Notes to Consolidated Financial Statements

NEC CORPORATION AND CONSOLIDATED SUBSIDIARIES

1 NATURE OF OPERATIONS

The company is primarily engaged in the development, manufacture and sale of information/communications systems—comprising communications systems and equipment and computers and industrial electronic systems—as well as electron devices. The company's principal business activities are based on the integration of computer and communications products and technology ("C&C"), supported by semiconductor and software technology. For the years ended March 31, 1996, 1997, and 1998, sales of information/communications systems operations accounted for 72 percent, 76 percent and 76 percent and sales of electron devices operations accounted for 24 percent, 20 percent and 20 percent of consolidated net sales, respectively. The company operates both in Japan and overseas, with manufacturing facilities in Japan, the United States of America, Europe, Asia, and other countries and sales offices in Japan and around the world. During the years ended March 31, 1996, 1997 and 1998, sales to customers in Japan were 72 percent, 78 percent and 76 percent of consolidated net sales, respectively. In these Notes, references to the "company" are (unless the context does not so permit) to the parent company and its consolidated subsidiaries.

2 SIGNIFICANT ACCOUNTING POLICIES

The parent company and its Japanese subsidiaries maintain their records and prepare their financial statements in accordance with accounting principles generally accepted in Japan, and its foreign subsidiaries in conformity with those of the countries of their domicile. Certain adjustments and reclassifications, including those relating to the tax effects of temporary differences, the accrual of certain expenses, and the accounting for foreign currency translation, lease transactions and common stock warrants have been incorporated in the accompanying consolidated financial statements to conform with accounting principles generally accepted in the United States of America. These adjustments were not recorded in the statutory books of account.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant accounting policies, after reflecting adjustments for the above, are as follows:

Basis of consolidation and investments in affiliated companies

The consolidated financial statements include those of the parent company and those of its majority-owned subsidiaries. All significant intercompany transactions and accounts are eliminated.

Investments in 50 percent or less owned companies over which the company does not have control, but has the ability to exercise significant influence, are accounted for by the equity method.

The excess of the cost over the underlying net equity of investments which have been revalued to fair value of assets and liabilities in consolidated companies and investments accounted for by the equity method is recognized as goodwill and is amortized on a straight-line basis over the period of expected benefit which does not exceed 10 years.

Cash equivalents

All highly liquid investments, including time deposits, with original maturities of three months or less are considered to be cash equivalents.

Foreign currency translation

Asset and liability accounts of foreign consolidated subsidiaries and equity investments are translated into yen at appropriate year-end rates of exchange and all revenue and expense accounts are translated at average rates of exchange prevailing during the year. The resulting translation adjustments are accumulated and reported as a component of shareholders' equity.

Marketable securities and other investments

The current and noncurrent portfolios of marketable equity securities are each carried at the lower of aggregate cost or market. Other marketable securities are carried at the lower of cost or market. Other investment securities are stated at cost or less. Realized gains or losses on the sale of marketable equity securities are based on the average cost of all of the shares of a particular security held at the time of sale. (See Note 5 to the consolidated financial statements for an explanation of the effects of not adopting the provisions of Statement of Financial Accounting Standards ("SFAS") No. 115.)

Inventories

Inventories are stated at the lower of cost or market.

Finished products made to customer specifications are costed on the basis of accumulated production costs. Mass-produced standard products are principally costed on a first-in, first-out basis.

Work in process made to customer specifications represents accumulated production costs of job orders. Work in process of mass-produced standard products is stated on an average cost basis. The cost of semifinished components is principally determined on a first-in, first-out basis.

Raw materials and purchased components are principally stated on a first-in, first-out basis and, for certain subsidiaries, on an average cost method.

Effective April 1, 1997, the company changed its inventory costing method for other finished products, semifinished components, and raw materials and purchased components, principally from last-in, first-out basis to first-in, first-out basis. The company has recently been experiencing reductions in manufacturing cost through lower cost of purchased components and increased labor efficiency. The company believes that the first-in, first-out methodology is more representative of fair value of inventory. The effect of the change in accounting principle was not material to the financial position or results of operations.

Property, plant and equipment and depreciation

Property, plant and equipment is stated at cost. Depreciation is computed primarily on the declining-balance method and, for certain subsidiaries, on the straight-line method, at rates based on the following estimated useful lives of the assets: buildings, two to 65 years, machinery and equipment, two to 22 years. Maintenance and repairs, including minor renewals and betterments, are charged to income as incurred.

Income taxes

The provision for income taxes is based on the pretax income included in the consolidated statements of income and retained earnings and is computed under the asset and liability approach. Under this approach, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting basis and tax basis of assets and liabilities. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

Additional paid-in capital and free distributions of common stock

Under the Japanese Commercial Code, the entire amount of the issue price of shares is required to be accounted for in the common stock account although a company in Japan may, by a resolution of its board of directors, account for an amount not exceeding one-half of the issue price of the shares as additional paid-in capital.

The company in Japan has made, based on the resolution of the board of directors, a free distribution of shares to shareholders, which is clearly distinguished from a "stock dividend" paid out of profits that, under the Commercial Code, must be approved by the shareholders. In accounting for the free distribution of shares, the Commercial Code permitted the board of directors to authorize either (1) a transfer from additional paid-in capital to the common stock account or (2) no entry if free shares were distributed from the portion of previously issued shares accounted for as excess of par value in the common stock account. Companies in the United States of America issuing shares in amounts comparable to those of the free share distributions of the parent company would be required to account for them as stock dividends and the fair value of the shares would be transferred from retained earnings to appropriate capital accounts. Such transfer, however, has no effect on total shareholders' equity.

Net income per share

In the fiscal year ended March 31, 1998, the company adopted SFAS No. 128, "Earnings per Share" which requires dual presentation of basic net income per share ("EPS") and diluted EPS on the face of the income statement for all entities with complex capital structures and requires a reconciliation of the numerator and denominator of the basic EPS computation to the numerator and denominator of the diluted EPS computation. Basic EPS is computed by dividing income available to common stockholders by the weighted-average number of shares of common stock outstanding for the period. Diluted EPS assumes the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, or resulted in the issuance of common stock. All prior-period EPS data presented have been restated to conform with the provisions of this statement.

Sales

Sales of computers and certain types of major equipment are recorded when the units are installed and accepted by the customers, while sales of other equipment, components and appliances are recorded when completed units are shipped. The estimated accrued losses arising from estimated future returns of leased computers, and the related future tax benefit, are reflected in the financial statements.

Financial instruments

The company has entered into forward exchange contracts as hedges against the adverse impact of foreign currency fluctuations on monetary assets and liabilities arising from the company's operations. Gains and losses on these contract hedges are deferred and included in the measurement of the related foreign currency transactions so that foreign exchange gains or losses on the underlying assets and liabilities could be effectively offset. Agreements that are, in substance, essentially the same as forward exchange contracts, such as currency swaps, are accounted for in a manner similar to the accounting for forward exchange contracts. The interest rate swap agreements are fully integrated with underlying debt obligations and designed to convert fixed rate debt into floating rate debt, or vice versa and interest rate option agreements are also arranged so that exposures to losses resulting from fluctuations in interest rates are managed. The differentials to be paid or received related to interest rate swap agreements are recognized in interest expense over the lives of the agreements. See Note 12 to the consolidated financial statements for detailed descriptions of these financial instruments.

Reclassifications

Certain accounts in the consolidated financial statements for the years ended March 31, 1996 and 1997 have been reclassified to conform to the 1998 presentation.

3 U.S. DOLLAR AMOUNTS

U.S. dollar amounts are included solely for the convenience of the readers of the financial statements. These translations should not be construed as representations that the yen amounts actually represent, or have been or could be converted into, U.S. dollars.

As the amounts shown in U.S. dollars are for convenience only, and are not intended to be computed in accordance with generally accepted translation procedures, the rate of ¥133=U.S.$1, the approximate current rate at March 31, 1998, has been used for the purpose of presentation of the U.S. dollar amounts in the accompanying consolidated financial statements.

4 INVESTMENTS IN AFFILIATED COMPANIES

The investees accounted for by the equity method together with a percentage of the company's ownership of voting share are Nippon Electric Glass Co., Ltd. (42.2%), ANRITSU CORPORATION (26.9%), Toyo Communication Equipment Co., Ltd. (39.0%), NITSUKO CORPORATION (34.3%), Nippon Electric Industry Co., Ltd. (47.9%), Tokin Corporation (41.1%), NEC Leasing, Ltd. (50.0%), Sumitomo 3M Limited (25.0%), Packard Bell NEC, Inc. ("PBN") (49.0%) and six other companies at March 31, 1998.

Summarized financial information relating to 50 percent or less owned companies accounted for under the equity method is as follows:

	In millions of yen		In thousands of U.S. dollars
March 31	1997	**1998**	**1998**
Current assets	¥1,025,055	**¥1,089,749**	**$8,193,602**
Other assets, including property, plant and equipment	1,014,442	**1,064,536**	**8,004,030**
Current liabilities	862,489	**937,307**	**7,047,421**
Long-term liabilities	699,000	**797,261**	**5,994,444**
Redeemable preferred stock	101,303	**150,597**	**1,132,308**

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Sales and operating revenue	¥1,342,154	¥1,715,434	**¥1,755,668***	**$13,200,511**
Net income (loss)	13,420	(34,797)	**(43,551)***	**(327,451)**

*Including the amounts related to PBN for 1998, ¥461,551 million ($3,470,308 thousand) and ¥(76,798) million ($577,429 thousand), respectively. The company recognized ¥15,320 million ($115,188 thousand) as equity loss.

Of the 15 companies at March 31, 1998 (16 companies at March 31, 1997) accounted for under the equity basis, the stocks of six companies carried at equity of ¥112,184 million and ¥115,384 million ($867,549 thousand) at March 31, 1997 and 1998, respectively, were quoted on the market at an aggregate value of ¥240,446 million and ¥201,449 million ($1,514,654 thousand), respectively, at those dates.

The balances and transactions with companies accounted for under the equity method are shown below:

	In millions of yen		In thousands of U.S. dollars
March 31	1997	**1998**	**1998**
Receivables, trade	¥66,814	**¥33,212**	**$249,714**
Payables, trade	52,929	**46,447**	**349,226**

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Sales	¥212,777	¥253,393	**¥257,170**	**$1,933,609**
Purchases	116,441	112,776	**117,016**	**879,820**

On August 31, 1995, for consideration of ¥17,026 million the company acquired 4,040,149 shares of voting convertible preferred stock of Packard Bell Electronics, Inc. ("PB") representing 19.97% of the then combined outstanding common and preferred stock of PB.

On April 1, 1996, the company purchased 6,725,285 shares of non-voting redeemable convertible preferred stock from PB for ¥30,706 million. On June 30, 1996, the parent company, NEC Technologies, Inc., a wholly owned subsidiary, and PB effected an agreement to transfer certain assets and liabilities of the company's personal computer business to PB in order to integrate their worldwide personal computer businesses, except in Japan and China. The company received 7,306,000 shares of non-voting redeemable convertible preferred stock of PB for ¥35,270 million consideration for the assets transferred. On July 11, 1996, PB changed its name to Packard Bell NEC, Inc. On June 30, 1997, the company purchased 6,772,814 shares of non-voting redeemable convertible preferred stock from PBN for ¥32,875 million ($247,180 thousand). On December 26, 1997 and February 6, 1998, the company purchased senior subordinated convertible notes for ¥19,725 million ($148,308 thousand) and ¥18,780 million ($141,203 thousand), respectively.

In February 1998, in connection with the note purchase, 11,445,000 shares of non-voting redeemable convertible preferred stock of PBN held by the company have been exchanged on a one-for-one basis for 11,445,000 shares of voting convertible preferred stock of PBN.

The preferred stock exchanged has been devalued to fair value and a loss of ¥10,663 million ($80,173 thousand) has been recognized on this exchange. The company also recognized a loss of ¥19,706 million ($148,165 thousand), relating to the devaluation of the investment. (See Note 5 to the consolidated financial statements.) After the exchange, the company's share of the outstanding voting shares of PBN has increased to 49% of the combined outstanding common and voting shares of PBN.

The non-voting redeemable convertible preferred stock is classified as debt securities based on the provisions of SFAS No. 115.

5 MARKETABLE AND INVESTMENT SECURITIES

At the request of the company and other Japanese companies which file their consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America, with the United States Securities and Exchange Commission (the "SEC") and the Japanese Ministry of Finance, in August 1993 the SEC issued a confirmation letter that the SEC would accept filings by the company and other Japanese companies that do not adopt the provisions of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," in their primary financial statements, but provide the information required by the provisions of SFAS No. 115 in a note to the financial statements. SFAS No. 115 addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Under SFAS No. 115, certain investments in debt and equity securities are classified in the following three categories: held-to-maturity, trading or available-for-sale securities. Debt and equity securities classified as available-for-sale securities are reported at fair value, with unrealized gains and losses reported in a separate component of shareholders' equity, net of taxes.

The effects on the consolidated balance sheet accounts at March 31, 1997 and 1998 of the departure from the provisions of SFAS No. 115 are summarized as follows:

	In millions of yen		In thousands of U.S. dollars
March 31	1997	**1998**	**1998**
Shareholders' equity as reported	¥1,003,371	**¥1,070,757**	**$8,050,805**
Net increase in carrying amount of:			
Marketable and investment securities			
—Current	66,997	**41,321**	**310,684**
—Noncurrent	131,802	**113,677**	**854,714**
Net decrease in deferred tax assets and increase in deferred tax liabilities:			
Deferred tax assets —Current	9,655	**10,845**	**81,541**
—Noncurrent	330	**530**	**3,985**
Deferred tax liabilities —Current	(43,998)	**(30,292)**	**(227,759)**
—Noncurrent	(70,079)	**(56,332)**	**(423,549)**
Net increase in investments and advances—affiliated companies and other	8,411	**12,002**	**90,241**
Net increase in minority interest	(773)	**(221)**	**(1,662)**
Shareholders' equity in accordance with accounting principles generally accepted in the United States of America	¥1,105,716	**¥1,162,287**	**$8,739,000**

The following is a summary of marketable and investment securities by major security type:

	In millions of yen							
	1997				**1998**			
March 31	Carrying amount	Gross unrealized holding gains	Gross unrealized holding losses	Fair value	Carrying amount	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Current								
Available-for-sale:								
Equity securities...	¥ 89,512	¥ 86,042	¥19,273	¥156,281	**¥ 99,856**	**¥ 64,214**	**¥23,130**	**¥140,940**
Debt securities.....	19,431	228	—	19,659	**20,537**	**237**	**—**	**20,774**
	¥108,943	¥ 86,270	¥19,273	¥175,940	**¥120,393**	**¥ 64,451**	**¥23,130**	**¥161,714**
Noncurrent								
Available-for-sale:								
Equity securities...	¥138,212	¥128,138	¥ 941	¥265,409	**¥142,628**	**¥110,161**	**¥ 1,482**	**¥251,307**
Debt securities.....	92,180	4,605	—	96,785	**86,845**	**4,998**	**—**	**91,843**
	¥230,392	¥132,743	¥ 941	¥362,194	**¥229,473**	**¥115,159**	**¥ 1,482**	**¥343,150**

	In thousands of U.S. dollars			
	1998			
March 31	Carrying amount	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Current				
Available-for-sale:				
Equity securities..........	**$ 750,797**	**$482,812**	**$173,910**	**$1,059,699**
Debt securities..........	**154,414**	**1,782**	**—**	**156,196**
	$ 905,211	**$484,594**	**$173,910**	**$1,215,895**
Noncurrent				
Available-for-sale:				
Equity securities..........	**$1,072,391**	**$828,278**	**$ 11,143**	**$1,889,526**
Debt securities..........	**652,970**	**37,579**	**—**	**690,549**
	$1,725,361	**$865,857**	**$ 11,143**	**$2,580,075**

The net unrealized holding gains, net of taxes, on available-for-sale securities increased by ¥59,155 million for the year ended March 31, 1996 and decreased by ¥85,297 million and ¥10,815 million ($81,316 thousand) for the years ended March 31, 1997 and 1998, respectively.

Contractual maturities of available-for-sale debt securities at March 31, 1998 are in the period from April 1, 1998 to June 15, 2015.

Proceeds from sales of available-for-sale securities were ¥11,506 million, ¥118,259 million and ¥22,419 million ($168,564 thousand) for the years ended March 31, 1996, 1997 and 1998, respectively. Gross realized gains on those sales were ¥2,380 million, ¥52,137 million and ¥16,885 million ($126,955 thousand) for the years ended March 31, 1996, 1997 and 1998, respectively, and gross realized losses were ¥469 million, ¥194 million and ¥30,412 million ($228,662 thousand), including ¥10,663 million ($80,173 thousand) and ¥19,706 million ($148,165 thousand), relating to the investments in affiliated companies described in Note 4, for the years ended March 31, 1996, 1997 and 1998, respectively.

6 INVENTORIES

Inventories at March 31, 1997 and 1998 comprise the following:

	In millions of yen		In thousands of U.S. dollars
March 31	1997	**1998**	**1998**
Finished products..........	¥300,829	**¥296,352**	**$2,228,211**
Work in process and semifinished components..........	485,731	**434,866**	**3,269,669**
Less—Advance payments received..........	(30,988)	**(34,026)**	**(255,834)**
Raw materials and purchased components..........	185,295	**167,841**	**1,261,962**
	¥940,867	**¥865,033**	**$6,504,008**

7 SHORT-TERM BORROWINGS AND LONG-TERM DEBT

Short-term borrowings at March 31, 1997 and 1998 comprise the following:

March 31	In millions of yen 1997	In millions of yen 1998	In thousands of U.S. dollars 1998
Loans, principally from banks, including bank overdrafts (average interest rate of 2.20% at March 31, 1997 and 2.62% at March 31, 1998):			
Secured	¥ 2,282	**¥ 60,152**	**$ 452,271**
Unsecured	700,316	**612,131**	**4,602,489**
Commercial paper (interest rates of 5.23% to 5.90% at March 31, 1997 and 0.70% to 6.10% at March 31, 1998)	40,330	**129,630**	**974,661**
	¥742,928	**¥801,913**	**$6,029,421**

Long-term debt at March 31, 1997 and 1998 comprises the following:

March 31	In millions of yen 1997	In millions of yen 1998	In thousands of U.S. dollars 1998
Loans, principally from banks and insurance companies, due 1997 to 2010 with interest rates of 0.511% to 9.72% at March 31, 1997 and due 1998 to 2010 with interest rates of 0.705% to 9.72% at March 31, 1998:			
Secured	¥ 58,680	**¥ 42,416**	**$ 318,917**
Unsecured	451,632	**449,949**	**3,383,075**
5.6% to 7.15% at March 31, 1997 and 1998 unsecured yen bonds due 1997 to 2007 at March 31, 1997 and due 1998 to 2007 at March 31, 1998 issued in the Euromarket	160,000	**130,000**	**977,444**
2.45% to 3.3% at March 31, 1997 and 1.9% to 3.3% at March 31, 1998 unsecured yen debentures due 1997 to 2005 at March 31, 1997 and due 1999 to 2009 at March 31, 1998	120,000	**270,000**	**2,030,075**
Floating rate unsecured yen notes due 1997 and 1998 issued in the Euromarket	30,000	**—**	**—**
1.9% unsecured yen convertible debentures due 2004, convertible currently at ¥1,962.90 for one common share, redeemable before due date	118,527	**118,522**	**891,143**
1.0% unsecured yen convertible debentures due 2011, convertible currently at ¥1,375.00 for one common share, redeemable before due date	99,977	**99,460**	**747,820**
1.8% unsecured yen convertible debentures due 2002, convertible currently at ¥2,066.80 for one common share, redeemable before due date	95,042	**95,041**	**714,594**
1.9% unsecured yen convertible debentures due 2001, convertible currently at ¥976.00 for one common share, redeemable before due date	30,343	**27,412**	**206,105**
1.7% unsecured yen convertible debentures due 1999, convertible currently at ¥976.00 for one common share, redeemable before due date	26,180	**21,796**	**163,880**
2.1% unsecured yen convertible debentures due 1998, convertible currently at ¥1,414.10 for one common share, redeemable before due date	19,540	**19,515**	**146,729**
1.0% unsecured Swiss Francs convertible notes (Swiss Francs 383,350 thousand—1997 and Swiss Francs 81,350 thousand—1998) due 1999, convertible currently at ¥976.00 for one common share, redeemable before due date	33,117	**7,131**	**53,616**
0.375% unsecured yen convertible notes issued by a consolidated subsidiary due 2002	—	**12,000**	**90,226**
0.2% to 1.6% yen medium-term notes issued by a consolidated subsidiary due 1999 to 2001 (swapped for LIBOR related Sterling Pound obligation)	—	**29,121**	**218,955**
Long-term capital lease obligation, due 1997 to 2003 with interest rates of 2.5% to 8.0% at March 31, 1997 and due 1998 to 2003 with interest rates of 2.3% to 8.4% at March 31, 1998	55,397	**67,780**	**509,624**
Other	3,459	**1,756**	**13,203**
	1,301,894	**1,391,899**	**10,465,406**
Unamortized premium	680	**408**	**3,068**
	1,302,574	**1,392,307**	**10,468,474**
Less—Portion due within one year	233,364	**218,205**	**1,640,639**
	¥1,069,210	**¥1,174,102**	**$ 8,827,835**

The following are pledged as security for short-term borrowings and long-term debt at March 31, 1998:

Description	In millions of yen	In thousands of U.S. dollars
Current notes and accounts receivable	¥ 63,633	$ 478,444
Marketable securities—Noncurrent	49	368
Long-term receivables, trade	6,563	49,346
Property, plant and equipment (net book value)	161,586	1,214,932

Floating rate unsecured yen notes issued in the Euromarket comprise three notes each of ¥10,000 million. The interest rates thereon in the particular interest period are 0.1 percent, 0.25 percent and 0.375 percent above the three-month Euro-yen deposit rate in the London interbank market as defined in the agreements.

The 2.1 percent and 1.8 percent unsecured yen convertible debenture agreements stipulate, among other things, that (1) the parent company is required to deposit with a designated bank, as a sinking fund payment, amounts adjusted for redemptions and conversions made to the dates specified in the agreements and (2) certain restrictions are placed on the payment of dividends. Under the agreements the parent company deposited, instead of the cash, marketable securities amounting to ¥11,844 million and ¥30,318 million ($227,955 thousand) at March 31, 1997 and 1998, respectively.

The agreement of the 1.9 percent unsecured yen convertible debentures due 2004 stipulates, among other things, that the parent company is required to deposit with a designated bank, as a sinking fund payment, amounts adjusted for redemptions and conversions made to the dates specified in the agreement.

The sinking fund payments, adjusted for the conversions made to March 31, 1998, are as follows:

	Sinking fund payments		
		Amount of each payment	
Convertible debentures	Date	In millions of yen	In thousands of U.S. dollars
1.8%	March 31, 1999, 2000 and 2001	¥12,000	$ 90,226
1.9%	March 31, 1999 and 2000	10,000	75,188
	March 31, 2001, 2002 and 2003	14,000	105,263

At March 31, 1998, an aggregate of 250,060 thousand shares of common stock would have been issuable upon conversion of all convertible debt of the parent company.

The company has basic agreements with lending banks to the effect that, with respect to all present or future loans with such banks, the company shall provide collateral (including sums on deposit with such banks) or guarantors therefor immediately upon the bank's request and that any collateral furnished, pursuant to such agreements or otherwise, will be applicable to all indebtedness to such banks.

Certain of the loan agreements provide, among other things, that the company submits to the lenders (upon their request) for approval its proposed appropriation of income (including dividends) before such appropriation can be submitted to the shareholders for approval.

Annual maturities and sinking fund requirements on long-term debt during the five years ending March 31, 2003 are as follows:

Year ending March 31	In millions of yen	In thousands of U.S. dollars
1999	¥240,205	$1,806,053
2000	249,075	1,872,744
2001	221,305	1,663,947
2002	186,563	1,402,729
2003	160,279	1,205,105

8 PENSION AND SEVERANCE PLANS

The parent company and subsidiaries in Japan have severance indemnity plans and non-contributory defined benefit funded pension plans, or only severance indemnity plans, covering substantially all of their employees who meet eligibility requirements of the retirement regulations. Under the plans, employees whose service with the company is terminated are, under most circumstances, entitled to lump-sum severance indemnities and/or pension payments, determined by reference to current basic rate of pay, length of service and conditions under which the termination occurs. The funding policy is to make contributions that can be deducted for Japanese income tax purposes.

The parent company and certain subsidiaries in Japan also have contributory defined benefit pension plans, covering substantially all of their employees, including the governmental welfare pension benefit plan which would otherwise be provided by the Japanese government. The pension benefits are determined based on years of service and the compensation amount as stipulated in the regulations. The governmental welfare pension contributions are funded in conformity with the requirements regulated by the Japanese Welfare Pension Insurance Law. The contributions to the contributory and the non-contributory pension plans are placed into trusted pension funds.

Most subsidiaries outside Japan have various retirement plans covering substantially all of their employees, which are primarily defined contribution plans. The funding policy for the defined contribution plans is to annually contribute an amount equal to a certain percentage of the participants' annual salaries.

The combined funded status of the defined benefit pension plans at March 31, 1997 and 1998, were as follows:

	In millions of yen		In thousands of U.S. dollars
March 31	1997	**1998**	**1998**
Actuarial present value of benefit obligations:			
Vested benefit obligation	¥522,542	**¥702,836**	**$5,284,481**
Accumulated benefit obligation	¥666,853	**¥861,758**	**$6,479,384**
Projected benefit obligation	¥864,322	**¥951,749**	**$7,156,008**
Plan assets at fair value	(548,975)	**(616,682)**	**(4,636,707)**
Unrecognized prior service cost and net loss	(82,207)	**(109,979)**	**(826,910)**
Unrecognized net obligation at April 1, 1989 being recognized over 17 years	(27,787)	**(24,740)**	**(186,015)**
Additional minimum liability	—	**44,728**	**336,301**
Accrued pension and severance liability stated in the balance sheets	¥205,353	**¥245,076**	**$1,842,677**

The vested benefit obligation shown above is the amount of the actuarial present value of the vested benefits to which the employee is currently entitled but based on the employee's expected date of separation or retirement.

Components of net pension and severance cost for all defined benefit plans including both the company's and employees' contributory portion of such plans for the years ended March 31, 1996, 1997 and 1998 were as follows:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Service cost-benefits earned during the period	¥39,562	¥44,154	**¥44,851**	**$337,226**
Interest cost on projected benefit obligation	32,073	36,487	**38,894**	**292,436**
Actual return on plan assets	(24,154)	(22,296)	**(35,039)**	**(263,451)**
Net amortization and deferral	13,096	13,728	**10,298**	**77,428**
Net pension and severance cost for all defined benefit plans	¥60,577	¥72,073	**¥59,004**	**$443,639**

The weighted-average discount rate and the rate of increase in future compensation levels which were used in determining the actuarial present value of the projected benefit obligation, and the expected long-term rate of return on plan assets were as follows:

Year ended March 31	1996	1997	**1998**
Weighted-average discount rate	4.5%	4.5%	**4.2%**
Rate of increase in future compensation levels	2.1%–3.9%	1.7%–3.8%	**1.7%–3.8%**
Expected long-term rate of return on plan assets	5.0%	5.0%	**4.2%**

The plan assets consist principally of corporate equity securities, government securities and corporate debt securities.

The total cost for all defined benefit and defined contribution plans was as follows:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Net pension and severance cost for all defined benefit plans	¥60,577	¥72,073	**¥59,004**	**$443,639**
Net pension cost for employees' portion of the contributory defined benefit pension plans	(4,887)	(13,144)	**(13,688)**	**(102,917)**
Pension and severance cost for defined contribution plans and severance indemnity plans	459	1,560	**1,952**	**14,676**
Total cost for all defined benefit and defined contribution plans	¥56,149	¥60,489	**¥47,268**	**$355,398**

9 INCOME TAXES

The components of income tax expense are as follows:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Current	¥108,254	¥22,507	**¥67,985**	**$511,165**
Deferred	(31,878)	2,393	**(19,952)**	**(150,015)**
	¥ 76,376	¥24,900	**¥48,033**	**$361,150**

The company is subject to a number of different income taxes which, in the aggregate, indicate a normal statutory tax rate in Japan of approximately 51 percent for the years ended March 31, 1996, 1997 and 1998. On March 31, 1998, the Japanese government passed a law that changed the tax rates for corporations. As a result of the change, a normal statutory tax rate in Japan will be approximately 47 percent for the year beginning on April 1, 1998 and subsequent years. A reconciliation between the reported total income tax expense and the amount computed by multiplying the income before tax by the applicable normal statutory income tax rate is as follows:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Current "expected" tax expense	¥77,172	¥61,823	**¥46,406**	**$348,917**
Increase (decrease) in taxes resulting from:				
a) Disposition of an investment in a consolidated subsidiary	—	(49,980)	**—**	**—**
b) Changes in valuation allowance	(16,068)	8,054	**(12,857)**	**(96,669)**
c) Non-deductible expense for tax purposes	4,126	4,836	**4,570**	**34,361**
d) International tax rate differences	5,096	674	**78**	**586**
e) Effect of change in normal statutory tax rate in Japan	—	—	**6,604**	**49,654**
f) Other	6,050	(507)	**3,232**	**24,301**
Actual total income tax expenses	¥76,376	¥24,900	**¥48,033**	**$361,150**

The significant components of deferred tax assets and liabilities at March 31, 1997 and 1998 are as follows:

March 31	In millions of yen 1997	In millions of yen 1998	In thousands of U.S. dollars 1998
Deferred tax assets:			
Intercompany profit on inventories and tangible fixed assets between consolidated companies	¥ 48,720	**¥ 33,909**	**$ 254,955**
Accrued pension and severance costs	49,373	**40,560**	**304,962**
Operating lease	26,256	**33,479**	**251,722**
Loss carryforwards	85,643	**97,504**	**733,113**
Other	88,162	**88,737**	**667,196**
	298,154	**294,189**	**2,211,948**
Less—Valuation allowance	89,008	**65,158**	**489,910**
Total	¥209,146	**¥229,031**	**$1,722,038**
Deferred tax liabilities:			
Tax deductible reserve	¥ 40,563	**¥ 37,423**	**$ 281,376**
Tax on undistributed earnings	12,723	**22,260**	**167,369**
Marketable securities	14,629	**16,710**	**125,639**
Other	28,139	**27,445**	**206,353**
Total	¥ 96,054	**¥103,838**	**$ 780,737**

In Japan, consolidated tax returns are not permitted; accordingly, company subsidiaries are required to file separate tax returns. The valuation allowance is primarily related to deferred tax assets of certain consolidated subsidiaries with operating loss carryforwards which are not expected to be realized. The net changes in the total valuation allowance for the years ended March 31, 1996, 1997 and 1998 were decreases of ¥29,460 million, ¥8,773 million and ¥23,850 million ($179,323 thousand), respectively. Of the changes in the valuation allowance, the amounts attributable to the release of the beginning-of-the-year balance due to favorable developments in the subsequent year for the years ended March 31, 1996, 1997 and 1998 were decreases of ¥14,470 million, ¥15,560 million and ¥21,576 million ($162,226 thousand), respectively.

At March 31, 1998, for tax return purposes, the company had tax loss carryforwards amounting to approximately ¥216,147 million ($1,625,165 thousand) which will expire primarily during the period from 1999 through 2003 and in 2007, 2008 and 2010. Realization is dependent on companies generating sufficient taxable income prior to expiration of the tax loss carryforwards. Although realization is not assured, management believes it is more likely than not that the net deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

Changes in common stock, additional paid-in capital, legal reserve, cumulative translation adjustments and treasury stock are shown below:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Common stock:				
Balance at beginning of year	¥189,005	¥191,294	**¥200,403**	**$1,506,790**
Conversion of convertible debt	2,289	9,109	**15,650**	**117,669**
Balance at end of year	¥191,294	¥200,403	**¥216,053**	**$1,624,459**
Additional paid-in capital:				
Balance at beginning of year	¥298,095	¥300,374	**¥312,192**	**$2,347,308**
Conversion of convertible debt	2,279	10,207	**18,303**	**137,617**
Change in interest in consolidated subsidiaries	—	1,611	**435**	**3,271**
Gain on sale of treasury stock	—	—	**1**	**7**
Balance at end of year	¥300,374	¥312,192	**¥330,931**	**$2,488,203**
Legal reserve:				
Balance at beginning of year	¥ 27,857	¥ 29,826	**¥ 31,985**	**$ 240,489**
Transfer from retained earnings	1,969	2,159	**2,096**	**15,759**
Balance at end of year	¥ 29,826	¥ 31,985	**¥ 34,081**	**$ 256,248**
Cumulative translation adjustments:				
Balance at beginning of year	¥ (48,910)	¥ (25,536)	**¥ 3,601**	**$ 27,075**
Translation adjustment for the year	23,374	29,137	**9,261**	**69,632**
Balance at end of year	¥ (25,536)	¥ 3,601	**¥ 12,862**	**$ 96,707**
Treasury stock, at cost:				
Balance at beginning of year	¥ (2)	¥ (7)	**¥ (15)**	**$ (113)**
Net change resulting from purchase and sales of fractional shares of less than "One Unit" as defined by the Japanese Commercial Code	(5)	(8)	**7**	**53**
Balance at end of year	¥ (7)	¥ (15)	**¥ (8)**	**$ (60)**

(1) Common stock and additional paid-in capital

Issuances of common stock in connection with conversions of convertible debt for the years ended March 31, 1996, 1997 and 1998 were 4,874,097 shares, 19,454,109 shares and 32,439,230 shares, respectively.

Prior to 1985, the parent company made free share distributions of 233,182,146 shares. The cumulative amount of the fair value of these shares at the time of issuance was ¥258,755 million. Had the company accounted for these free share distributions in the manner used by United States companies, that amount would have been transferred from retained earnings to appropriate capital accounts.

(2) Legal reserve and retained earnings

The Japanese Commercial Code provides that an amount equal to at least 10 percent of cash dividends and other distributions from retained earnings paid by the parent company and its Japanese subsidiaries be appropriated as a legal reserve. No further appropriation is required when the legal reserve equals 25 percent of their respective stated capital.

The amount of retained earnings available for dividends is based on the parent company's retained earnings determined in accordance with generally accepted accounting principles and the Commercial Code in Japan. The appropriations of retained earnings for the year ended March 31, 1998, as incorporated in the accompanying consolidated financial statements, include year-end dividends of ¥8,789 million ($66,083 thousand) which, in accordance with the Japanese Commercial Code, was approved at the Ordinary General Meeting of Shareholders which was held on June 26, 1998 and was recorded in the statutory books of account on that date.

11 NET INCOME PER SHARE

Basic and diluted net income per share are computed as follows:

Year ended March 31	In exact shares 1996	1997	**1998**
Number of shares for basic per share computations for net income:			
Weighted-average number of shares of common stock outstanding for the year	1,543,813,308	1,551,017,559	**1,592,406,790**
Add—Incremental shares related to convertible bonds	231,404,097	296,731,689	**254,578,150**
Number of shares for diluted per share computations for net income	1,775,217,405	1,847,749,248	**1,846,984,940**

Year ended March 31	In millions of yen 1996	1997	**1998**	In thousands of U.S. dollars **1998**
Net income available to common shareholders	¥77,166	¥91,581	**¥41,302**	**$310,541**
Net income effect of interest on convertible bonds	2,962	3,354	**3,109**	**23,376**
Net income available to common shareholders and assumed conversions	¥80,128	¥94,935	**¥44,411**	**$333,917**

Year ended March 31	Yen 1996	1997	**1998**	U.S. dollars **1998**
Net income per share of common stock:				
Basic	¥49.98	¥59.05	**¥25.94**	**$0.195**
Diluted	45.14	51.38	**24.05**	**0.181**

12 FINANCIAL INSTRUMENTS

(1) Fair value of financial instruments

The carrying amounts of cash and cash equivalents, time deposits, notes and accounts receivable and payable, trade, short-term borrowings, employees' savings deposits, accrued taxes on income and other current assets and liabilities approximated fair value because of their short-term maturities. The carrying amounts and estimated fair values of the other financial instruments are summarized as follows:

	In millions of yen				In thousands of U.S. dollars	
	1997		**1998**		**1998**	
March 31	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Marketable and investment securities	¥ 339,335	¥ 538,134	**¥ 349,866**	**¥ 504,864**	**$2,630,572**	**$ 3,795,970**
Long-term receivables, trade	43,162	44,107	**40,111**	**41,010**	**301,586**	**308,346**
Long-term loans	30,443	30,464	**21,533**	**21,677**	**161,902**	**162,985**
Long-term debt, including current portion and excluding capital lease obligation	(1,247,177)	(1,307,914)	**(1,324,527)**	**(1,377,861)**	**(9,958,850)**	**(10,359,857)**
Derivatives:						
Forward exchange contracts	(730)	(743)	**279**	**209**	**2,098**	**1,571**
Interest rate and currency swap agreements	(2,557)	2,048	**5,194**	**(2,621)**	**39,053**	**(19,707)**
Option contracts—Purchased	567	296	**440**	**338**	**3,308**	**2,541**
Written	(7)	(7)	**0**	**0**	**0**	**0**

The fair values of financial instruments at March 31, 1997 and 1998 are determined by using a variety of methods and assumptions such as reference to various market and other data as appropriate. For marketable securities, fair value is determined based on quoted market prices. For investment debt securities, fair value is determined based on information obtained from independent third parties. For long-term receivables, trade and long-term loans included in investments and advances—other, fair value is estimated using estimated discounted values of future cash flows. For long-term debt, fair value is estimated using market quotes, or where market quotes are not available, using estimated discounted future cash flows for the same or similar types of instruments. Investments in equity securities, included in investments and advances—other, with an aggregated carrying value of ¥77,383 million and ¥91,454 million ($687,624 thousand) at March 31, 1997 and 1998, respectively, consist of numerous investments in securities of non-public companies. It is not practicable to reasonably estimate the fair values of these investments. Fair value of the forward exchange contracts is estimated by obtaining quotes for futures contracts with similar maturities, and fair value of the interest rate and currency swap agreements is estimated based on the discounted values of net future cash flows, and fair value of the option contracts is estimated using pricing models based upon current market interest and foreign exchange rates and volatilities.

(2) Derivative financial instruments

In the normal course of business, the company enters into various derivative financial instruments in order to manage exposures resulting from fluctuations in foreign currency exchange rates and interest rates. The primary classes of derivatives used by the company are forward exchange contracts, interest rate swap agreements, currency swap agreements and foreign currency purchased and written options as a normal part of its risk management efforts, which include those transactions designed as hedges but that do not qualify for hedge accounting under accounting principles generally accepted in the United States of America. Gains and losses on those derivative financial instruments qualified for hedge accounting are deferred and effectively offset gains and losses on the underlying hedged assets and liabilities by recognizing them in the same period. Other derivatives used for hedging purposes but not qualifying for hedge accounting under accounting principles generally accepted in the United States of America are marked to market.

The forward exchange contracts have been entered into as hedges against the adverse impact of fluctuations in foreign currency exchange rates on monetary assets and liabilities denominated in foreign currencies arising from the company's operating activities. The company had outstanding forward exchange contracts which, at March 31, 1997, mature through September 1997 to purchase the equivalent of ¥120,475 million, principally U.S. Dollars, and to sell the equivalent of ¥110,671 million, principally U.S. Dollars and German Marks, of various foreign currencies. At March 31, 1998, the company had outstanding forward exchange contracts which mature through March 1999 to purchase the equivalent of ¥85,082 million ($639,714 thousand), principally U.S. Dollars, and to sell the equivalent of ¥49,345 million ($371,015 thousand), principally U.K. Pounds, German Marks and U.S. Dollars, of various foreign currencies.

The interest rate swap agreements are fully integrated with underlying debt obligations and designed to convert fixed rate debt into floating rate debt, or vice versa, and interest rate option agreements are also arranged so that exposures to losses resulting from fluctuations in interest rates are managed. The currency swap agreements and options are designed to limit exposures to losses resulting from fluctuations in foreign currency exchange rates. The aggregate notional principal amounts for interest rate swap agreements and currency swap agreements were ¥305,286 million and ¥527,188 million ($3,963,820 thousand) at March 31, 1997 and 1998, respectively. These agreements mature through 2009. The differentials to be paid or received related to interest rate swap agreements are recognized in interest expense over the terms of the agreements. The notional principal amounts of purchased interest rate option contracts were ¥29,587 million and ¥29,737 million ($223,586 thousand) at March 31, 1997 and 1998, respectively. These agreements mature through 2007. The notional principal amounts of written interest rate option contracts at March 31, 1997 and 1998 were ¥2,482 million and ¥2,642 million ($19,865 thousand). These agreements mature through 1998.

The counterparties to the company's derivative transactions are major financial institutions. As a normal business risk, the company is exposed to credit loss in the event of nonperformance by the counterparties, however, the company does not anticipate nonperformance by the counterparties to these agreements, and no material losses are expected.

13 RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses included in selling, general and administrative expenses approximated ¥298,713 million, ¥348,537 million and ¥381,239 million ($2,866,459 thousand) for the years ended March 31, 1996, 1997 and 1998, respectively.

14 ADVERTISING COSTS

The company expenses advertising costs as incurred. Advertising expenses amounted to ¥40,162 million, ¥42,527 million and ¥45,684 million ($343,489 thousand) for the years ended March 31, 1996, 1997 and 1998, respectively.

15 EXCHANGE GAINS AND LOSSES

Foreign currency transaction gains and losses which were included in other income were as follows:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Net exchange gains	¥511	¥19,373	**¥1,954**	**$14,692**

16 LEASING ARRANGEMENTS

(1) Leasing of computer equipment

In the normal course of business, the company sells certain equipment to an affiliated financing company which in turn leases the equipment to certain government and government agency customers under operating leases. The company also agrees to repurchase that equipment at prescribed amounts at the expiration of the lease. The company has previously accounted for these transactions as sales which is consistent with accounting practices in Japan. The estimated accrued losses arising from future repurchases of computers have been provided for. Effective December 1, 1995, the company began to account for these transactions as assets owned and leased to others under operating leases as required by accounting principles generally accepted in the United States of America. The company has not restated prior periods because the effect on earnings of applying the new accounting practice is not material. During a period of transition, which will continue for approximately three years, income before taxes was reduced by ¥19,528 million for the year ended March 31, 1996, ¥23,800 million for the year ended March 31, 1997 and ¥17,309 million ($130,143 thousand) for the year ended March 31, 1998 compared to income that would have been reported if the company had previously followed the new accounting practice.

At March 31, 1997 and 1998, the company invested in computer equipment to be leased to others as described above, amounting to ¥80,733 million less accumulated depreciation of ¥44,218 million and ¥70,640 million ($531,128 thousand) less accumulated depreciation of ¥39,131 million ($294,218 thousand), respectively. Future minimum lease payments from noncancelable leases as of March 31, 1998 are ¥7,798 million ($58,632 thousand) and ¥605 million ($4,549 thousand) for the years ending March 31, 1999 and 2000, respectively.

(2) Lease of facilities and equipment for the company's use

The company leases certain facilities and equipment for its own use. Gross amount of leased assets under capital leases included in machinery and equipment was ¥77,747 million and ¥107,287 million at March 31, 1997 and 1998, respectively. Accumulated amortization of the leased assets at March 31, 1997 and 1998 was ¥28,147 million and ¥46,708 million, respectively.

The following is a schedule by year of the future minimum lease payments under capital leases together with the present value of the net minimum lease payments at March 31, 1998:

Year ending March 31	In millions of yen	In thousands of U.S. dollars
1999	¥21,646	$162,752
2000	19,540	146,917
2001	15,478	116,376
2002	11,890	89,398
2003	4,935	37,105
2004	639	4,805
Total minimum lease payments	74,128	557,353
Less—Amount representing interest	6,348	47,729
Present value of net minimum lease payments	67,780	509,624
Less—Current obligation	19,620	147,519
Long-term lease obligation	¥48,160	$362,105

Rental expenses under operating leases were as follows:

	In millions of yen			In thousands of U.S. dollars
Year ended March 31	1996	1997	**1998**	**1998**
Rental expenses under operating leases	¥111,049	¥120,056	**¥122,730**	**$922,782**

Future minimum rental payments are as follows:

Year ending March 31	In millions of yen	In thousands of U.S. dollars
1999	¥16,028	$120,511
2000	14,732	110,767
2001	8,582	64,526
2002	4,895	36,805
2003	4,043	30,398
2004 and thereafter	18,291	137,526

17 COMMITMENTS AND CONTINGENT LIABILITIES

Commitments outstanding at March 31, 1998 for the purchase of property, plant and equipment approximated ¥40,498 million ($304,496 thousand).

Contingent liabilities at March 31, 1998 for notes discounted, loans guaranteed and other guarantees amounted to approximately ¥256,114 million ($1,925,669 thousand).

18 SUBSEQUENT EVENTS

(1) On April 23, 1998, the parent company issued ¥50,000 million ($375,940 thousand) of 2.6 percent unsecured yen debentures due 2008 by public offerings. The issue price was 100 percent of the face value of the bonds.

(2) On May 25, 1998, the parent company issued ¥30,000 million ($225,564 thousand) of 1.2 percent unsecured yen debentures due 2001 and ¥30,000 million ($225,564 thousand) of 1.9 percent unsecured yen bonds due 2005 by public offerings. The issue price was 100 percent of the face value of the bonds.

(3) Based on the resolution of the Board of Directors meeting of the parent company, which was held on June 26, 1998, the parent company announced on July 7, 1998 to issue ¥20,000 million ($150,376 thousand) of 1.55 percent unsecured yen debentures due 2003, ¥20,000 million ($150,376 thousand) of 1.9 percent unsecured yen debentures due 2005 and ¥30,000 million ($225,564 thousand) of 2.25 percent unsecured yen debentures due 2008 by public offerings on July 22, 1998. The issue price will be 100 percent of the face value of the bonds.