term debt	20,467	10,000	10,432	22	13
Operating lease obligations	60,378	16,025	22,565	10,532	11,256
Purchase commitments for					
Property plant and equipment	107,685	107,685	—	—	—
Parts and raw materials	85,403	85,403	—	—	—
Total	¥284,518	224,376	37,847	11,019	11,276

Thousands of U.S.dollars

		Payments Due By Period			
	Total	Less than 1 year	1–3 years	3–5 years	More than 5 years
Contractual obligations:					
Long-term debt					
Capital lease obligations	$ 88,950	44,226	40,756	3,908	60
Other long-term debt	171,991	84,034	87,664	185	108
Operating lease obligations	507,378	134,664	189,622	88,504	94,588
Purchase commitments for					
Property plant and equipment	904,916	904,916	—	—	—
Parts and raw materials	717,672	717,672	—	—	—
Total	$2,390,907	1,885,512	318,042	92,597	94,756

Canon provides warranties generally less than one year against defects in materials and workmanship on most of its consumer products. Estimated product warranty related costs are established at the time revenue is recognized and is included in selling, general and administrative expenses. Estimates for accrued product warranty cost are primarily based on historical experience, and are affected by ongoing product failure rates, specific product class failures outside of the baseline experience, material usage and service delivery costs incurred in correcting a product failure. As of December 31, 2006, accrued product warranty costs amounted to ¥18,144 million (U.S.$152 million).

At December 31, 2006, commitments outstanding for the purchase of property, plant and equipment approximated ¥107,685 million (U.S.$905 million), and commitments outstanding for the purchase of parts and raw materials approximated ¥85,403 million (U.S.$718 million), both for use in the ordinary course of its business. Canon anticipates that funds needed to fulfill these commitments will be generated internally through operations.

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

RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

Canon kicked off the year 2006, the first year of Phase III (2006–2010) of the Excellent Global Corporation Plan, with an objective to realize "Sound Growth" toward "Joining the World's Top 100 Companies."

Canon has established the following as key strategies:

- Realize the overwhelming No.1 position worldwide in all current core businesses,
- Expand operations through diversification and
- Identify new business domains and accumulate necessary technological capabilities

Canon is striving to achieve these strategies as follows:

- Realize the No.1 position worldwide in all current core businesses: Product R&D divisions will work together with the corporate R&D headquarters to bolster product competitiveness through development of superior next-generation products.

- Expand operations through diversification: Canon is studying existing technologies to expand business opportunities and develop required technologies for new SED businesses to make SEDs the windows for images and information in living rooms.
- Identify new business domains and accumulate necessary technological capabilities: Canon has established a Strategic Committee for New Businesses. In addition, Canon developing and strengthening relationships with universities and other research institutes to carry on fundamental research and develop cutting-edge technologies. Canon has signed a comprehensive partnership agreement with Tokyo Institute of Technology in 2005 regarding joint research on advanced materials and imaging technologies. Canon has also tied up with Kyoto University to develop next-generation medical-image processing technologies.

Canon has utilized 3D-CAD systems for some time to boost R&D efficiency by curtailing product development times and costs. Moreover, Canon enhanced and evolved its simulation, measurement, and analysis technologies by introducing leading-edge facilities, including one of Japan's highest-performance cluster computers in 2005. As a result, Canon has succeeded in further reducing the need for prototypes, dramatically lowering costs and shortening development lead times.

Canon has R&D centers worldwide, including the USA. Each of our R&D centers, with its expertise, is collaborating with other centers to achieve synergies, and cultivating closer ties in fields ranging from basic research to product development.

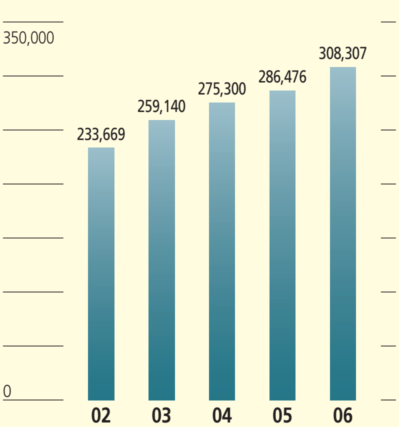
The Company's R&D activities are conducted in the following four organizations:

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

Canon's consolidated R&D expenditures were ¥308,307 million (U.S.$2,591 million) in fiscal 2006, ¥286,476 million in fiscal 2005 and ¥275,300 million in fiscal 2004. The ratios of R&D expenditure to consolidated total net sales for fiscal 2006, 2005, and 2004 were 7.4 %, 7.6% , and 7.9%, respectively.

Canon believes that new products protected by seminal patents will not easily allow competitors to catch up with it, and provide Canon with advantages in establishing standards in the market and industry. According to the United States patent annual list, which IFI CLAIMS® Patent Services released, Canon obtained the 3rd-greatest number of private sector patents in 2006. This achievement marks Canon's fifteenth consecutive year as one of the top three patent-receiving private-sector organizations.

R&D Expenditure
(Millions of yen)



RECENT DEVELOPMENTS

Canon has decided to purchase from Toshiba Corporation ("Toshiba") all of Toshiba's outstanding shares of SED Inc., a Canon subsidiary. On completion of the purchase, SED Inc. became a wholly owned subsidiary of Canon, effective January 29, 2007. In accordance with this decision, which was based on the assumption of prolonged litigation pending against Canon in the United States with respect to SED technology, Canon will carry out the SED panel business independently in order to facilitate the earliest possible launch of a commercial SED television business. Canon, with the necessary cooperation from Toshiba, will make every effort for the smooth launch of its television business based on the high image quality achieved by SED technology.

Canon Electronics Inc. acquired the shares of e-System Corporation (listed on the Hercules Section of the Osaka Securities Exchange) through a third-party distribution and made it into a subsidiary as of December 27, 2006. By making e-System Corporation a subsidiary, Canon Electronics Inc. aims to make further advances in its group's information-related business and develop it into a core business.

MARKET RISK EXPOSURE

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

Equity Price Risk

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

Maturities and fair values of such marketable securities and investments were as follows at December 31, 2006.

Available-for-sale securities	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥ 295	294	$ 2,478	2,470
Due after one year through five years	5,606	7,104	47,109	59,697
Due after five years	2,891	2,947	24,294	24,765
Equity securities	12,648	29,852	106,286	250,857
	¥21,440	40,197	$180,167	337,789

Held-to-maturity securities	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥10,151	10,151	$ 85,303	85,303
Due after one year through five years	10,311	10,311	86,647	86,647
	¥20,462	20,462	$171,950	171,950

Foreign Currency Exchange Rate and Interest Rate Risk

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

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

The following table provides information about Canon's major derivative financial instruments related to foreign currency exchange transactions existing at December 31, 2006. All of the foreign exchange contracts described in the following table have a contractual maturity date in 2007.

				Millions of yen
Forwards to sell foreign currencies:	U.S.$	euro	Others	Total
Contract amounts	¥392,402	286,148	38,586	717,136
Estimated fair value	(6,692)	(8,671)	(392)	(15,755)
Forwards to buy foreign currencies:				
Contract amounts	¥ 34,004	3,204	13,981	51,189
Estimated fair value	(310)	(111)	(1,051)	(1,472)

				Thousands of U.S. dollars
Forwards to sell foreign currencies:	U.S.$	euro	Others	Total
Contract amounts	$3,297,496	2,404,605	324,252	6,026,353
Estimated fair value	(56,235)	(72,866)	(3,294)	(132,395)
Forwards to buy foreign currencies:				
Contract amounts	$ 285,748	26,924	117,488	430,160
Estimated fair value	(2,605)	(933)	(8,832)	(12,370)

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

For debt obligations, the table below presents principal cash flows by expected maturity dates and related weighted average interest rates, as of December 31, 2006.

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

	Weighted Average Interest Rates	Total	Expected Maturity Date 2007	2008	2009	2010	2011	Thereafter	Estimated Fair Value
Japanese yen notes	2.61%	**¥20,000**	10,000	10,000	—	—	—	—	20,319
Japanese yen convertible debentures	1.30%	**318**	—	318	—	—	—	—	1,819
Other long-term debt	1.34%	**10,734**	5,263	3,132	1,832	418	69	20	10,657
Total		**¥31,052**	15,263	13,450	1,832	418	69	20	32,795

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

	Weighted Average Interest Rates	Total	Expected maturity date 2007	2008	2009	2010	2011	Thereafter	Estimated Fair Value
Japanese yen notes	2.61%	**$168,068**	84,034	84,034	—	—	—	—	170,748
Japanese yen convertible debentures	1.30%	**2,672**	—	2,672	—	—	—	—	15,286
Other long-term debt	1.34%	**90,201**	44,226	26,319	15,395	3,513	580	168	89,554
Total		**$260,941**	128,260	113,025	15,395	3,513	580	168	275,588

Note: All long-term debt is fixed rate.

Derivative financial instruments designated as fair value hedges principally relate to interest rate swaps associated with fixed-rate debt obligations. Changes in fair values of the hedged debt obligations and derivative instruments designated as fair value hedges of these debt obligations are recognized in other income (deductions). There is no hedging ineffectiveness or net gains or losses excluded from the assessment of hedge effectiveness for fiscal 2004 as the critical terms of the interest rate swaps match the terms of the hedged debt obligations. Canon had no fair value hedges in 2006 or 2005.

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

The amounts of the hedging ineffectiveness are not material for the years ended December 31, 2006, 2005 and 2004. The amounts of net gains or losses excluded from the assessment of hedge effectiveness which are recorded in other income (deductions) are net losses of ¥5,917 million (U.S.$50 million), ¥3,725 million and ¥2,096 million for the years ended December 31, 2006, 2005 and 2004, respectively.

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

LOOKING FORWARD

The global economy is generally expected to maintain a prolonged economic growth this year, despite predictions of slightly lower growth rate in major areas of Japan, the U.S., and Europe. Business competition in general, however, is expected to further intensify and the business conditions surrounding the Canon Group will likely remain difficult.

Under these circumstances, the Canon Group has positioned 2007, the second year of Phase III (2006 to 2010) of its "Excellent Global Corporation Plan," as a year for fundamental strengthening to achieve 2010 objectives and will accelerate our growth.

For this year, the 70th anniversary of our founding, key objectives toward that end include, first of all, introducing even more competitive new products to boost our competitiveness against other companies with the aim of achieving the overwhelming No.1 position worldwide in all of our current core businesses. Secondly, we aim to achieve steady cost reductions and further reduce our cost ratio through continuous measures to improve productivity, such as promoting production automation by introducing high-speed automation equipment; bringing the in-house production of more key parts, taking procurement innovation activities to an even higher level; and building an IT system that centralizes business information for everything from planning and development to production, sales, procurement, and logistics.

Renewing our awareness that companies' mission is to maintain product quality, we will build or enhance our systems for quality management, safety management and crisis management, including measures to heighten awareness, to help ensure that our quality fits for an excellent global corporation.

We will also reform our research and development activities from the new perspective to secure robust patents, which are a critical lifeline for a manufacturer and the very source of competitiveness for a high-value-added manufacturing business. Lastly, toward the objective of becoming a truly excellent global corporation, we will bring to bear the resource of the entire Canon Group to ensure that our compliance activities are thoroughly implemented, that our internal controls are strictly enforced, and that our management excels in transparency.

Business Machines Segment

Office imaging products

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

To maintain and enhance a competitive edge and to meet more sophisticated customer demands, Canon is strengthening its marketing capabilities by reinforcing its hardware and software product lineups and by improving functionality. In 2006, Canon strengthened the product lineups of its color digital devices in addition to its existing full line of monochrome machines and maintained its market share by executing business strategies in line with current market trends.

Computer peripheral products

In the Inkjet printer market, Canon expects a continuation of declines in market prices, slowdown in market growth, and a shift from single-function printers ("SFP") to MFPs. To manage in line with these trends, Canon launched new lineups of SFP and MFP from flagship to entry models in order to expand its printer sales.

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

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

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

Business information products

The market for business-use document scanners has further expanded as demand for document scanners has accelerated due to the evolving office IT environment and the need to comply with various laws related to the management of information. Under these conditions, in the "DR Scanner series", Canon has introduced the "DR-2050C II" as a new product for the segment of affordable machines with the most significantly expanding demand and worked to expand sales of this product and the "DR-1210C" introduced in the first half of 2006. As a result, sales steadily increased.

With regard to servers and personal computers, demand from corporate clients in the Japanese market held steady in fiscal 2006, but a decline in sales was caused by Canon's change in marketing strategy from selling single products to a solutions business involving the proposal of unique combinations of various products. This trend is expected to continue in fiscal 2007.

Cameras Segment

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

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

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

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

Canon played a major role in the continued expansion of the digital SLR market in fiscal 2006. This market is expected to continue growing for the time being. However, Canon expects the growth rate to decline over-time .

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

Canon expects the interchangeable lens market to grow as a result of the rapid market penetration of digital SLR cameras. Canon aims to expand its sales and market share by introducing the most suitable products for the digital SLR camera market, which is expected to continue growing.

For video camcorders, analog camcorder sales have been further replaced by sales of digital camcorders even in the United States and Europe, where this transition had been comparatively slow. Now almost the entire world has made the switch over to digital. Against this background two new trends have emerged in the market. First, the introduction of video cameras using DVDs, HDDs, SD cards and other new forms of media has resulted in a trend in which convenience offered by the products is increasingly emphasized. Second, the trend towards higher picture quality has evolved, provided by products using high-resolution recording methods such as HDV and AVC HD. Canon believes that these two trends are stimulating the market by responding to more diverse user needs, and will likely contribute to further growth for the overall digital video market.

Canon will seek continued sales growth with a stronger product line while investing in research and development in order to better respond to new market trends.

Canon expects that the market for business-use liquid crystal projectors will continue to grow by about 20% per year on a unit basis, while market prices will continue to decline, resulting in almost no growth in monetary terms. In addition to our independently developed SX50 high-resolution projector released at the end of 2004, Canon has also introduced the SX6, 60 and X600 models late in the second half of 2006. The high picture quality and resolution offered by these models have won high praise from system integrators, allowing Canon to capture a large share of the market for high-resolution projectors. Canon expects to continue to develop distinctive, value-added products by further improving picture quality, resolution and brightness.

Optical and Other Products Segment

In the semiconductor-production equipment industry, equipment manufacturers must provide high quality products corresponding to rapid technology progress.

Canon will continue to focus on developing new products which adopt leading-edge technologies, such as immersion exposure technology and ultra precision processing and measurement technology.

In the LCD production mask aligner market, Canon will seek to strengthen its technical capabilities to meet the recent trend toward larger glass-substrates due to the increasing demand for larger LCD televisions.

In addition, Canon will continue to make distinctive products enabling high resolution and high productivity.

In the TV lens market, demand for HDTV, which has grown in the United States and Japan, is now growing as well in Europe. In particular, there has been increased demand for lenses used for broadcasting sporting events and for producing dramas and documentaries. Canon also expects to see new demand in China and other Asian markets thanks to greater progress in digitalization. At the same time, there have been signs of expanded HDTV applications by the press in Japan and the United States while Canon already has a major market share worldwide for this class of lens, it intends to continue to strengthen its position in this market.

Forward Looking Statements

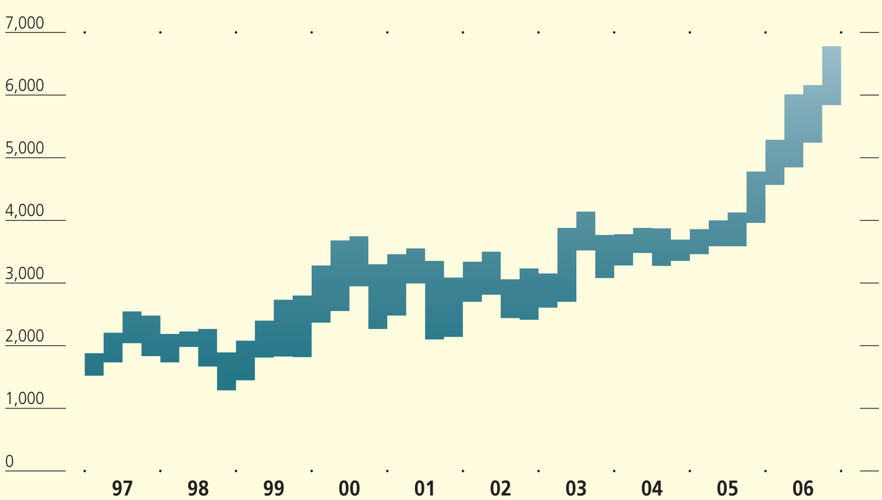
The foregoing discussion and other disclosure in this report contains forward-looking statements that reflect management's current views with respect to certain future events and financial performance. Actual results may differ materially from those projected or implied in the forward-looking statements. Further, certain forward-looking statements are based upon assumptions of future events that may not prove to be accurate. The following important factors could cause actual results to differ materially from those projected or implied in any forward-looking statements: foreign currency exchange rate fluctuations; the uncertainty of Canon's ability to implement its plans to localize production and other measures to reduce the impact of foreign currency exchange rate fluctuations; uncertainty as to economic conditions, in Canon's major markets; uncertainty of continued demand for Canon's high-value-added products; uncertainty as to the recovery of computer and related markets; uncertainty of recovery in demand for Canon's semiconductor production equipment; Canon's ability to continue to develop products and to market products that incorporate new technology on a timely basis, are competitively priced and achieve market acceptance; the possibility of losses resulting from foreign currency transactions designed to reduce financial risks from changes in foreign currency exchange rate; and inventory risk due to shifts in market demand.

TEN-YEAR FINANCIAL SUMMARY

Millions of yen except per share amounts

	2006	2005	2004	2003
Net sales:				
Domestic	¥ 932,290	856,205	849,734	801,400
Overseas	3,224,469	2,897,986	2,618,119	2,396,672
Total	4,156,759	3,754,191	3,467,853	3,198,072
Percentage of previous year	110.7%	108.3	108.4	108.8
Net income	455,325	384,096	343,344	275,730
Percentage of sales	11.0%	10.2	9.9	8.6
Advertising	116,809	106,250	111,770	100,278
Research and development	308,307	286,476	275,300	259,140
Depreciation of property, plant and equipment	235,804	205,727	174,397	168,636
Capital expenditure	379,657	383,784	318,730	210,038
Long-term debt, excluding current installments	15,789	27,082	28,651	59,260
Stockholders' equity	2,986,606	2,604,682	2,209,896	1,865,545
Total assets	4,521,915	4,043,553	3,587,021	3,182,148
Per share data:				
Income before cumulative effect of change in accounting principles:				
Basic	341.95	288.63	258.53	209.21
Diluted	341.84	288.36	257.85	207.17
Net income:				
Basic	341.95	288.63	258.53	209.21
Diluted	341.84	288.36	257.85	207.17
Cash dividends declared	83.33	66.67	43.33	33.33
Stock price:				
High	6,780	4,780	3,880	4,140
Low	4,567	3,460	3,273	2,607
Average number of common shares in thousands	1,331,542	1,330,761	1,328,048	1,317,974
Number of employees	118,499	115,583	108,257	102,567

Common Stock Price Range (Tokyo Stock Exchange)
(Yen)



2002	2001	2000	1999	1998	1997	Thousands of U.S. dollars except per share amounts 2006
732,551	827,288	779,366	718,513	725,063	811,455	**$ 7,834,370**
2,207,577	2,080,285	1,917,054	1,812,383	2,011,021	1,858,079	**27,096,378**
2,940,128	2,907,573	2,696,420	2,530,896	2,736,084	2,669,534	**34,930,748**
101.1	107.8	106.5	92.5	102.5	108.0	**110.7%**
190,737	167,561	134,088	70,234	109,569	118,813	**3,826,261**
6.5	5.8	5.0	2.8	4.0	4.5	**11.0%**
71,725	66,837	67,840	67,544	76,911	75,800	**981,588**
233,669	218,616	194,552	177,922	176,967	170,793	**2,590,815**
158,469	147,286	144,043	155,682	159,888	137,777	**1,981,546**
198,702	207,674	170,986	200,386	221,401	219,779	**3,190,395**
81,349	95,526	142,925	165,277	180,320	226,889	**132,681**
1,591,950	1,458,476	1,298,914	1,202,003	1,155,520	1,109,511	**25,097,529**
2,942,706	2,844,756	2,832,125	2,587,532	2,728,329	2,872,779	**37,999,286**
145.04	124.71	102.44	53.77	84.07	91.82	**2.87**
143.20	123.03	101.01	53.00	82.62	89.73	**2.87**
145.04	127.53	102.44	53.77	84.07	91.82	**2.87**
143.20	125.80	101.01	53.00	82.62	89.73	**2.87**
20.00	16.67	14.00	11.33	11.33	11.33	**0.70**
3,500	3,553	3,747	2,800	2,267	2,547	**56.97**
2,413	2,100	2,267	1,447	1,287	1,520	**38.38**
1,315,074	1,313,940	1,308,909	1,306,049	1,303,374	1,293,996	
97,802	93,620	86,673	81,009	79,799	78,767	

Notes: 1. U.S. dollar amounts are translated from yen at the rate of U.S.$1 = ¥119, the approximate exchange rate on the Tokyo Foreign Exchange Market as of December 29, 2006.
2. Canon has made a three-for-two stock split on July 1, 2006. All per share information has been adjusted to reflect the stock split.

CONSOLIDATED BALANCE SHEETS
CANON INC. AND SUBSIDIARIES

December 31, 2006 and 2005

	Millions of yen		Thousands of U.S. dollars (note 2)
ASSETS	2006	2005	2006
Current assets:			
Cash and cash equivalents	¥1,155,626	1,004,953	$ 9,711,143
Marketable securities (notes 4 and 11)	10,445	172	87,773
Trade receivables, net (note 5)	761,947	689,427	6,402,916
Inventories (note 6)	539,057	510,195	4,529,891
Prepaid expenses and other current assets (notes 1, 8 and 14)	315,274	253,822	2,649,361
Total current assets	2,782,349	2,458,569	23,381,084
Noncurrent receivables (note 20)	14,335	14,122	120,462
Investments (notes 4 and 11)	110,418	104,486	927,882
Property, plant and equipment, net (notes 7 and 8)	1,266,425	1,148,821	10,642,227
Other assets (notes 8, 9, 10, 13 and 14)	348,388	317,555	2,927,631
Total assets	¥4,521,915	4,043,553	$37,999,286

LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Short-term loans and current portion of long-term debt (note 11)	¥ 15,362	5,059	$ 129,092
Trade payables (note 12)	493,058	505,126	4,143,345
Income taxes (note 14)	133,745	110,844	1,123,908
Accrued expenses (note 20)	303,353	248,205	2,549,185
Other current liabilities (notes 7 and 14)	217,789	209,394	1,830,159
Total current liabilities	1,163,307	1,078,628	9,775,689
Long-term debt, excluding current installments (note 11)	15,789	27,082	132,681
Accrued pension and severance cost (note 13)	83,876	80,430	704,840
Other noncurrent liabilities (note 14)	55,536	52,395	466,689
Total liabilities	1,318,508	1,238,535	11,079,899
Minority interests	216,801	200,336	1,821,858
Commitments and contingent liabilities (note 20)			
Stockholders' equity:			
Common stock			
Authorized 3,000,000,000 shares; issued 1,333,445,830 shares in 2006 and 1,333,114,169 shares in 2005 (note 15)	174,603	174,438	1,467,252
Additional paid-in capital (note 15)	403,510	403,246	3,390,840
Legal reserve (note 16)	43,600	42,331	366,386
Retained earnings (note 16)	2,368,047	2,018,289	19,899,555
Accumulated other comprehensive income (loss) (note 17)	2,718	(28,212)	22,840
Treasury stock, at cost 1,794,390 shares in 2006 and 1,718,523 shares in 2005	(5,872)	(5,410)	(49,344)
Total stockholders' equity	2,986,606	2,604,682	25,097,529
Total liabilities and stockholders' equity	¥4,521,915	4,043,553	$37,999,286

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

CANON INC. AND SUBSIDIARIES

Year ended December 31 2006, 2005 and 2004

	Millions of yen			Thousands of U.S. dollars (note 2)
	2006	2005	2004	**2006**
Net sales	**¥4,156,759**	3,754,191	3,467,853	**$34,930,748**
Cost of sales (notes 10, 13 and 20)	**2,096,279**	1,935,148	1,754,510	**17,615,790**
Gross profit	**2,060,480**	1,819,043	1,713,343	**17,314,958**
Operating expenses:				
Selling, general and administrative expenses (notes 1, 10, 13 and 20)	**1,045,140**	949,524	894,250	**8,782,689**
Research and development expenses	**308,307**	286,476	275,300	**2,590,815**
	1,353,447	1,236,000	1,169,550	**11,373,504**
Operating profit	**707,033**	583,043	543,793	**5,941,454**
Other income (deductions):				
Interest and dividend income	**27,153**	14,252	7,118	**228,176**
Interest expense	**(2,190)**	(1,741)	(2,756)	**(18,403)**
Other, net (notes 1, 4 and 19)	**(12,853)**	16,450	3,961	**(108,009)**
	12,110	28,961	8,323	**101,764**
Income before income taxes and minority interests	**719,143**	612,004	552,116	**6,043,218**
Income taxes (note 14)	**248,233**	212,785	194,014	**2,085,991**
Income before minority interests	**470,910**	399,219	358,102	**3,957,227**
Minority interests	**15,585**	15,123	14,758	**130,966**
Net income	**¥ 455,325**	384,096	343,344	**$ 3,826,261**

	Yen			U.S. dollars (note 2)
Net income per share (note 18):				
Basic	**¥ 341.95**	288.63	258.53	**$ 2.87**
Diluted	**341.84**	288.36	257.85	**2.87**
Cash dividends per share	**83.33**	66.67	43.33	**0.70**

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

CANON INC. AND SUBSIDIARIES

	Millions of yen						
	Common Stock	Additional paid-in capital	Legal reserve	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total stockholders' equity
Balance at December 31, 2003	¥168,892	396,939	39,998	1,410,442	(143,275)	(7,451)	1,865,545
Conversion of convertible debt and other	4,972	4,966					9,938
Stock exchanged under exchange offering		114				2,691	2,805
Capital transaction by consolidated subsidiaries and affiliated companies		(246)					(246)
Cash dividends				(52,950)			(52,950)
Transfers to legal reserve			1,202	(1,202)			—
Comprehensive income:							
Net income				343,344			343,344
Other comprehensive income (loss), net of tax (note 17)							
Foreign currency translation adjustments					4,050		4,050
Net unrealized gains and losses on securities					686		686
Net gains and losses on derivative instruments					(396)		(396)
Minimum pension liability adjustments					37,623		37,623
Total comprehensive income							385,307
Repurchase of treasury stock, net						(503)	(503)
Balance at December 31, 2004	¥173,864	401,773	41,200	1,699,634	(101,312)	(5,263)	2,209,896
Conversion of convertible debt and other	574	574					1,148
Capital transaction by consolidated subsidiaries and affiliated companies		899					899
Cash dividends				(64,310)			(64,310)
Transfers to legal reserve			1,131	(1,131)			—
Comprehensive income:							
Net income				384,096			384,096
Other comprehensive income (loss), net of tax (note 17)							
Foreign currency translation adjustments					53,979		53,979
Net unrealized gains and losses on securities					(1,397)		(1,397)
Net gains and losses on derivative instruments					(481)		(481)
Minimum pension liability adjustments					20,999		20,999
Total comprehensive income							457,196
Repurchase of treasury stock, net						(147)	(147)
Balance at December 31, 2005	¥174,438	403,246	42,331	2,018,289	(28,212)	(5,410)	2,604,682
Conversion of convertible debt and other	**165**	**264**					**429**
Cash dividends				**(104,298)**			**(104,298)**
Transfers to legal reserve			**1,269**	**(1,269)**			**—**
Comprehensive income:							
Net income				**455,325**			**455,325**
Other comprehensive income (loss), net of tax (note 17)							
Foreign currency translation adjustments					**48,630**		**48,630**
Net unrealized gains and losses on securities					**1,992**		**1,992**
Net gains and losses on derivative instruments					**(489)**		**(489)**
Minimum pension liability adjustments					**(3,575)**		**(3,575)**
Total comprehensive income							**501,883**
Adjustment to initially apply SFAS 158, net of tax (note 13)					**(15,628)**		**(15,628)**
Repurchase of treasury stock, net						**(462)**	**(462)**
Balance at December 31, 2006	**¥174,603**	**403,510**	**43,600**	**2,368,047**	**2,718**	**(5,872)**	**2,986,606**
	Thousands of U.S. dollars (note 2)						
Balance at December 31, 2005	$1,465,865	3,388,622	355,722	16,960,412	(237,075)	(45,462)	21,888,084
Conversion of convertible debt and other	**1,387**	**2,218**					**3,605**
Cash dividends				**(876,454)**			**(876,454)**
Transfers to legal reserve			**10,664**	**(10,664)**			**—**
Comprehensive income:							
Net income				**3,826,261**			**3,826,261**
Other comprehensive income (loss), net of tax (note 17)							
Foreign currency translation adjustments					**408,655**		**408,655**
Net unrealized gains and losses on securities					**16,739**		**16,739**
Net gains and losses on derivative instruments					**(4,109)**		**(4,109)**
Minimum pension liability adjustments					**(30,042)**		**(30,042)**
Total comprehensive income							**4,217,504**
Adjustment to initially apply SFAS 158, net of tax (note 13)					**(131,328)**		**(131,328)**
Repurchase of treasury stock, net						**(3,882)**	**(3,882)**
Balance at December 31, 2006	**$1,467,252**	**3,390,840**	**366,386**	**19,899,555**	**22,840**	**(49,344)**	**25,097,529**

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

CANON INC. AND SUBSIDIARIES

Year ended December 31 2006, 2005 and 2004

	Millions of yen			Thousands of U.S. dollars (note 2)
	2006	2005	2004	**2006**
Cash flows from operating activities:				
Net income	**¥ 455,325**	384,096	343,344	**$ 3,826,261**
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	**262,294**	225,941	192,692	**2,204,151**
Loss on disposal of property, plant and equipment	**16,182**	13,784	24,597	**135,983**
Deferred income taxes	**(6,945)**	(766)	9,060	**(58,361)**
Increase in trade receivables	**(40,969)**	(48,391)	(53,595)	**(344,277)**
(Increase) decrease in inventories	**(5,542)**	27,558	(40,050)	**(46,571)**
(Decrease) increase in trade payables	**(2,313)**	16,018	65,873	**(19,437)**
Increase in income taxes	**22,657**	1,998	21,689	**190,395**
Increase in accrued expenses	**36,165**	31,241	8,196	**303,908**
Decrease in accrued pension and severance cost	**(20,309)**	(16,221)	(16,924)	**(170,664)**
Other, net	**(21,304)**	(29,580)	6,647	**(179,027)**
Net cash provided by operating activities	**695,241**	605,678	561,529	**5,842,361**
Cash flows from investing activities:				
Purchases of fixed assets	**(424,862)**	(395,055)	(256,714)	**(3,570,269)**
Proceeds from sale of fixed assets	**12,507**	14,827	7,431	**105,101**
Purchases of available-for-sale securities	**(7,768)**	(5,680)	(388)	**(65,277)**
Purchases of held-to-maturity securities	**—**	—	(21,544)	**—**
Proceeds from sale of available-for-sale securities	**4,047**	12,337	9,735	**34,008**
Increase in time deposits	**(35,863)**	(6,090)	—	**(301,370)**
Acquisitions of subsidiaries, net of cash acquired	**(2,485)**	(17,657)	—	**(20,882)**
Proceeds from sale of subsidiary common stock	**—**	—	9,731	**—**
Purchases of other investments	**(8,911)**	(19,531)	(8,628)	**(74,882)**
Other, net	**2,530**	15,708	7,410	**21,260**
Net cash used in investing activities	**(460,805)**	(401,141)	(252,967)	**(3,872,311)**
Cash flows from financing activities:				
Proceeds from issuance of long-term debt	**1,053**	1,716	2,115	**8,849**
Repayments of long-term debt	**(5,861)**	(15,187)	(43,175)	**(49,252)**
Decrease in short-term loans	**(828)**	(12,011)	(3,046)	**(6,958)**
Dividends paid	**(104,298)**	(64,310)	(52,950)	**(876,454)**
Purchases of treasury stock, net	**(462)**	(147)	(494)	**(3,882)**
Other, net	**2,909**	(4,000)	(4,718)	**24,445**
Net cash used in financing activities	**(107,487)**	(93,939)	(102,268)	**(903,252)**
Effect of exchange rate changes on cash and cash equivalents	**23,724**	6,581	(8,818)	**199,362**
Net increase in cash and cash equivalents	**150,673**	117,179	197,476	**1,266,160**
Cash and cash equivalents at beginning of year	**1,004,953**	887,774	690,298	**8,444,983**
Cash and cash equivalents at end of year	**¥1,155,626**	1,004,953	887,774	**$ 9,711,143**
Supplemental disclosure for cash flow information (note 22):				
Cash paid during the year for:				
Interest	**¥ 2,146**	1,919	2,981	**$ 18,034**
Income taxes	**244,236**	211,540	164,450	**2,052,403**

See accompanying notes to consolidated financial statements.

(1) Basis of Presentation and Significant Accounting Policies

(a) Description of Business

Canon Inc. (the "Company") and subsidiaries (collectively "Canon") is one of the world's leading manufacturers in such fields as office imaging products, computer peripherals, business information products, cameras, and optical related products. Office imaging products consist mainly of copying machines and digital multifunction devices. Computer peripherals consist mainly of laser beam and inkjet printers. Business information products consist mainly of computer information systems, micrographics and calculators. Cameras consist mainly of single lens reflex ("SLR") cameras, compact cameras, digital cameras and video camcorders. Optical related products include steppers and aligners used in semiconductor chip production, projection aligners used in the production of liquid crystal displays ("LCDs"), broadcasting lenses and medical equipment. Canon's consolidated net sales for the years ended December 31, 2006, 2005 and 2004 were distributed as follows: office imaging products 28%, 31% and 33%, computer peripherals 34%, 33% and 33%, business information products 3%, 3% and 3%, cameras 25%, 23% and 22%, and optical and other products 10%, 10% and 9%, respectively.

Sales are made principally under the Canon brand name, almost entirely through sales subsidiaries. These subsidiaries are responsible for marketing and distribution, and primarily sell to retail dealers in their geographical area. Approximately 75%, 74% and 73% of consolidated net sales for the years ended December 31, 2006, 2005 and 2004 were generated outside Japan, with 31%, 30% and 30% in the Americas, 31%, 32% and 31% in Europe, and 13%, 12% and 12% in other areas, respectively.

Canon sells laser beam printers on an OEM basis to Hewlett-Packard Company; such sales constituted approximately 22%, 21% and 21% of consolidated net sales for the years ended December 31, 2006, 2005 and 2004, respectively.

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

(b) Basis of Presentation

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

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

(c) Principles of Consolidation

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

(d) Use of Estimates

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

(e) Cash Equivalents and Time Deposits

All highly liquid investments acquired with an original maturity of three months or less are considered to be cash equivalents. Time deposits with an original maturity of more than three months are ¥41,953 million ($352,546 thousand) and ¥6,090 million at December 31, 2006 and 2005, respectively, and are included in prepaid expenses and other current assets in the accompanying consolidated balance sheets.

(f) Translation of Foreign Currencies

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

Gains and losses resulting from foreign currency transactions, including foreign exchange contracts, and translation of assets and liabilities denominated in foreign currencies are included in other income (deductions). Foreign currency exchange losses, net were ¥25,804 million ($216,840 thousand), ¥3,710 million and ¥17,800 million for the years ended December 31, 2006, 2005 and 2004, respectively.

(g) Marketable Securities and Investments

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

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

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

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

(h) Allowance for Doubtful Receivables

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

(i) Inventories

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

(j) Investments in Affiliated Companies

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

(k) Impairment of Long-Lived Assets

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

(l) Property, Plant and Equipment

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

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

(m) Goodwill and Other Intangible Assets

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

(n) Environmental Liabilities

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

(o) Income Taxes

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

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

(p) Issuance of Stock by Subsidiaries and Equity Investees

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

(q) Net Income per Share

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

(r) Revenue Recognition

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

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

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

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

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

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

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

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

(s) Research and Development Costs

Research and development costs are expensed as incurred.

(t) Advertising Costs

Advertising costs are expensed as incurred. Advertising expenses were ¥116,809 million ($981,588 thousand), ¥106,250 million and ¥111,770 million for the years ended December 31, 2006, 2005 and 2004, respectively.

(u) Shipping and Handling Costs

Shipping and handling costs totaled ¥62,626 million ($526,269 thousand), ¥50,052 million and ¥46,953 million for the years ended December 31, 2006, 2005 and 2004, respectively, and are included in selling, general and administrative expenses in the consolidated statements of income.

(v) Derivative Financial Instruments

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

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

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

(w) Guarantees

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

(x) New Accounting Standards

In June 2006, the FASB ratified the EITF consensus on EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43" ("EITF 06-2"). EITF 06-2 provides guidance for an accrual of compensated absences that require a minimum service period but have no increase in the benefit even with additional years of service. EITF 06-2 is effective for fiscal years beginning after December 15, 2006, and is required to be adopted by Canon in the first quarter beginning January 1, 2007. The adoption of EITF 06-2 will not have a material impact on Canon's consolidated results of operations and financial condition.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be adopted by Canon in the first quarter beginning January 1, 2007. The adoption of FIN 48 will not have a material impact on Canon's consolidated results of operations and financial condition.

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by Canon in the first quarter beginning January 1, 2008. Canon is currently evaluating the effect that the adoption of SFAS 157 will have on its consolidated results of operations and financial condition but does not expect SFAS 157 to have a material impact.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)" ("SFAS 158"). SFAS 158 requires plan sponsors of defined benefit pension and other postretirement benefit plans (collectively, "postretirement benefit plans") to recognize the funded status of their postretirement benefit plans in the consolidated balance sheet, measure the fair value of plan assets and benefit obligations as of the date of the fiscal year-end consolidated balance sheet, and provide additional disclosures. On December 31, 2006, Canon adopted the recognition and disclosure provisions of SFAS 158. The effect of adopting SFAS 158 on Canon's financial condition at December 31, 2006 has been included in the accompanying consolidated financial statements. SFAS 158 did not have an effect on Canon's consolidated financial condition at December 31, 2005. SFAS 158's provisions regarding the change in the measurement date of postretirement benefit plans will not have a material impact on Canon's consolidated results of operations and financial condition as Canon already uses a measurement date of December 31 for the majority of its plans. See Note 13 for further discussion of the effect of adopting SFAS 158 on Canon's consolidated financial statements.

In September 2006, the Securities and Exchange Commission ("SEC") staff published Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 requires quantification of the effects of financial statement errors on each of the balance sheets and statements of income and the related financial statement disclosures. SAB 108 was adopted by Canon in the year ended December 31, 2006. The adoption of SAB 108 did not have a material impact on Canon's consolidated results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115" ("SFAS 159"). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by Canon in the first quarter beginning January 1, 2008. Canon is currently evaluating the effect that the adoption of SFAS 159 will have on its consolidated results of operations and financial condition but does not expect SFAS 159 to have a material impact.

(y) Reclassification

Certain reclassifications have been made to the prior years' consolidated financial statements to conform with the presentation used for the year ended December 31, 2006.

(2) Basis of Financial Statement Translation

The consolidated financial statements presented herein are expressed in Japanese yen and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ¥119= U.S.$1, the approximate exchange rate prevailing on the Tokyo Foreign Exchange Market on December 29, 2006. This translation should not be construed as a representation that the amounts shown could be converted into United States dollars at such rate.

(3) Foreign Operations

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

	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	**2006**
December 31:				
Total assets	**¥1,995,927**	1,751,011	1,500,197	**$16,772,496**
Net assets	**907,845**	767,711	632,657	**7,628,950**
Year ended December 31:				
Net sales	**¥3,119,102**	2,774,443	2,548,700	**$26,210,941**
Net income	**114,916**	81,916	70,227	**965,681**

(4) Marketable Securities and Investments

The cost, gross unrealized holding gains, gross unrealized holding losses and fair value for available-for-sale securities and held-to-maturity securities by major security type at December 31, 2006 and 2005 were as follows:

December 31 Millions of yen	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2006: Current:				
Available-for-sale:				
Government bonds	**¥ 224**	**—**	**—**	**224**
Bank debt securities	**71**	**—**	**1**	**70**
	295	**—**	**1**	**294**
Held-to-maturity:				
Corporate debt securities	**10,151**	**—**	**—**	**10,151**
	¥10,446	**—**	**1**	**10,445**
Noncurrent:				
Available-for-sale:				
Government bonds	**¥ 335**	**—**	**15**	**320**
Corporate debt securities	**4,090**	**35**	**1**	**4,124**
Fund trusts	**4,072**	**1,536**	**1**	**5,607**
Equity securities	**12,648**	**17,479**	**275**	**29,852**
	21,145	**19,050**	**292**	**39,903**
Held-to-maturity:				
Corporate debt securities	**10,311**	**—**	**—**	**10,311**
	¥31,456	**19,050**	**292**	**50,214**

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

Thousands of U.S. dollars	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
2006: Current:				
Available-for-sale:				
Government bonds	$ 1,882	—	—	1,882
Bank debt securities	596	—	8	588
	2,478	—	8	2,470
Held-to-maturity:				
Corporate debt securities	85,303	—	—	85,303
	$ 87,781	—	8	87,773
Noncurrent:				
Available-for-sale:				
Government bonds	$ 2,815	—	126	2,689
Corporate debt securities	34,370	293	8	34,655
Fund trusts	34,218	12,908	8	47,118
Equity securities	106,286	146,882	2,311	250,857
	177,689	160,083	2,453	335,319
Held-to-maturity:				
Corporate debt securities	86,647	—	—	86,647
	$264,336	160,083	2,453	421,966

Maturities of debt securities and fund trusts classified as available-for-sale and held-to-maturity were as follows at December 31, 2006:

Available-for-sale securities

	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥ 295	294	$ 2,478	2,470
Due after one year through five years	5,606	7,104	47,109	59,697
Due after five years	2,891	2,947	24,294	24,765
	¥8,792	10,345	$73,881	86,932

Held-to-maturity securities

	Millions of yen		Thousands of U.S. dollars	
	Cost	Fair Value	Cost	Fair Value
Due within one year	¥10,151	10,151	$ 85,303	85,303
Due after one year through five years	10,311	10,311	86,647	86,647
	¥20,462	20,462	$171,950	171,950

The gross realized gains for the years ended December 31, 2006, 2005 and 2004 were ¥674 million ($5,664 thousand), ¥11,049 million and ¥3,867 million, respectively. The gross realized losses for the years ended December 31, 2006, 2005 and 2004 were not significant.

At December 31, 2006, substantially all of the available-for-sale and held-to-maturity securities with unrealized losses had been in a continuous unrealized loss position for less than 12 months.

Aggregate cost of non-marketable equity securities accounted for under the cost method totaled ¥18,462 million ($155,143 thousand) and ¥16,714 million at December 31, 2006 and 2005, respectively. Investments with an aggregate cost of ¥18,429 million ($154,866 thousand) were not evaluated for impairment because (a) Canon did not estimate the fair value of those investments as it was not practicable to estimate the fair value of the investments and (b) Canon did not identify any events or changes in circumstances that might have had significant adverse effects on the fair value of those investments.

Investments in affiliated companies accounted for by the equity method amounted to ¥40,143 million ($337,336 thousand) and ¥31,418 million at December 31, 2006 and 2005, respectively. Canon's share of the net earnings (losses) in affiliated companies accounted for by the equity method, included in other income (deductions), are earnings of ¥4,237 million ($35,605 thousand), ¥1,646 million and ¥1,921 million for the years ended December 31, 2006, 2005 and 2004, respectively.

(5) Trade Receivables

Trade receivables are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
Notes	**¥ 24,241**	27,328	**$ 203,706**
Accounts	**751,555**	673,827	**6,315,588**
	775,796	701,155	**6,519,294**
Less allowance for doubtful receivables	**(13,849)**	(11,728)	**(116,378)**
	¥761,947	689,427	**$6,402,916**

(6) Inventories

Inventories are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
Finished goods	**¥359,471**	359,934	**$3,020,765**
Work in process	**160,231**	132,520	**1,346,479**
Raw materials	**19,355**	17,741	**162,647**
	¥539,057	510,195	**$4,529,891**

(7) Property, Plant and Equipment

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

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
Land	**¥ 231,026**	199,595	**$ 1,941,395**
Buildings	**1,077,585**	997,351	**9,055,336**
Machinery and equipment	**1,261,176**	1,164,480	**10,598,118**
Construction in progress	**79,582**	59,558	**668,756**
	2,649,369	2,420,984	**22,263,605**
Less accumulated depreciation	**(1,382,944)**	(1,272,163)	**(11,621,378)**
	¥ 1,266,425	1,148,821	**$ 10,642,227**

Amounts due for purchases of property, plant and equipment were ¥122,081 million ($1,025,891 thousand) and ¥116,716 million at December 31, 2006 and 2005, respectively, and are included in other current liabilities in the accompanying consolidated balance sheets.

(8) Finance Receivables and Operating Leases

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

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
Total minimum lease payments receivable	**¥216,697**	204,774	**$1,820,983**
Unguaranteed residual values	**14,377**	13,849	**120,815**
Executory costs	**(2,923)**	(2,785)	**(24,563)**
Unearned income	**(24,930)**	(23,632)	**(209,496)**
	203,221	192,206	**1,707,739**
Less allowance for doubtful receivables	**(7,871)**	(8,372)	**(66,143)**
	195,350	183,834	**1,641,596**
Less amount due within one year	**(72,808)**	(69,211)	**(611,831)**
	¥122,542	114,623	**$1,029,765**

The cost of equipment leased to customers under operating leases included in property, plant and equipment, net at December 31, 2006 and 2005 was ¥62,357 million ($524,008 thousand) and ¥60,839 million, respectively. Accumulated depreciation on equipment under operating leases at December 31, 2006 and 2005 was ¥46,092 million ($387,328 thousand) and ¥45,285 million, respectively.

The following is a schedule by year of the future minimum lease payments to be received under financing leases and non-cancelable operating leases at December 31, 2006.

Year ending December 31	Millions of yen		Thousands of U.S. dollars	
	Financing Leases	Operating Leases	Financing Leases	Operating Leases
2007	¥ 86,961	5,689	$ 730,765	47,807
2008	64,107	2,996	538,714	25,176
2009	41,212	1,699	346,319	14,277
2010	18,368	770	154,353	6,471
2011	5,518	70	46,370	588
Thereafter	531	24	4,462	202
	¥216,697	11,248	$1,820,983	94,521

(9) Acquisitions

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

In 2004, the Company acquired all of the outstanding common shares of a precision plastic mold manufacturer, in an exchange offering for 866,880 shares of the Company's common stock. The aggregate value of the shares exchanged was approximately ¥2,805 million. In connection with this transaction, the Company recognized goodwill of ¥1,585 million, which was classified as other assets in the accompanying consolidated financial statements.

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

(10) Goodwill and Other Intangible Assets

Intangible assets acquired during the year ended December 31, 2006 totaled ¥46,791 million ($393,202 thousand), which are subject to amortization, and primarily consist of internal use software of ¥33,996 million ($285,681 thousand) and license fees of ¥5,898 million ($49,563 thousand). The weighted average amortization period for internal use software and license fees is approximately 4 years and 8 years, respectively.

The components of acquired intangible assets subject to amortization included in other assets at December 31, 2006 and 2005 were as follows:

December 31	2006		2005	
Millions of yen	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Software	**¥140,756**	**76,120**	¥121,729	70,535
License fees	**23,681**	**11,257**	20,567	11,329
Other	**24,899**	**4,919**	23,291	4,997
	¥189,336	**92,296**	¥165,587	86,861

	2006	
Thousands of U.S. dollars	Gross Carrying Amount	Accumulated Amortization
Software	**$ 1,182,824**	**639,664**
License fees	**199,000**	**94,597**
Other	**209,235**	**41,336**
	$ 1,591,059	**775,597**

Aggregate amortization expense for the years ended December 31, 2006, 2005 and 2004 was ¥26,490 million ($222,605 thousand), ¥20,214 million and ¥18,295 million, respectively. Estimated amortization expense for intangible assets currently held for the next five years ending December 31 is ¥29,979 million ($251,924 thousand) in 2007, ¥23,033 million ($193,555 thousand) in 2008, ¥14,374 million ($120,790 thousand) in 2009, ¥8,127 million ($68,294 thousand) in 2010, and ¥5,355 million ($45,000 thousand) in 2011.

Intangible assets not subject to amortization other than goodwill at December 31, 2006 and 2005 were not significant.

The changes in the carrying amount of goodwill for the years ended December 31, 2006 and 2005 were as follows:

Year ended December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Balance at beginning of year	¥40,161	24,233	$337,487
Goodwill acquired during the year	2,297	15,391	19,303
Recognition of acquired company's tax benefits	(1,038)	—	(8,723)
Translation adjustments and other	(619)	537	(5,201)
Balance at end of year	¥40,801	40,161	$342,866

During the year ended December 31, 2006, Canon recognized ¥1,038 million ($8,723 thousand) of deferred tax benefits relating to preexisting net operating tax losses of a company acquired in 2005. In connection therewith, Canon reduced the related goodwill by the same amount.

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

Short-term loans consisting of bank borrowings at December 31, 2006 and 2005 were ¥99 million ($832 thousand) and ¥67 million, respectively. The weighted average interest rate on short-term loans outstanding at December 31, 2006 and 2005 were 4.91% and 2.14%, respectively.

Long-term debt consisted of the following:

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Loans, principally from banks, maturing in installments through 2018; bearing weighted average interest of 1.34% and 1.40% at December 31, 2006 and 2005, respectively, partially secured by mortgage of property, plant and equipment	¥ 149	2,641	$ 1,251
2.95% Japanese yen notes, due 2007	10,000	10,000	84,034
2.27% Japanese yen notes, due 2008	10,000	10,000	84,034
1.30% Japanese yen convertible debentures, due 2008	318	649	2,672
Capital lease obligations	10,585	8,784	88,950
	31,052	32,074	260,941
Less amount due within one year	(15,263)	(4,992)	(128,260)
	¥ 15,789	27,082	$ 132,681

The aggregate annual maturities of long-term debt outstanding at December 31, 2006 were as follows:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2007	¥15,263	$128,260
2008	13,450	113,025
2009	1,832	15,395
2010	418	3,513
2011	69	580
Thereafter	20	168
	¥31,052	$260,941

Canon entered into an agreement whereby certain assets were deposited into an irrevocable trust to meet the debt service requirements of the: 2.95% Japanese yen notes; and 2.27% Japanese yen notes in the aggregate amount of ¥20,000 million ($168,068 thousand). The assets contributed by Canon were debt securities with carrying amounts of ¥20,462 million ($171,950 thousand) at December 31, 2006. Cash flows from such investments will be used solely to satisfy the principal and interest obligations for the debts. Accordingly, the debt securities are included in the consolidated balance sheets under the captions of marketable securities and investments.

Both short-term and long-term bank loans are made under general agreements which provide that security and guarantees for present and future indebtedness will be given upon request of the bank, and that the bank shall have the right to offset cash deposits against obligations that have become due or, in the event of default, against all obligations due to the bank.

The 1.30% Japanese yen convertible debentures due 2008 are convertible into approximately 319,000 shares of common stock at a conversion price of ¥998.00 ($8.39) per share at December 31, 2006. The debentures are redeemable at the option of the Company between January 1, 2007 and December 31, 2007 at premiums of 1%, and at par thereafter.

(12) Trade Payables

Trade payables are summarized as follows:

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
Notes	**¥ 15,902**	17,567	**$ 133,630**
Accounts	**477,156**	487,559	**4,009,715**
	¥493,058	505,126	**$4,143,345**

(13) Employee Retirement and Severance Benefits

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

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

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

Effective January 1, 2007, Canon and certain of its domestic subsidiaries have amended their defined benefit pension plans, and the projected benefit obligation has decreased by ¥101,620 million ($853,950 thousand). In conjunction therewith, Canon and certain of its domestic subsidiaries also have implemented a defined contribution pension plan for certain future pension benefits attributable to employees' future services.

Canon uses a measurement date of December 31 for the majority of its plans.

On December 31, 2006, Canon adopted the recognition and disclosure provisions of SFAS 158. SFAS 158 required Canon to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plans in the December 31, 2006 consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income (loss), net of tax. The adjustment to accumulated other comprehensive income (loss) at adoption represents the unrecognized actuarial loss, unrecognized prior service cost, and unrecognized net transition obligation, all of which were previously netted against the plans' funded status in the consolidated balance sheet pursuant to the provisions of SFAS 87. These amounts will be subsequently recognized as net periodic benefit cost pursuant to Canon's historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods will be recognized as a component of other comprehensive income (loss). Those amounts will be subsequently recognized as a component of net periodic benefit cost on the same basis as the amounts recognized in accumulated other comprehensive income (loss) at adoption of SFAS 158.

The incremental effects of adopting the provisions of SFAS 158 on the accompanying consolidated balance sheet at December 31, 2006 are presented in the following table. The adoption of SFAS 158 had no effect on the consolidated statement of income for the years ended December 31, 2006, or for any prior period presented, and it will not effect Canon's operating results in future periods. Had Canon not been required to adopt SFAS 158 at December 31, 2006, it would have recognized an additional minimum liability pursuant to the provisions of SFAS 87. The effect of recognizing the additional minimum liability is included in the table below in the column labeled "Before application of SFAS 158."

	Millions of yen		
	Before Application of SFAS 158	Adjustments	After Application of SFAS 158
Other assets	¥ 5,230	(2,206)	¥ 3,024
Accrued expenses	—	(90)	(90)
Accrued pension and severance cost	(57,031)	(26,845)	(83,876)
Deferred income taxes	6,408	9,516	15,924
Minority interests	1,517	3,997	5,514
Accumulated other comprehensive income (loss)	10,914	15,628	26,542

	Thousands of U.S. dollars		
	Before Application of SFAS 158	Adjustments	After Application of SFAS 158
Other assets	$ 43,949	(18,537)	$ 25,412
Accrued expenses	—	(757)	(757)
Accrued pension and severance cost	(479,252)	(225,588)	(704,840)
Deferred income taxes	53,849	79,966	133,815
Minority interests	12,748	33,588	46,336
Accumulated other comprehensive income (loss)	91,714	131,328	223,042

Obligations and funded status

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

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Change in benefit obligations:			
Benefit obligations at beginning of year	¥620,493	582,212	$5,214,227
Service cost	27,399	25,801	230,244
Interest cost	17,309	16,172	145,454
Plan participants' contributions	1,412	1,161	11,865
Amendments	(954)	(6,212)	(8,017)
Actuarial gain	23,586	3,340	198,202
Benefits paid	(13,064)	(12,239)	(109,782)
Acquisition	714	10,106	6,000
Foreign currency exchange rate changes	11,696	167	98,286
Other	—	(15)	—
Benefit obligations at end of year	688,591	620,493	5,786,479
Change in plan assets:			
Fair value of plan assets at beginning of year	545,518	418,798	4,584,185
Actual return on plan assets	18,858	93,844	158,471
Employer contributions	44,981	40,059	377,992
Plan participants' contributions	1,412	1,161	11,865
Benefits paid	(13,064)	(12,239)	(109,782)
Acquisition	320	3,486	2,689
Foreign currency exchange rate changes	9,624	409	80,874
Fair value of plan assets at end of year	607,649	545,518	5,106,294
Funded status at end of year	¥ (80,942)	(74,975)	$ (680,185)

Amounts recognized in the consolidated balance sheet at December 31, 2006 consist of:

	Millions of yen	Thousands of U.S. dollars
Other assets	**¥ 3,024**	**$ 25,412**
Accrued expenses	**(90)**	**(757)**
Accrued pension and severance cost	**(83,876)**	**(704,840)**
	¥ (80,942)	**$ (680,185)**

Amounts recognized in accumulated other comprehensive income (loss) at December 31, 2006 consist of:

	Millions of yen	Thousands of U.S. dollars
Actuarial loss	**¥ 139,305**	**$1,170,630**
Prior service cost	**(94,935)**	**(797,773)**
Net transition obligation	**3,610**	**30,336**
	¥ 47,980	**$ 403,193**

The funded status at December 31, 2005, reconciled to the net amount recognized in the consolidated balance sheet at that date, is summarized as follows:

	Millions of yen
Funded status	¥ (74,975)
Unrecognized actuarial loss	110,424
Unrecognized prior service cost	(101,552)
Unrecognized net transition obligation	3,955
Net amount recognized	¥ (62,148)

Amounts recognized in the consolidated balance sheet at December 31, 2005 consist of:

	Millions of yen
Other assets	¥ 3,089
Accrued pension and severance cost	(80,430)
Accumulated other comprehensive income (loss)	15,193
Net amount recognized	¥ (62,148)

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

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Accumulated benefit obligation	¥641,199	578,627	$5,388,227

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

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Plans with projected benefit obligations in excess of plan assets:			
Projected benefit obligations	¥656,722	587,162	$5,518,673
Fair value of plan assets	572,756	510,287	4,813,076
Plans with accumulated benefit obligations in excess of plan assets:			
Accumulated benefit obligations	608,812	545,375	5,116,067
Fair value of plan assets	568,615	506,634	4,778,277

Components of Net Periodic Benefit Cost

Net periodic benefit cost for Canon's employee retirement and severance defined benefit plans for the years ended December 31, 2006, 2005 and 2004 consisted of the following components:

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	2006
Service cost	¥ 27,399	25,801	26,571	$ 230,244
Interest cost	17,309	16,172	19,108	145,454
Expected return on plan assets	(26,199)	(19,651)	(17,054)	(220,160)
Amortization of net transition obligation	345	345	344	2,899
Amortization of prior service cost	(7,549)	(8,007)	(6,814)	(63,437)
Recognized actuarial loss	3,779	10,542	12,505	31,756
Settlement loss resulting from plan termination	—	—	2,784	—
Settlement loss resulting from transfer of substitutional portion of EPFs to the Japanese government	—	—	69,651	—
	¥ 15,084	25,202	107,095	$ 126,756

The estimated net transition obligation, prior service cost and actuarial loss for the defined benefit pension plans that will be amortized from accumulated other comprehensive income (loss) into net periodic benefit cost over the next year are summarized as follows.

The above prior service cost that will be amortized over the next year includes amortization amounting to ¥5,834 million ($49,025 thousand) of prior service cost resulting from the plan amendment effective January 1, 2007.

	Millions of yen	Thousands of U.S. dollars
Net transition obligation	¥ 345	$ 2,899
Prior service cost	(13,491)	(113,370)
Actuarial loss	6,100	51,261

Assumptions

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

December 31	2006	2005
Discount rate	**2.8%**	2.7%
Assumed rate of increase in future compensation levels	**3.4%**	3.3%

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

Year ended December 31	2006	2005	2004
Discount rate	**2.7%**	2.7%	2.7%
Assumed rate of increase in future compensation levels	**3.3%**	3.0%	2.0%
Expected long-term rate of return on plan assets	**4.8%**	4.6%	3.6%

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

Plan assets

The weighted-average asset allocations of Canon's benefit plans at December 31, 2006 and 2005 and target asset allocation by asset category are as follows:

December 31	2006	2005	Target Allocation
Asset category:			
Equity securities	**40.5%**	50.8%	37.5%
Debt securities	**40.5%**	34.6%	44.5%
Cash	**0.4%**	0.7%	0.1%
Life insurance company general accounts	**15.9%**	13.5%	15.7%
Other	**2.7%**	0.4%	2.2%
	100.0%	100.0%	100.0%

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

The plan's equity securities include common stock of the Company and certain of its subsidiaries in the amounts of ¥1,797 million ($15,101 thousand) and ¥1,311 million at December 31, 2006 and 2005, respectively.

Contributions

Canon expects to contribute ¥17,369 million ($145,958 thousand) to its defined benefit plans for the year ending December 31, 2007.

Estimated future benefit payments

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

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2007	¥ 10,709	$ 89,992
2008	12,514	105,160
2009	13,914	116,924
2010	15,216	127,866
2011	16,800	141,176
2012—2016	109,869	923,269

(14) Income Taxes

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

Year ended December 31	Millions of yen		
	Japanese	Foreign	Total
2006: Income before income taxes and minority interests	**¥556,759**	**162,384**	**719,143**
Income taxes:			
Current	**¥201,022**	**54,156**	**255,178**
Deferred	**(73)**	**(6,872)**	**(6,945)**
	¥200,949	**47,284**	**248,233**
2005: Income before income taxes and minority interests	¥492,709	119,295	612,004
Income taxes:			
Current	¥172,595	40,956	213,551
Deferred	3,441	(4,207)	(766)
	¥176,036	36,749	212,785
2004: Income before income taxes and minority interests	¥447,864	104,252	552,116
Income taxes:			
Current	¥162,679	22,275	184,954
Deferred	(1,065)	10,125	9,060
	¥161,614	32,400	194,014

	Thousands of U.S. dollars		
	Japanese	Foreign	Total
2006: Income before income taxes and minority interests	**$4,678,647**	**1,364,571**	**6,043,218**
Income taxes:			
Current	**$1,689,260**	**455,092**	**2,144,352**
Deferred	**(613)**	**(57,748)**	**(58,361)**
	$1,688,647	**397,344**	**2,085,991**

The Company and its domestic subsidiaries are subject to a number of income taxes, which, in the aggregate, represent a statutory income tax rate of approximately 40% for the years ended December 31, 2006 and 2005, and 42% for the year ended December 31, 2004.

Amendments to the Japanese tax regulations were enacted on March 24, 2003. As a result of these amendments, the statutory income tax rate was reduced from approximately 42% to 40% effective from the year beginning January 1, 2005. Consequently, the statutory tax rate utilized for deferred tax assets and liabilities expected to be settled or realized subsequent to January 1, 2005 is approximately 40%.

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

Year ended December 31	**2006**	2005	2004
Japanese statutory income tax rate	**40.0%**	40.0%	42.0%
Increase (reduction) in income taxes resulting from:			
Expenses not deductible for tax purposes	**0.3**	0.3	0.4
Tax benefits not recognized on operating losses of subsidiaries	**—**	—	0.1
Income of foreign subsidiaries taxed at lower than Japanese statutory tax rate	**(2.1)**	(1.9)	(2.1)
Tax credit for research and development expenses	**(4.1)**	(3.9)	(4.0)
Other	**0.4**	0.3	(1.3)
Effective income tax rate	**34.5%**	34.8%	35.1%

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

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Prepaid expenses and other current assets	¥ 66,839	52,116	$ 561,672
Other assets	67,568	61,325	567,798
Other current liabilities	(4,133)	(3,500)	(34,731)
Other noncurrent liabilities	(39,299)	(36,329)	(330,243)
	¥ 90,975	73,612	$ 764,496

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities at December 31, 2006 and 2005 are presented below:

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Deferred tax assets:			
Inventories	¥ 20,077	13,459	$ 168,714
Accrued business tax	10,654	8,599	89,530
Accrued pension and severance cost	33,633	34,257	282,630
Research and development—costs capitalized for tax purposes	31,068	23,629	261,076
Property, plant and equipment	26,577	21,839	223,336
Accrued expenses	21,277	20,132	178,798
Net operating losses carried forward	1,767	1,388	14,849
Other	28,061	24,362	235,807
Total gross deferred tax assets	173,114	147,665	1,454,740
Less valuation allowance	(6,500)	(3,345)	(54,622)
Net deferred tax assets	166,614	144,320	1,400,118
Deferred tax liabilities:			
Undistributed earnings of foreign subsidiaries	(9,138)	(6,806)	(76,790)
Net unrealized gains on securities	(7,521)	(6,480)	(63,202)
Tax deductible reserve	(11,955)	(14,307)	(100,462)
Financing lease revenue	(35,990)	(35,395)	(302,437)
Other	(11,035)	(7,720)	(92,731)
Total gross deferred tax liabilities	(75,639)	(70,708)	(635,622)
Net deferred tax assets	¥ 90,975	73,612	$ 764,496

The net changes in the total valuation allowance were an increase of ¥3,155 million ($26,513 thousand) for the year ended December 31, 2006, and decreases of ¥150 million and ¥4,906 million for the years ended December 31, 2005 and 2004, respectively.

Based upon the level of historical taxable income and projections for future taxable income over the periods which the net deductible temporary differences are expected to reverse, management believes it is more likely than not that Canon will realize the benefits of these deferred tax assets, net of the existing valuation allowance at December 31, 2006.

At December 31, 2006, Canon had net operating losses which can be carried forward for income tax purposes of ¥5,567 million ($46,782 thousand) to reduce future taxable income. Periods available to reduce future taxable income vary in each tax jurisdiction and generally range from one year to ten years as follows:

	Millions of yen	Thousands of U.S. dollars
Within one year	¥ 2,979	$ 25,034
After one year through five years	967	8,126
After five years through ten years	101	849
Indefinite period	1,520	12,773
Total	¥ 5,567	$ 46,782

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

Canon has not recognized deferred tax liabilities of ¥36,568 million ($307,294 thousand) for a portion of undistributed earnings of foreign subsidiaries that arose for the year ended December 31, 2006 and prior years because Canon currently does not expect to have such amounts distributed or paid as dividends to the Company in the foreseeable future. Deferred tax liabilities will be recognized when Canon expects that it will realize those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investments. At December 31, 2006, such undistributed earnings of these subsidiaries were ¥597,969 million ($5,024,950 thousand).

(15) Common Stock

Based on the resolution of Board of Directors on May 11, 2006, the Company made a three-for-two stock split on July 1, 2006, for stockholders recorded in the stockholders' register as of June 30, 2006. All share and per share information has been adjusted to reflect the implementation of the stock split.

For the years ended December 31, 2006, 2005 and 2004, the Company issued 331,661 shares, 1,148,292 shares and 9,957,909 shares of common stock, respectively, in connection with the conversion of convertible debt. In accordance with the Corporation Law of Japan, conversion into common stock of convertible debt is accounted for by crediting one-half or more of the conversion price to the common stock account and the remainder to the additional paid-in capital account.

(16) Legal Reserve and Retained Earnings

The Corporation Law of Japan provides that an amount equal to 10% of distributions from retained earnings paid by the Company and its Japanese subsidiaries be appropriated as a legal reserve. No further appropriations are required when the total amount of the additional paid-in capital and the legal reserve equals 25% of their respective stated capital. The Corporation Law of Japan also provides that additional paid-in capital and legal reserve are available for appropriations by the resolution of the stockholders. Certain foreign subsidiaries are also required to appropriate their earnings to legal reserves under the laws of the respective countries.

Cash dividends and appropriations to the legal reserve charged to retained earnings for the years ended December 31, 2006, 2005 and 2004 represent dividends paid out during those years and the related appropriations to the legal reserve. Retained earnings at December 31, 2006 do not reflect current year-end dividends in the amount of ¥66,583 million ($559,521 thousand) which will be payable in March 2007 upon approval by the stockholders.

The amount available for dividends under the Corporation Law of Japan is based on the amount recorded in the Company's nonconsolidated books of account in accordance with financial accounting standards of Japan. Such amount was ¥1,494,372 million ($12,557,748 thousand) at December 31, 2006.

Retained earnings at December 31, 2006 included Canon's equity in undistributed earnings of affiliated companies accounted for by the equity method in the amount of ¥13,493 million ($113,387 thousand).

(17) Other Comprehensive Income (Loss)

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

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	**2006**
Foreign currency translation adjustments:				
Balance at beginning of year	**¥ (25,772)**	(79,751)	(83,801)	**$(216,571)**
Adjustments for the year	**48,630**	53,979	4,050	**408,655**
Balance at end of year	**22,858**	(25,772)	(79,751)	**192,084**
Net unrealized gains and losses on securities:				
Balance at beginning of year	**6,073**	7,470	6,784	**51,034**
Adjustments for the year	**1,992**	(1,397)	686	**16,739**
Balance at end of year	**8,065**	6,073	7,470	**67,773**
Net gains and losses on derivative instruments:				
Balance at beginning of year	**(1,174)**	(693)	(297)	**(9,866)**
Adjustments for the year	**(489)**	(481)	(396)	**(4,109)**
Balance at end of year	**(1,663)**	(1,174)	(693)	**(13,975)**
Minimum pension liability adjustments:				
Balance at beginning of year	**(7,339)**	(28,338)	(65,961)	**(61,672)**
Adjustments for the year	**(3,575)**	20,999	37,623	**(30,042)**
Adjustment to initially apply SFAS 158	**10,914**	—	—	**91,714**
Balance at end of year	**—**	(7,339)	(28,338)	**—**
Pension liability adjustments:				
Adjustment to initially apply SFAS 158	**(26,542)**	—	—	**(223,042)**
Balance at end of year	**(26,542)**	—	—	**(223,042)**
Total accumulated other comprehensive income (loss):				
Balance at beginning of year	**(28,212)**	(101,312)	(143,275)	**(237,075)**
Adjustments for the year	**46,558**	73,100	41,963	**391,243**
Adjustment to initially apply SFAS 158	**(15,628)**	—	—	**(131,328)**
Balance at end of year	**¥ 2,718**	(28,212)	(101,312)	**$ 22,840**

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

Year ended December 31	Millions of yen		
	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2006:			
Foreign currency translation adjustments	**¥ 49,518**	**(888)**	**48,630**
Net unrealized gains and losses on securities:			
Amount arising during the year	**3,708**	**(1,502)**	**2,206**
Reclassification adjustments for gains and losses realized in net income	**(388)**	**174**	**(214)**
Net change during the year	**3,320**	**(1,328)**	**1,992**
Net gains and losses on derivative instruments:			
Amount arising during the year	**(7,126)**	**2,858**	**(4,268)**
Reclassification adjustments for gains and losses realized in net income	**6,309**	**(2,530)**	**3,779**
Net change during the year	**(817)**	**328**	**(489)**
Minimum pension liability adjustments	**(4,391)**	**816**	**(3,575)**
Other comprehensive income (loss)	**¥ 47,630**	**(1,072)**	**46,558**
2005:			
Foreign currency translation adjustments	¥ 55,345	(1,366)	53,979
Net unrealized gains and losses on securities:			
Amount arising during the year	9,005	(3,892)	5,113
Reclassification adjustments for gains and losses realized in net income	(10,793)	4,283	(6,510)
Net change during the year	(1,788)	391	(1,397)
Net gains and losses on derivative instruments:			
Amount arising during the year	(9,137)	3,658	(5,479)
Reclassification adjustments for gains and losses realized in net income	8,333	(3,335)	4,998
Net change during the year	(804)	323	(481)
Minimum pension liability adjustments	40,364	(19,365)	20,999
Other comprehensive income (loss)	¥ 93,117	(20,017)	73,100
2004:			
Foreign currency translation adjustments	¥ 4,400	(350)	4,050
Net unrealized gains and losses on securities:			
Amount arising during the year	5,022	(2,202)	2,820
Reclassification adjustments for gains and losses realized in net income	(3,698)	1,564	(2,134)
Net change during the year	1,324	(638)	686
Net gains and losses on derivative instruments:			
Amount arising during the year	(1,673)	708	(965)
Reclassification adjustments for gains and losses realized in net income	929	(360)	569
Net change during the year	(744)	348	(396)
Minimum pension liability adjustments	78,179	(40,556)	37,623
Other comprehensive income (loss)	¥ 83,159	(41,196)	41,963

Year ended December 31	Thousands of U.S. dollars		
	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2006:			
Foreign currency translation adjustments	$ 416,117	(7,462)	408,655
Net unrealized gains and losses on securities:			
Amount arising during the year	31,160	(12,622)	18,538
Reclassification adjustments for gains and losses realized in net income	(3,261)	1,462	(1,799)
Net change during the year	27,899	(11,160)	16,739
Net gains and losses on derivative instruments:			
Amount arising during the year	(59,883)	24,017	(35,866)
Reclassification adjustments for gains and losses realized in net income	53,017	(21,260)	31,757
Net change during the year	(6,866)	2,757	(4,109)
Minimum pension liability adjustments	(36,899)	6,857	(30,042)
Other comprehensive income (loss)	$ 400,251	(9,008)	391,243

(18) Net Income per Share

The basic and diluted net income per share as well as the number of shares has been calculated to reflect the three-for-two stock split that was completed on July 1, 2006.

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

Year ended December 31	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	2006
Net income	¥455,325	384,096	343,344	$3,826,261
Effect of dilutive securities:				
1.20% Japanese yen convertible debentures, due 2005	—	5	24	—
1.30% Japanese yen convertible debentures, due 2008	8	18	72	67
Diluted net income	¥455,333	384,119	343,440	$3,826,328
	Number of shares			
Average common shares outstanding	1,331,542,074	1,330,760,715	1,328,047,686	
Effect of dilutive securities:				
1.20% Japanese yen convertible debentures, due 2005	—	185,755	694,235	
1.30% Japanese yen convertible debentures, due 2008	474,796	1,118,931	3,187,917	
Diluted common shares outstanding	1,332,016,870	1,332,065,401	1,331,929,838	
	Yen			U.S. dollars
Net income per share:				
Basic	¥341.95	288.63	258.53	$2.87
Diluted	341.84	288.36	257.85	2.87

(19) Derivatives and Hedging Activities

Risk management policy

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

Foreign currency exchange rate risk management

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

Interest rate risk management

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

Fair value hedge

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

Cash flow hedge

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

The amount of the hedging ineffectiveness was not material for the years ended December 31, 2006, 2005 and 2004. The amount of net gains or losses excluded from the assessment of hedge effectiveness (time value component) which was recorded in other income (deductions) was net losses of ¥5,917 million ($49,723 thousand), ¥3,725 million and ¥2,096 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Derivatives not designated as hedges

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

Contract amounts of foreign exchange contracts at December 31, 2006 and 2005 are set forth below:

December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
To sell foreign currencies	**¥717,136**	645,188	**$6,026,353**
To buy foreign currencies	**51,189**	46,424	**430,160**

(20) Commitments and Contingent Liabilities

Commitments

At December 31, 2006, commitments outstanding for the purchase of property, plant and equipment approximated ¥107,685 million ($904,916 thousand), and commitments outstanding for the purchase of parts and raw materials approximated ¥85,403 million ($717,672 thousand).

Canon occupies sales offices and other facilities under lease arrangements accounted for as operating leases. Deposits made under such arrangements aggregated ¥13,648 million ($114,689 thousand) and ¥13,790 million at December 31, 2006 and 2005, respectively, and are included in noncurrent receivables in the accompanying consolidated balance sheets. Rental expenses under the operating lease arrangements amounted to ¥36,157 million ($303,840 thousand), ¥38,297 million and ¥41,381 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Future minimum lease payments required under noncancelable operating leases that have initial or remaining lease terms in excess of one year at December 31, 2006 are as follows:

Year ending December 31	Millions of yen	Thousands of U.S. dollars
2007	¥16,025	$134,664
2008	12,975	109,034
2009	9,590	80,588
2010	5,962	50,101
2011	4,570	38,403
Thereafter	11,256	94,588
Total future minimum lease payments	¥60,378	$507,378

Guarantees

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

For each guarantee provided, Canon would have to perform under a guarantee if the borrower defaults on a payment within the contract periods of 1 year to 30 years, in the case of employees with housing loans, and of 1 year to 10 years, in the case of affiliates and other companies. The maximum amount of undiscounted payments Canon would have had to make in the event of default is ¥30,051 million ($252,529 thousand) at December 31, 2006. The carrying amounts of the liabilities recognized for Canon's obligations as a guarantor under those guarantees at December 31, 2006 were not significant.

Canon also issues contractual product warranties under which it generally guarantees the performance of products delivered and services rendered for a certain period or term. Changes in accrued product warranty cost for the years ended December 31, 2006 and 2005 are summarized as follows:

Year ended December 31	Millions of yen		Thousands of U.S. dollars
	2006	2005	**2006**
Balance at beginning of year	**¥ 16,746**	14,264	**$ 140,723**
Addition	**15,213**	18,510	**127,840**
Utilization	**(14,266)**	(15,580)	**(119,882)**
Other	**451**	(448)	**3,790**
Balance at end of year	**¥ 18,144**	16,746	**$ 152,471**

Legal proceedings

In February 2003, a lawsuit was filed by St. Clair Intellectual Property Consultants, Inc. (“St. Clair”) against the Company and one of its subsidiaries in the United States District Court of Delaware, which accused the Company of infringement of patents related to certain technology. In connection with this case, in October 2004, a jury preliminarily found damages against the Company of approximately ¥4,000 million ($33,613 thousand) based on a percentage of certain product sales in the United States through 2003. Subsequent to this jury finding, St. Clair also made a motion to the court for damages relating to certain 2004 sales, using the same royalty rate awarded by the jury. In March 2006, the Company and St. Clair entered into a settlement agreement, pursuant to which the lawsuit was withdrawn in July 2006.

In October 2003, a lawsuit was filed by a former employee against the Company at the Tokyo District Court in Japan. The lawsuit alleges that the former employee is entitled to ¥45,872 million ($385,479 thousand) as compensation for an invention related to certain technology used by the Company, and the former employee has sued for a partial payment of ¥1,000 million ($8,403 thousand) and interest thereon. On January 30, 2007, the Tokyo District Court in Japan ordered the Company to pay the former employee approximately ¥33.5 million ($282 thousand) and interest thereon. On the same day, the Company appealed the decision.

In Germany, Verwertungsgesellschaft Wort (“VG Wort”), a collecting agency representing certain copyright holders, has filed a series of lawsuits seeking to impose copyright levies upon digital products such as PCs and printers, that allegedly enable the reproduction of copyrighted materials, against the companies importing and distributing these digital products. In May 2004, VG Wort filed a civil lawsuit against Hewlett-Packard GmbH seeking levies on multi-function printers. This is an industry test case under which Hewlett-Packard GmbH represents other companies sharing common interests, and Canon has undertaken to be bound by the final decision of this court case. The court of first instance and the court of appeals held that the multi-function printers were subject to a levy. In particular, the court of appeals ordered Hewlett-Packard GmbH to pay the amount equivalent to the levies imposed on photocopiers (EUR 38.35 to EUR 613.56 per unit, depending on printing speed and color printing capability). This lawsuit is currently under appeal before the German Federal Supreme Court. With regard to single-function printers, VG Wort filed a separate lawsuit in January 2006 against Canon seeking payment of copyright levies, and the court of first instance in Düsseldorf ruled in favor of the claim by VG Wort in November 2006. Canon lodged an appeal against such decision in December 2006. In a similar court case, which does not include Canon, seeking copyright levies on single-function printers of Epson Deutschland GmbH, Xerox GmbH and Kyocera Mita Deutschland GmbH, the court of appeals in Düsseldorf rejected such alleged levies on January 23, 2007. Canon, other companies and the industry associations have expressed opposition to such extension of the levy scope and the final conclusion of these court cases including the amount of levies to be imposed, remains uncertain.

In April 2005, a lawsuit was filed by Nano-Proprietary Inc. (“NPI”) against the Company and Canon U.S.A. Inc. in the United States District Court of Texas alleging that SED Inc., a joint venture company established by the Company and Toshiba Corporation, is not regarded as a “Subsidiary” under the Patent License Agreement between the Company and NPI (the “Agreement”) and that the extension of the license to SED Inc. constitutes a breach of the Agreement. NPI also alleges that there was fraudulent conduct by the Company in executing the Agreement, and requests rescission of the Agreement and compensatory damages. This case is still pending and the final outcome, including any liability to the Company, is not yet determined, but in November 2006, the Court denied the Company’s Motion for a summary judgment that SED Inc. is a Subsidiary of the Company. In January 2007, the Company purchased all the shares of SED Inc. owned by Toshiba Corporation, making SED Inc. a 100% owned subsidiary of the Company. However, on February 22, 2007, the court issued a summary judgment stating that SED Inc. (before the above stock purchase) was not a Subsidiary of the Company, and that the Agreement has been terminated due to a material breach of the Agreement by the Company. The remaining pending issues at the district court are whether the Company was engaged in fraudulent conduct and whether compensatory damages should be granted. The Company will appeal to the appellate court immediately after the current proceeding at the district court has been concluded regardless of any judgments rendered by the district court.

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

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

Fair value of financial instruments

The estimated fair values of Canon's financial instruments at December 31, 2006 and 2005 are set forth below. The following summary excludes cash and cash equivalents, trade receivables, finance receivables, noncurrent receivables, short-term loans, trade payables, accrued expenses for which fair values approximate their carrying amounts. The summary also excludes marketable securities and investments which are disclosed in Note 4.

December 31	Millions of yen				Thousands of U.S. dollars	
	2006		2005		**2006**	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Long-term debt, including current installments	**¥(31,052)**	**(32,795)**	(32,074)	(35,194)	**$(260,941)**	**(275,588)**
Foreign exchange contracts:						
Assets	**307**	**307**	2,250	2,250	**2,580**	**2,580**
Liabilities	**(17,534)**	**(17,534)**	(10,062)	(10,062)	**(147,345)**	**(147,345)**

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

Long-term debt

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

Foreign exchange contracts

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

Limitations

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

Concentrations of credit risk

At December 31, 2006 and 2005, one customer accounted for approximately 14% and 12% of consolidated trade receivables, respectively. Although Canon does not expect that the customer will fail to meet its obligations, Canon is potentially exposed to concentrations of credit risk if the customer failed to perform according to the terms of the contracts.

(22) Supplemental Cash Flow Information

For the years ended December 31, 2006, 2005 and 2004, aggregate common stock and additional paid-in capital arising from conversion of convertible debt amounted to ¥331 million ($2,782 thousand), ¥1,147 million and ¥9,938 million, respectively.

(23) Subsequent Event

On February 15, 2007, the Board of Directors of the Company approved a plan to repurchase up to 17 million shares of the Company's common stock at a cost of up to ¥100,000 million ($840,336 thousand) for the period from February 16, 2007 to March 16, 2007. Such repurchases are intended to improve capital efficiency and ensure flexible capital strategy. Common stock repurchased in the Tokyo Stock Exchange between February 16, 2007 and March 6, 2007 under the aforementioned plan was 15,423,300 shares at a cost of ¥100,000 million ($840,336 thousand).

On March 8, 2007, the Board of Directors of the Company approved an additional plan to repurchase up to 17 million shares of the Company's common stock at a cost of up to ¥100,000 million ($840,336 thousand) for the period from March 9, 2007 to April 9, 2007.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Canon is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the company's principal executive and principal financial officers and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Canon's management assessed the effectiveness of internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control-Integrated Framework* (the COSO criteria).

Based on its assessment, management concluded that, as of December 31, 2006, Canon's internal control over financial reporting was effective based on the COSO criteria.

Canon's independent registered public accounting firm, Ernst & Young ShinNihon has issued an audit report on our assessment of internal control over financial reporting.

Fujio Mitarai
Chairman and CEO

Toshizo Tanaka
Senior Managing Director,
Group Executive of Finance and Accounting Headquarters

March 16, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

ERNST & YOUNG

■ ERNST & YOUNG SHINNIHON
Hibiya Kokusai Bldg.
2-2-3, Uchisaiwai-cho
Chiyoda-ku, Tokyo, Japan 100-0011
C.P.O. Box 1196, Tokyo, Japan 100-8641

■ Tel : 03 3503 1191
Fax : 03 3503 1277

The Board of Directors and Stockholders of
Canon Inc.

We have audited the accompanying consolidated balance sheets of Canon Inc. and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006, all expressed in Japanese yen. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

In our opinion, except for the omission of segment information as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Canon Inc. and subsidiaries at December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Canon Inc. and subsidiaries' internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 16, 2007 expressed an unqualified opinion thereon.

We have also recomputed the translation of the consolidated financial statements as of and for the year ended December 31, 2006 into United States dollars. In our opinion, the consolidated financial statements expressed in Japanese yen have been translated into United States dollars on the basis described in Note 2.

March 16, 2007

Ernst & Young ShinNihon

ERNST & YOUNG

ERNST & YOUNG SHINNIHON
Hibiya Kokusai Bldg.
2-2-3, Uchisaiwai-cho
Chiyoda-ku, Tokyo, Japan 100-0011
C.P.O. Box 1196, Tokyo, Japan 100-8641

Tel : 03 3503 1191
Fax : 03 3503 1277

The Board of Directors and Stockholders of
Canon Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Canon Inc. and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Canon Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Canon Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the accompanying consolidated balance sheets of Canon Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006, all expressed in Japanese yen, and our report thereon dated March 16, 2007 stated that, except for the omission of segment information required by Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Canon Inc. and subsidiaries at December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

March 16, 2007

Ernst & Young ShinNihon

TRANSFER AND REGISTRAR'S OFFICE

Canon Inc.
30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501, Japan

Manager of the Register of Stockholders
Mizuho Trust & Banking Co., Ltd.
2-1, Yaesu 1-chome, Chuo-ku, Tokyo 103-8670, Japan

Depositary and Agent with Respect to American Depositary Receipts for Common Shares
JPMORGAN Chase Bank
4 New York Plaza, New York, N.Y. 10004, U.S.A.

Depositaries and Agents with Respect to Global Bearer Certificates for Common Shares
Clearstream Banking AG
Neue Börsenstraße 1, 60487 Frankfurt am Main, Germany
Deutsche Bank AG
Taunusanlage 12, 60325 Frankfurt am Main, Germany

STOCKHOLDER INFORMATION

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

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

Stockholders' Annual General Meeting:
March 29, 2007, in Tokyo

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

This publication was printed on 100% recycled paper by an ISO 14001-accredited printer. The inks used, containing neither VOCs (volatile organic compounds) nor mineral oils, excel in decomposition and de-inking.

PUB. BEP016 0704SZ 19.3 Printed in Japan

CANON INC.   30-2, Shimomaruko 3-chome, Ohta-ku, Tokyo 146-8501, Japan