

Notes to Consolidated Financial Statements

Noritz Corporation and Consolidated Subsidiaries

1. BASIS OF FINANCIAL STATEMENTS

Noritz Corporation (the "Company") and its consolidated domestic subsidiaries maintain their official accounting records in Japanese yen and in accordance with the provisions set forth in the Japanese Commercial Code and accounting principles and practices generally accepted in Japan ("Japanese GAAP"). The accounts of overseas subsidiary are based on its accounting records maintained in conformity with generally accepted accounting principles and practices prevailing in China. Certain accounting principles and practices generally accepted in Japan are different from International Accounting Standards and standards in other countries in certain respects as to application and disclosure requirements. Accordingly, the accompanying consolidated financial statements are intended for use by those who are informed about Japanese accounting principles and practices.

The accompanying consolidated financial statements have been restructured and translated into English (with some expanded descriptions and the inclusion of statements of shareholders' equity) from the consolidated financial statements of the Company prepared in accordance with Japanese GAAP and filed with the appropriate Local Finance Bureau of the Ministry of Finance as required by the Securities and Exchange Law. Some supplementary information included in the statutory Japanese language consolidated financial statements, but not required for fair presentation, is not presented in the accompanying consolidated financial statements.

The translations of the Japanese yen amounts into U.S. dollars are included solely for the convenience of readers outside Japan, using the prevailing exchange rate at December 31, 2003, which was ¥107.14 to U.S.\$1.00. The convenience translations should not be construed as representations that the Japanese yen amounts have been, could have been or could in the future be converted into U.S. dollars at this or any other rate of exchange.

2. SIGNIFICANT ACCOUNTING POLICIES

(1) Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its 14 (12 in 2002) significant companies over which the Company has power of control through majority voting right or existence of certain conditions evidencing control by the Company. Investment in 2002 and portion 2003 in an affiliate over which the Company has the ability to exercise significant influence over operating and financial policies of the investees is accounted for on the equity method.

In the elimination of investments in subsidiaries, the assets and liabilities of the subsidiaries, including the portion attributable to minority shareholders, are evaluated using the fair value at the time the Company acquired control of the respective subsidiaries.

The difference, if considered significant, between the cost of investments and equity in subsidiaries' net assets at dates of acquisition is amortised over five years.

(2) Securities

Available for sales securities with maturities that mature within one year are classified in marketable securities.

Equity securities issued by subsidiaries and affiliated companies which are not consolidated or accounted for using the equity method are stated at moving-average cost. Available-for-sale securities with available fair market values are stated at fair market value. Unrealised gains and unrealised losses on these securities are reported, net of applicable income taxes, as a separate component of shareholders' equity. Realised gains and losses on sale of such securities are computed using moving-average cost.

Debt securities with no available fair market value are stated at amortised cost, net of the amount considered not collectible. Other securities with no available fair market value are stated at moving-average cost.

If the market value of equity securities issued by unconsolidated subsidiaries and affiliated companies and available-for-sale securities declines significantly, such securities are stated at fair market value and the difference between fair market value and the carrying amount is recognised as a loss in the period of the decline. If the fair market value of equity securities issued by unconsolidated subsidiaries and affiliated companies not on the equity method is not readily available, such securities should be written down to net asset value with a corresponding charge in the income statement in the event net asset value declines significantly. In these cases, such fair market value or the net asset value will be the carrying amount of the securities at the beginning of the next year.

(3) Derivatives and hedge accounting

If derivative financial instruments are used as hedges and meet certain hedging criteria, the Companies defer recognition of gains or losses resulting from changes in fair value of derivative financial instruments until the related losses or gains on the hedged items are recognised.

(4) Inventories

With respect to the Company, finished products and work in process are valued at weighted-average cost, whereas purchased goods, raw materials and supplies are valued at moving-average cost.

With respect to the consolidated subsidiaries, inventories are valued at weighted-average cost, last purchase costs or the first-in, first-out cost method.

(5) Property, plant and equipment

Property, plant and equipment are carried at cost. Depreciation is provided on a declining-balance method over the estimated useful lives of the assets. However, in accordance with changes in the Corporation Tax Law, effective April 1, 1998, the Companies depreciate newly acquired buildings on the straight-line method.

(6) Research and development expenses

Research and development expenses are charged to income as incurred. Such expenses for the years ended December 31, 2002 and 2003 were ¥4,777 million and ¥4,443 million (\$41,469 thousand), respectively.

(7) Software costs

The Companies include software in intangible assets and depreciate it using the straight-line method over the estimated useful lives (five years).

(8) Allowance for doubtful receivables

The allowance for doubtful receivables is provided for in an amount sufficient to cover possible losses on collection. With respect to normal trade accounts receivable, it is stated at an amount based on the actual rate of historical bad debts, and for certain doubtful receivables, the uncollectible amount has been individually estimated.

(9) Bonuses

The Companies follow the general Japanese practice of paying bonuses to employees in July and December. Accrued bonus liabilities of the Companies at the balance sheet date are calculated based upon management's estimate of annual amounts thereof. Accrued bonuses are included in the liability for accrued expenses in the consolidated balance sheets.

Bonuses to directors and statutory auditors, which are subject to approval at the shareholders' meeting, are accounted for as an appropriation of retained earnings.

(10) Reserve for product warranty

The reserve for product warranty is calculated on the basis of sales of products and actual product warranties in the past. The reserve is included in the liability for accrued expenses in the consolidated balance sheets.

(11) Income taxes

The Companies use the asset and liability approach to recognise deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

(12) Retirement benefits

(i) Employees

The Companies provide two types of post-employment benefit plans: unfunded lump-sum payment plans and funded non-contributory pension plans, under which all eligible employees are entitled to benefits based on the level of wages and salaries at the time of retirement or termination, length of service and certain other factors.

The Companies provided for employees' severance and retirement benefits at December 31, 2002 and 2003 based on the estimated amounts of projected benefit obligation and the fair value of the plan assets at those dates.

The excess of the projected benefit obligation over the total of the fair value of pension assets as of January 1, 2001 and the liabilities for severance and retirement benefits recorded as of January 1, 2001 (the "net transition obligation" at the time of adopting a new accounting standard) is being recognised in expenses in approximately equal amounts primarily over three years commencing with the year ended December 31, 2001. Prior service costs are recognised in expenses in equal amounts over three years, and actuarial gains and losses are recognised in expenses using the straight-line method over 10 years commencing with the following period.

The Company obtained approval from Japan's Ministry of Health, Labour and Welfare for exemption from the future benefit obligation with respect to the portion that the Company operates for the government (the so-called substitutional portion) on

November 26, 2002. Pursuant to transitional measures of Paragraph 47-2 of "Practical Guidelines of Accounting for Retirement Benefits (JICPA's Accounting Committee Report No. 13)," the Company recognised a gain on the relinquishment of the substitutional portion of the retirement benefit obligations of welfare pension funds on the date when the exemption was approved. The amount of the relinquished fair value of pension assets for the year ended December 31, 2002 is ¥6,295 million.

(ii) Directors and statutory auditors

The liability for directors' and statutory auditors' retirement benefits is provided based upon the Company's internally established criteria.

(13) Translation of foreign currencies

Receivables and payables denominated in foreign currencies are translated into Japanese yen at the year-end rates.

(14) Accounting for leases

Finance leases which do not transfer ownership may be accounted for in the same manner as operating leases under generally accepted accounting principles in Japan.

(15) Net income per share

Computations of net income per share of common stock are based on the weighted average number of shares adjusted for any stock splits. Diluted net income per share is not disclosed because there were no potentially dilutive securities.

Effective January 1, 2003, the Company adopted the new accounting standard for earnings per share and related guidance (Accounting Standards Board Statement No. 2, "Accounting Standard for Earnings Per Share" and Financial Standards Implementation Guidance No. 4, "Implementation Guidance for Accounting Standards for Earnings Per Share", issued by the Accounting Standards Board of Japan on September 25, 2002).

Net income per share for year ended December 31, 2002 would have been ¥64.42, if this new accounting standard were applied retroactively.

(16) Cash and cash equivalents and statements of cash flow

In preparing the consolidated statements of cash flows, cash on hand, readily available deposits and short-term highly liquid investments with maturities not exceeding three months at the time of purchase are considered to be cash and cash equivalents.

3. STATEMENTS OF CASH FLOWS

The reconciliation of cash and time deposits in the consolidated balance sheets and cash and cash equivalents in the consolidated statements of cash flows as of December 31, 2002 and 2003 is as follows:

	Millions of yen		Thousands of
	2002	2003	U.S. dollars
Cash and time deposits in			
the consolidated balance sheets	¥16,475	¥30,166	\$281,557
Marketable securities	13,364	9,395	87,689
Other (trust)	2,000	1,000	9,334
Time deposits with maturities			
exceeding 3 months	(1,849)	(1,583)	(14,775)
Bonds with maturities			
exceeding 3 months	(2,036)	(3,106)	(28,991)
Cash and cash equivalents in			
the consolidated statements			
of cash flows	¥27,954	¥35,872	\$334,814

4. MARKETABLE SECURITIES AND INVESTMENT SECURITIES

The following tables summarise acquisition costs and book values (fair values) of securities with available fair values as of December 31, 2002 and 2003:

Available-for-sale securities

Securities with book values exceeding acquisition costs are as follows:

Type	Millions of yen						Thousands of U.S. dollars		
	2002			2003			2003		
	Acquisition cost	Book value	Difference	Acquisition cost	Book value	Difference	Acquisition cost	Book value	Difference
Equity securities	¥1,348	¥1,704	¥356	¥2,431	¥3,586	¥1,155	\$22,690	\$33,470	\$10,780
Bonds	1,432	1,452	20	2,802	2,830	28	26,153	26,414	261
Others	—	—	—	11	13	2	102	121	19
Total	¥2,780	¥3,156	¥376	¥5,244	¥6,429	¥1,185	\$48,945	\$60,005	\$11,060

Other securities are as follows:

Type	Millions of yen						Thousands of U.S. dollars		
	2002			2003			2003		
	Acquisition cost	Book value	Difference	Acquisition cost	Book value	Difference	Acquisition cost	Book value	Difference
Equity securities	¥ 3,110	¥2,524	¥ (586)	¥1,372	¥1,272	¥(100)	\$12,806	\$11,872	\$ (934)
Bonds	6,828	6,530	(298)	1,785	1,670	(115)	16,660	15,587	(1,073)
Others	976	761	(215)	790	601	(189)	7,374	5,610	(1,764)
Total	¥10,914	¥9,815	¥(1,099)	¥3,947	¥3,543	¥(404)	\$36,840	\$33,069	\$(3,771)

The following tables summarise book values of securities with no available fair values as of December 31, 2002 and 2003.

Available-for-sale securities

Type	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Non-listed equity securities	¥ 151	¥ 147	\$ 1,372
Mutual funds	185	50	467
Commercial paper	11,794	7,697	71,841
Total	¥12,130	¥7,894	\$73,680

Available-for-sale securities with maturities mature as follows:

Type	Millions of yen										Thousands of U.S. dollars				
	2002					2003					2003				
	Within one year	Within five years	Within ten years	Over ten years	Total	Within one year	Within five years	Within ten years	Over ten years	Total	Within one year	Within five years	Within ten years	Over ten years	Total
Bonds	¥1,000	¥5,118	¥700	¥500	¥7,318	¥1,350	¥2,418	¥300	¥500	¥4,568	\$12,600	\$22,569	\$2,800	\$4,667	\$42,636
Others	9	333	—	—	342	—	282	—	—	282	—	2,632	—	—	2,632
Total	¥1,009	¥5,451	¥700	¥500	¥7,660	¥1,350	¥2,700	¥300	¥500	¥4,850	\$12,600	\$25,201	\$2,800	\$4,667	\$45,268

Total sales of available-for-sale securities in the year ended December 31, 2002 amounted to ¥7,400 million and the related gains and losses amounted to ¥49 million and ¥86 million, respectively.

Total sales of available-for-sale securities in the year ended December 31, 2003 amounted to ¥30,548 million (\$285,122 thousand) and the related gains and losses amounted to ¥149 million (\$1,391 thousand) and ¥13 million (\$121 thousand), respectively.

5. DERIVATIVE TRANSACTIONS

As a part of investment of available funds, at December 31, 2001 and 2002, the Company also utilised some compound financial investments which include derivatives within the specified limits on the amounts of transactions allowed. The compound financial instruments are exposed to the risk of the fluctuation of the Nikkei Stock Average.

At December 31, 2003, the Company had no compound financial investments.

To minimise credit risk, the Company uses highly rated financial institutions as counterparties to these transactions. The Company has established policies that restrict dealing in derivatives and that require reviews and reporting to the Board of Directors.

6. LEASES

Finance leases, except for those in which ownership is deemed to be transferred to the lessee, are accounted for as operating leases. Original lease obligations and future minimum lease payments at December 31, 2002 and 2003 are as follows:

	Millions of yen						Thousands of U.S. dollars
	2002			2003			2003
	Machinery and equipment	Other	Total	Machinery and equipment	Other	Total	Total
Original lease obligation (including finance charges)	¥2,337	¥137	¥2,474	¥2,143	¥230	¥2,373	\$22,149
Payments remaining	1,156	77	1,233	956	114	1,070	9,987
Payments due within one year			425			464	4,331
Payments due after one year			808			606	5,656
Total			¥1,233			¥1,070	\$ 9,987

Total lease payments under non-capitalised finance leases for the years ended December 31, 2002 and 2003 were ¥468 million and ¥509 million (\$4,751 thousand), respectively.

Lease payments for the years ended December 31, 2002 and 2003 were ¥468 million and ¥509 million (\$4,751 thousand), respectively.

Future minimum rents under non-cancellable operating leases at December 31, 2002 and 2003 consist of the following:

	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Due within one year	¥ 6	¥3	\$28
Due after one year	6	2	19
	¥12	¥5	\$47

7. BANK LOANS AND LONG-TERM DEBT

Short-term bank loans and long-term debt at December 31, 2002 and 2003 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Short-term bank loans—0.65%	¥1,046	¥1,960	\$18,294
Long-term bank loans—			
1.5% to 1.68%	¥ 900	¥ —	\$ —
Less: due within one year	200	—	—
Long-term debt due after one year	¥ 700	¥ —	\$ —

8. CONTINGENT LIABILITIES

At December 31, 2003, the Companies were contingently liable as follows:

	Millions of yen	Thousands of U.S. dollars
As endorser of notes endorsed	¥ 10	\$ 93
As guarantor of indebtedness of an affiliate and other companies	1,763	16,455
	¥1,773	\$16,548

9. INCOME TAXES

The Companies are subject to a number of taxes based on income, which, in the aggregate, indicate a statutory tax rate in Japan of approximately 42% for the years ended December 31, 2002 and 2003.

The following table summarises the significant differences between the statutory tax rate and the Companies' effective tax rate for financial statement purposes for the years ended December 31, 2002 and 2003.

	Percentage	
	2002	2003
Statutory tax rate:	42.0%	42.0%
Permanently non-deductible expenses	1.7	2.3
Permanently non-taxable dividend income	(0.5)	(0.4)
Per capita inhabitants' tax	0.8	2.1
Equity in income (losses) of affiliates	1.0	(0.5)
Decrease in deferred tax assets due to change in tax rate	—	3.0
Other	1.7	3.3
Effective tax rate	46.7%	51.8%

Significant components of the Companies' deferred tax assets and liabilities as of December 31, 2002 and 2003 are as follows:

	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Deferred tax assets:			
Employees' retirement benefits	¥4,039	¥5,332	\$49,767
Excess bad-debt expenses	1,146	319	2,978
Directors' and statutory auditors' retirement benefits	336	286	2,669
Accrued enterprise tax	200	152	1,419
Write-down of securities	573	274	2,557
Loss carryforwards (for tax purposes)	215	226	2,109
Other	183	330	3,080
Total deferred tax assets	6,692	6,919	64,579
Valuation allowance	(157)	(145)	(1,353)
Net deferred tax assets	6,535	6,774	63,226
Deferred tax liabilities:			
Net unrealised holding gains on securities	—	(258)	(2,408)
Land	(189)	(422)	(3,939)
Net deferred tax assets	¥6,346	¥6,094	\$56,879

	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Short-term deferred tax assets	¥ 738	¥ 737	\$ 6,879
Long-term deferred tax assets	5,797	5,657	52,800
Long-term deferred tax liabilities	(189)	(300)	(2,800)
	¥6,346	¥6,094	\$56,879

The aggregate statutory income tax rate will be reduced for the years commencing on January 1, 2005 or later due to the revised local tax law. At December 31, 2003, the Company and consolidated domestic subsidiaries applied the reduced aggregate statutory income tax rate of 40.7% for calculating deferred tax assets and liabilities that are expected to be recovered or settled in the years commencing on January 1, 2005 or later. As a result, deferred taxes assets decreased by ¥170 million (\$1,587 thousand), net unrealised holding gains on securities increased by ¥11 million (\$103 thousand) and provision for deferred income taxes increased by ¥181 million (\$1,689 thousand) compared with what would be reported using the currently applicable tax rate of 42.0%.

10. EMPLOYEES' SEVERANCE AND RETIREMENT BENEFITS

As explained in Note 2 (12) Retirement benefits, (i) Employees, effective January 1, 2001, the Companies adopted the new accounting standard for employees' severance and retirement benefits, under which the liabilities and expenses for severance and retirement benefits are determined based on the amounts obtained by actuarial calculations.

The liabilities for severance and retirement benefits included in the liabilities section of the consolidated balance sheet as of December 31, 2002 and 2003 consist of the following:

	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Projected benefit obligation	¥24,846	¥22,821	\$213,002
Unrecognised prior service costs	62	3,043	28,402
Unrecognised actuarial differences	(4,611)	(4,381)	(40,890)
Less fair value of pension assets	(7,043)	(7,262)	(67,781)
Less unrecognised net transition obligation	(1,894)	—	—
Prepaid pension cost	—	47	439
Liabilities for severance and retirement benefits	¥11,360	¥14,268	\$133,172

Included in the consolidated statements of income for the years ended December 31, 2002 and 2003 are severance and retirement benefit expenses comprised of the following:

	Millions of yen		Thousands of U.S. dollars
	2002	2003	2003
Service costs—			
benefits earned during the year	¥1,545	¥1,384	\$12,918
Interest cost on projected benefit obligation	799	618	5,768
Expected return on plan assets	(416)	(138)	(1,288)
Amortisation of prior service costs	(339)	(35)	(327)
Amortisation of actuarial differences	149	490	4,574
Amortisation of net transition obligation	2,687	1,812	16,912
Severance and retirement benefit expenses	¥4,425	¥4,131	\$38,557

The discount rates and the rates of expected return on plan assets used by the Company are 2.7% and 3.5% in 2002 and 2.7% and 2.3% in 2003, respectively. The estimated amount of all retirement benefits to be paid at future retirement dates is allocated equally to each service year using the estimated number of total service years.

11. SHAREHOLDERS' EQUITY

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

Effective October 1, 2001, the Japanese Commercial Code provides that an amount equal to at least 10% of cash dividends and other cash appropriations shall be appropriated and set aside as a legal reserve until the total amount of the legal reserve and additional paid-in capital equals 25% of common stock. The legal reserve and additional paid-in capital may be used to eliminate or reduce a deficit by resolution of the shareholders' meeting or may be capitalised by resolution of the Board of Directors. On condition that the total amount of the legal reserve and additional paid-in capital remains equal to or exceeding 25% of common stock, they are available for dividends by the resolution of the shareholders' meeting. The legal reserve is included in retained earnings and additional paid-in capital is included in capital surplus in the accompanying financial statements.

(2) The maximum amount that the Company can distribute as dividends is calculated based on the unconsolidated financial statements of the Company in accordance with the Commercial Code of Japan.

12. SEGMENT INFORMATION

The Companies primarily are engaged in the manufacture and sale of household-related products, bath heaters, water heaters and bathroom- and kitchen-related products.

As these activities comprise one industry segment, segment information by industry is not disclosed. As sales outside Japan are less than 10% of the Company's consolidated net sales, segment information by geographic area is not disclosed.

13. SUBSEQUENT EVENT

Appropriation of retained earnings

At the ordinary shareholders' meeting of the Company held on March 30, 2004, the following appropriations of retained earnings for the year ended December 31, 2003 were duly approved:

	Millions of yen	Thousands of U.S. dollars
Appropriations:		
Cash dividends—¥8.5 per share	¥426	\$3,976
Bonuses to directors and statutory auditors	42	392