Financial Review

(1) Significant Accounting Policies and Estimates

The consolidated financial statements of the KDDI Group have been prepared in conformity with accounting standards generally accepted in Japan. In particular, the significant accounting policies described below had a material impact on the major accounting judgments and estimates by the KDDI Group that were used in the compilation of these consolidated financial statements.

(a) Estimated useful lives of fixed assets

The useful lives of fixed assets are based on reasonable estimates. The estimated useful life of submarine cable systems was reduced in the fiscal year ended March 2004 in recognition of major market shifts and other changes in the telecoms business environment in the past few years. The KDDI Group sees no need to make any further reductions in the estimated useful lives of fixed assets. However, such need may arise in the future if market, environmental, or technological changes occur more rapidly than projected or in the event of new legal or regulatory developments.

(b) Impairment of fixed assets

Impairment losses are calculated based on the grouping of assets into the smallest-possible units capable of generating cash flows that are independent of other assets or asset groups. In the fiscal year ended March 2006, the KDDI Group posted extraordinary losses of ¥104.2 billion against the impairment of fixed assets related to the provision of TU-KA cellular phone services (such as PDC equipment) and of ¥9.9 billion against the impairment of underutilized fixed assets, including some domestic transmission infrastructure.

(c) Deferred tax assets

Deferred tax assets and liabilities are stated based on the statutory effective tax rate in recognition of any temporary differences between the carrying values of assets and liabilities and corresponding values listed in filings to tax authorities. Valuation allowances are stated against deferred tax assets, based on future likelihood. Evaluations of the necessity of recording such valuation allowances take into account projected future taxable income levels and utilizable tax planning. Losses carried forward for tax purposes arising from the merger with POWEREDCOM Inc. and any related temporary differences are also stated based on considerations of future likelihood.

(d) Retirement benefits and pension obligations

Retirement and severance benefits and pension obligations are calculated using certain fundamental parameters that are based on actuarial calculations. The key parameters used include the discount rate, projected mortality rates, forecast retirement rates, and projected rates of increase in wage and salary levels. The discount rate is computed based on the market yields of long-term Japanese government bonds. Projected mortality rates, forecast retirement rates, and projected rates of increase in wage and salary levels are all computed based on statistical values. The expected rate of return is computed based on historical portfolio performance.

The effects of any differences that arise between actual results and the initial assumptions, or of any systemic changes related to mergers, stock splits, or other developments, would by their nature be cumulative and subject to recognition on a regular basis over future fiscal periods. Hence, such changes and differences could potentially have a material effect on the future values of pension-related expenses and allowances.

The following pages provide an analysis of the financial condition and business results of the KDDI Group for the fiscal year ended March 2006. Any forecasts, predictions, projections, outlooks, plans, policies, or comments regarding the future contained in these pages constitute forward-looking statements and as such represent the best judgment of management as of the end of March 2006 based on information available at that time. Actual results may differ materially because of the risks and uncertainties inherent in such statements.

(2) Analysis of Consolidated Business Results

Executive Summary

The market for broadband services continued to grow in Japan. Competition between telecoms carriers to secure customers entered a new phase as the market for personal cellular phone services showed signs of maturity. In the fixed-line communications market, carriers competed to offer a range of direct access services. In the mobile phone market, existing carriers introduced new services and tariff menus, while other companies decided to enter the market. The KDDI Group responded to rapidly changing business conditions through an emphasis on strategy and speed. Efforts focused on strengthening the base of operations to withstand increasingly fierce market competition with the aim of generating sustained growth in consolidated revenue and profits.

Key moves (mobile communications market):

• Absorption of three subsidiaries (TU-KA Cellular Tokyo, Inc., TU-KA Cellular Tokai, Inc., and TU-KA Phone Kansai, Inc.) by KDDI Corporation in response to the anticipated intensification of competition and rapid changes in the business environment (October 2005)

Key moves (fixed-line communications market):

- Comprehensive alliance concluded with Tokyo Electric Power Co. (TEPCO) in communications sector (October 2005)
- Integrated fiber-optic FTTH services launched by KDDI and TEPCO using joint promotional campaign (November 2005)
- Merger of KDDI with POWEREDCOM Inc. (January 2006)
- Equity stakes acquired in Japan Cablenet Holdings Limited and Japan Cablenet Limited as part of a strategy to expand customer base to benefit from future development of the broadband services industry in Japan (March 2006)

Overview

Total operating revenues increased ¥140.7 billion (4.8%) on a year-on-year basis, to ¥3,060.8 billion. The au mobile business remained the main contributor to revenue growth. Higher sales of 3G CDMA 1X WIN mobile handsets enabled KDDI to secure a 48.1% share of the overall annual net increase in subscribers. Continued strong growth in the mobile communications sector more than offset the effect of the October 2004 transfer of PHS operations (which caused a year-on-year decline in revenue of ¥86.8 billion). Revenue from the fixed-line communications business also rose, because of the aggressive marketing of the KDDI Metal Plus service and the merger with POWEREDCOM in January 2006.

Operating expenses increased ¥140.3 billion (5.3%) on a year-on-year basis, to ¥2,764.2 billion. This was mainly attributable to aggressive marketing efforts to expand sales of CDMA 1X WIN handsets and to promote the KDDI Metal Plus service. Operating income rose ¥0.4 billion (0.1%), to ¥296.5 billion.

Net other expenses totaled ¥2.5 billion, an improvement of ¥7.2 billion over the previous year. Principal contributory factors included a further steady reduction in interest-bearing debt and lower interest expense. Ordinary income increased ¥7.6 billion, to ¥294.0 billion.

Total extraordinary losses on a net basis amounted to ¥113.3 billion, reducing profits ¥120.5 billion compared with the previous year. The major factor was an impairment loss of ¥114.2 billion recorded for the fiscal year ended March 2006 against PDC equipment and other TU-KA business-related fixed assets.

Income before income taxes and minority interests decreased ¥112.9 billion, to ¥180.6 billion. Total income taxes, which comprised corporation, resident, and enterprise taxes totaling ¥61.1 billion, together with an income tax credit that resulted in higher deferred taxes of ¥74.5 billion, declined ¥101.5 billion compared with the previous year. This chiefly reflected loss carryforwards and tax relief items inherited as a result of the merger with POWEREDCOM, which had the effect of reducing taxes ¥65.0 billion.

Minority interests declined ¥1.3 billion compared with the previous year, to ¥3.4 billion. Net income declined ¥10.0 billion, to ¥190.5 billion.

(3) Segment Financial Reviews

(a) Operating revenues

Mobile Business

As a result of the merger of KDDI Corporation with three TU-KA Group firms in October 2005, the au business and the TU-KA business were integrated into a new segment called the mobile communications business.

In the mobile communications segment, KDDI has sought to differentiate its offerings from those of rivals by focusing on generally upgrading products and services (including mobile handsets, fee structures, and content) to leverage prior investments in infrastructure supporting 3G mobile phone services.

- Development of a wide variety of new handsets upgraded the range, including successes such as the world's first handset capable of receiving One Seg services and the neon model from the au design project

The range of mobile handsets for au subscribers was augmented substantially, with a total of 32 new models introduced to cater to diverse user requirements. Models launched during the year included the following:

- A model fitted with an advanced GPS function that allows users such as family members to be located using a service called Safe Navi
- A handset compatible with One Seg, the world's first terrestrial digital television broadcasting service for mobile users
- A model fitted with a 4 GB hard disk drive (a first for Japan) and that provides access to au LISTEN MOBILE SERVICE (LISMO), the industry's first comprehensive music service suite for mobile phones
- Neon: the fifth model from the au design project
- Models compatible with mobile payment services, such as EZ FeliCa and Mobile Suica
- Initiation of LISMO for au subscribers, the industry's first comprehensive music service suite for mobile phones

Building on the success of EZ Chaku-Uta® and EZ Chaku-uta Full®, the new LISMO service for au subscribers allows seamless connections between mobile handsets and PCs. This comprehensive music download service, the first in the industry, has made music even more accessible to mobile users.

- LISMO's au Music Player enables users with mutually compatible handsets to exchange music playlists and to make use of the music communication service Uta-tomo™. Users can enjoy interactive music with just a handset.
- Sharing music between mobile phones and PCs is made easy with au Music Port, a music management software program for PCs.

In February 2006, KDDI launched au Shopping Mall, an e-shopping site that allows au subscribers to search for various products at shops operating on the EZweb Internet service. The service also allows users to purchase a number of products from different vendors in an easy and convenient format.

- Pricing and discount plans were further upgraded with the introduction of new tariff options, such as Double Flat Rates Light, Family Discount Wide Support, and My Plan Discount:
- Double Flat Rates Light (May 2005): A flat-rate tariff for packet-switched data communications services designed to enable more CDMA 1X WIN handset owners to gain easier access to rich broadband content (¥1,000/month)
- Family Discount Wide Support (November 2005): Extends the appeal of the Family Discount pricing plan by offering CDMA 1X services for children of elementary and middle school age and for people over 60 at a basic monthly charge of just ¥1,500;* the number of applicable lines for Family Discount was also increased, from 6 to 10

  *¥2,000 if less than three months since initial subscription to au service
- My Plan Discount (February 2006): Based on a two-year contract, this option allows single subscribers to CDMA 1X or CDMA 1X WIN services to benefit from the deeper discounts on the basic monthly charge available through the Family Discount or Annual Discount plans

Mobile phone solution services for corporate clients

Following the November 2004 introduction of OFFICE WISE services for corporate clients, in December 2005 KDDI added a new package of services, including such novel functions as message boards. These make business more convenient while responding to corporate requirements for enhanced security and improved productivity and the like. In March 2006, KDDI also launched the au B01K mobile handset for corporate clients. It is equipped with a high-capacity battery and remote-control security features, such as data deletion and handset locking. KDDI continues to develop new and improved services for this sector.

Campaign to promote same-number subscription switches from TU-KA to au

Following the merger of the three TU-KA companies with KDDI, the company began offering TU-KA mobile phone subscribers the opportunity to switch to an au contract without changing numbers or losing accumulated loyalty points. In February 2006, this promotional offer was upgraded to allow users to keep the same EZweb e-mail address as well.

Until now, KDDI has offered separate mobile phone services under the au and TU-KA brands to cater to varied customer needs. However, in view of the sharp reduction in new subscriptions to the TU-KA service and the steady migration of TU-KA subscribers to au contracts using the same numbers and e-mail addresses (totaling 710,000 users in the second half of the fiscal year ended March 2006), KDDI decided to close the TU-KA mobile phone service to new subscribers from June 30, 2006. Going forward, KDDI plans to focus on making au mobile services as attractive as possible to boost customer satisfaction. KDDI also plans to review whether to maintain TU-KA services, depending on usage status.

These various moves helped to boost considerably the competitiveness of KDDI's mobile phone services, which are now mainly focused on 3G handsets. Operating revenues in this segment in the fiscal year ended March 2006 totaled ¥2,510.3 billion, a year-on-year increase of ¥197.8 billion. A brief analysis of the major contributory factors is provided below.

Cumulative subscribers (thousands)

	At March 31, 2005	At March 31, 2006	Net increase	Share of annual net increase
au	19,542	22,699	3,157	65.8%
(module-type)	487	586	99	
CDMA 1X WIN (EV-DO)	3,252	8,280	5,028	
CDMA 1X	14,683	13,548	(1,135)	
CdmaOne	1,608	871	(737)	
TU-KA (PDC)	3,590	2,739	(850)	-17.7%
Total	23,132	25,439	2,307	48.1%

Note: Net increase = new subscriptions - cancellations

High share of annual net subscriber growth
Total subscriber numbers equaled 25.44 million as of the end of March 2006, representing a 27.7% share of cumulative subscriptions. KDDI achieved a share of 48.1% of overall net subscriber growth during the year (2.31 million users). This factor contributed significantly to higher operating revenues.

KDDI expects other carriers to try to expand their share of the 3G mobile phone services market aggressively in the run-up to the introduction of mobile number portability (MNP) in Japan in autumn 2006. The KDDI Group will respond with further efforts to boost product competitiveness.

Positive impact of increased sales of CDMA 1X WIN handsets
Growth in the number of CDMA 1X WIN users accelerated as KDDI expanded and upgraded the handset lineup and improved available content. Subscribers numbered 8.28 million by the end of March 2006 (up 5.03 million from the previous year-end) and accounted for approximately one-third of the total. KDDI has also introduced a variety of flat-rate tariffs, such as Double Flat and Double Flat Light to encourage users to make more use of data packet-based services. A broader selection of tariff menus resulted in KDDI maintaining the proportion of subscribers on flat-rate pricing plans at a high level (81%). CDMA 1X WIN user growth and a higher ratio of 3G subscribers within KDDI's user base helped to expand the number of high-ARPU* customers, which helped to support growth in operating revenue. Total ARPU (the sum of ARPU for voice and data services) for the fiscal year ended March 2006 was ¥7,040, a decline of ¥130 compared with the previous year. However, data ARPU increased ¥150, to ¥1,890.
*ARPU: Average Revenue per User (average monthly revenue per subscriber)

Improvement in churn rate
The average churn rate for au-branded mobile phone services improved significantly, falling from 1.44% to 1.20%. This reflected ongoing efforts to provide customers with a more-attractive lineup of products (such as handsets, content, software applications, and pricing plans) and services, as well as continued success in boosting au brand power.

Introduction of EV-DO Rev. A
KDDI plans the introduction of EV-DO Rev. A functional extensions to its CDMA 2000 1x EV-DO data infrastructure for au mobile phones in mid-2006. With EV-DO Rev. A, data communication speeds will rise to 3.1 Mbps, downloading, and 1.8 Mbps, uploading. The shift to the new standard will also improve control over service quality by minimizing packet data delays. This move promises to pave the way for the development of entirely new services.

Fixed-line business
Amid a rapid shift toward direct-access, fixed-line services for residential users and the growth of IP and broadband services, KDDI devoted considerable efforts in this segment to strengthening the customer base through business development initiatives. These included promoting sales of the direct-access service KDDI Metal Plus and the development of FTTH services based on a wide-ranging alliance with TEPCO in the telecommunications field and the associated merger with POWEREDCOM.

Expanded sales of KDDI Metal Plus high-quality IP phone services
During the fiscal year ended March 2006, KDDI aggressively promoted sales of KDDI Metal Plus, a high-quality IP phone service offering all the features expected of a fixed-line service at competitive prices along with a simple fee structure. Customers can gain access to these services through a simple connection of their existing landline to KDDI's high-quality IP network. Subscriber numbers had reached 1.8 million by the end of March 2006.

Upgrading of wide-area Ethernet services for corporate clients
In January 2006, KDDI merged with POWEREDCOM, a leading Japanese provider of wide-area Ethernet services for corporate clients. Going forward, the growth of corporate fixed-line data communications is expected to increase demand within the market for wide-area Ethernet services. KDDI is positioning KDDI Powered Ethernet as its main branded service for this segment. KDDI is also working to increase customer satisfaction by leveraging the strengths of POWEREDCOM to offer high-quality service provision and related customer support structures and by developing new services with added convenience.

As a result of KDDI's business development initiatives in responding to the rapid shift toward direct-access, IP, and broadband services, segment operating revenues in the fiscal year ended March 2006 totaled ¥619.3 billion, an increase of ¥23.2 billion on a year-on-year basis. Amid an ongoing trend among users toward the adoption of mobile and IP phone telecommunications services, during the second half of the year KDDI was able to arrest the fall in voice telephony revenue through its aggressive promotion of KDDI Metal Plus services. Other contributory factors in the favorable segment performance were solid growth in income from Internet-type services and new growth due to revenue from wide-area Ethernet services following the merger with POWEREDCOM.

Comprehensive telecommunications alliance with TEPCO and provision of integrated services
In October 2005, KDDI entered into a comprehensive telecommunications alliance with TEPCO, based on which discussions immediately

began relating to joint business development initiatives. In April 2006, another agreement was concluded to enter into discussions with a view to merging the optical network operations of the TEPCO Group into KDDI by January 1, 2007. Discussions on the value of this TEPCO Group business are ongoing, with the aim of reaching a conclusion by the end of September 2006.

Under the same alliance, KDDI and TEPCO also began offering an integrated FTTH service in November 2005. Plans call for the full-scale development of these operations from June 2006 onward.

Through the merger into KDDI of these telecommunications operations, KDDI and TEPCO aim to build a stronger and more competitive telecommunications business group.

IP conversion plans for fixed-line network

KDDI has already announced plans for the phased IP conversion of its fixed-line network. By the end of March 2008, KDDI plans to become one of the world's first carriers to convert its entire fixed-line network to IP. This move will enable KDDI to upgrade the original high-quality IP network that is the backbone for the Hikari one and KDDI Metal Plus services and to shift entirely to software-based switches in place of the existing fixed-line exchanges, which will result in substantial facility cost savings. At the same time, KDDI plans to reduce on an ongoing basis the level of connection fees paid to two NTT regional operating companies by promoting the shift toward direct-access services. The IP conversion of the network also promises to enable KDDI to offer customers high-quality services at lower prices.

PHS business

The PHS segment was eliminated effective the fiscal year ended March 2006 following the transfer of PHS business operations in October 2004.

Segment operating revenues in the first half of the previous year prior to the business transfer were ¥86.8 billion. The segment elimination caused operating revenues in the fiscal year ended March 2006 to fall by the same amount.

Other businesses

In other businesses, the KDDI Group focused on responding to rapid changes in operating conditions in telecoms markets by boosting competitiveness through a restructuring of group operations. This involved moves to consolidate business functions between KDDI Group firms to increase efficiency while strengthening the operational base to foster future growth.

With the aim of consolidating operations and increasing profits, consolidated subsidiary KDDI Evolva Inc., which is involved in call center operations, merged in turn with CTC Create Corporation (May 2005); KSS Clean Corporation (July 2005); and TU-KA Service Co., Ltd. (February 2006). Evolva was the surviving entity in each case.

Segment operating revenues totaled ¥103.5 billion, a year-on-year increase of ¥22.1 billion.

Note: The figures for operating revenues by business segment in the above analysis include sales to external customers as well as sales from intersegment transactions. Because of the change in segment classification effective the fiscal year ended March 2006, the year-on-year growth amounts refer to comparable operations as defined in the revised classification.

(b) Operating expenses

Mobile Business

Mobile communications segment operating expenses in the fiscal year ended March 2006 totaled ¥2,155.9 billion, an increase of ¥135.6 billion compared with the previous year. The major factors contributing to the rise in costs are outlined below.

Increased sales expenses for mobile handsets

The extension of the handset lineup due to the launch of innovatively designed models (the au design project) and the introduction of upgraded CDMA 1X WIN handsets helped to attract more new subscribers and to accelerate the shift among users toward 3G-compatible CDMA 1X WIN models. This pushed up overall sales expenses for au-branded models. However, average procurement costs per handset were lower than in the previous year because of a combination of more-advanced handset functions and lower development costs.

Increased sales of CDMA 1X WIN handsets and lower sales commissions

KDDI pays sales commissions to agency sales outlets per subscriber contract. Sales commissions for au-branded handsets in the fiscal year ended March 2006 totaled ¥492.0 billion, an increase of ¥48.0 billion compared with the previous year. This mostly represented growth in au-branded handset sales volumes, which increased 1.66 million units on a year-on-year basis, to 13.25 million units (including new subscriptions and model switches). However, the average sales commission per handset declined ¥1,000 compared with the previous year, to ¥37,000 (including new subscriptions and model switches).

Other significant factors contributing to growth in operating expenses in this segment included higher access charges and increased costs incurred for facility maintenance and outsourced customer support services.

Fixed-line business

Fixed-line segment operating expenses in the fiscal year ended March 2006 totaled ¥680.6 billion, an increase of ¥84.2 billion compared with the previous year. The major factors contributing to the rise in costs are outlined below.

Increased KDDI Metal Plus-related costs due to aggressive service promotion

The major items pushing up costs related to KDDI Metal Plus services were commissions, usage fees for dry copper connections, contract fees for the use of telecommunications services supplied by NTT, and outsourced customer support services.

Increased depreciation expenses related to capital investment plans

KDDI is investing in a phased expansion of the coverage area for KDDI Metal Plus services. Related new capital investment resulted in an increase in depreciation expenses of ¥15.5 billion compared with the previous year.

Other significant factors contributing to growth in operating expenses in this segment included higher access charges.

PHS business

The decline in the PHS business segment's operating expenses in the fiscal year ended March 2006 compared with the previous year was ¥81.3 billion (equal to the operating expenses posted in the first half of the previous fiscal year prior to the business transfer).

Other businesses

In the other businesses segment, the KDDI Group focused on boosting overall competitiveness, on increasing efficiency through the consolidation of business functions, and on strengthening operations in the sectors with the greatest growth potential.

Segment operating expenses in the fiscal year ended March 2006 increased ¥18.6 billion compared with the previous year, to ¥99.1 billion, primarily as a result of higher operating revenues.

(c) Operating income

Operating income in the fiscal year ended March 2006 amounted to ¥296.5 billion, a rise of ¥0.4 billion compared with the previous year. By business segment, the mobile communications business recorded operating income of ¥354.4 billion, a year-on-year increase of ¥62.1 billion; the fixed-line business posted an operating loss of ¥61.3 billion, a net decrease of ¥60.9 billion from the previous year; and other businesses recorded operating income of ¥4.3 billion, up ¥3.4 billion over the previous year. In addition, the elimination of the PHS business segment depressed operating income ¥5.4 billion compared with the previous year.

(d) Other income and expenses

Net other expenses totaled ¥2.5 billion, an improvement of ¥7.2 billion over the previous year. The major contributory factors are outlined below.

Interest expense

Consolidated interest-bearing debt totaled ¥770.6 billion at March 31, 2006, a decline of ¥93.9 billion compared with the previous year-end. As a result, interest expense in the fiscal year ended March 2006 was ¥15.6 billion, or ¥5.2 billion less than in the previous year.

Equity in profit of affiliates

Equity in the profit of affiliates resulted in a gain of ¥2.2 billion, which represented a year-on-year increase of ¥0.8 billion. The major equity-method affiliates that contributed to this figure were Mobicom Corporation, which supplies mobile phone services in Mongolia, and Kyocera Communication Systems Co., Ltd., which provides IT outsourcing solutions, IP services, and telecoms engineering services.

(e) Ordinary income

Ordinary income in the fiscal year ended March 2006 totaled ¥294.0 billion, a year-on-year increase of ¥7.6 billion.

(f) Exceptional items

Net extraordinary losses totaled ¥113.3 billion. This represented a year-on-year increase in such losses of ¥120.5 billion. The materially significant items are outlined below.

Fiscal year ended March 2006

Gain from debt forgiveness (¥1.2 billion)

An extraordinary gain was recorded related to an exemption from liabilities associated with undersea cable-laying operations on the completion of the liquidation of consolidated subsidiary KDDI Submarine Cable Systems Inc.

Impairment losses (¥114.2 billion)

The KDDI Group calculates losses on the impairment of fixed assets based on the grouping of assets into the smallest-possible units capable of generating cash flows that are independent of other assets or asset groups. The major impairment losses in the fiscal year ended March 2006 are outlined below.

Impairment loss on TU-KA phone service related assets

In view of the sharp reduction in new subscriptions to the TU-KA service and the steady migration of TU-KA subscribers to au mobile phone service contracts, KDDI decided to close the TU-KA mobile phone service to new subscribers from June 30, 2006. The book value of assets related to the provision of TU-KA cellular phone services (such as PDC equipment) was therefore written down to the amount deemed recoverable, resulting in an extraordinary loss on asset impairment of ¥104.2 billion. The breakdown for this figure was machinery and facilities, ¥60.9 billion; antennas and related equipment, ¥22.5 billion; software, ¥6.0 billion; and other assets, ¥14.8 billion. Recoverable values for each asset group were measured in terms of utilization value and computed based on estimated future cash flows discounted using a rate of 2.45%.

Impairment loss on domestic transmission infrastructure and other idle assets

The book value of some domestic transmission infrastructure and other underutilized assets was written down to the amount deemed recoverable, resulting in an extraordinary loss on asset impairment of ¥9.9 billion. The breakdown was machinery and facilities, ¥1.2 billion; long-distance lines and related equipment, ¥3.0 billion; undersea cables and related equipment, ¥2.9 billion; and other assets, ¥2.8 billion. Recoverable values for each asset group were measured in terms of potential net proceeds on disposal. Market values were computed based on appraised values, with any assets judged unsalable being valued at zero.

Fiscal year ended March 2005

Gain from transfer of PHS business (¥27.6 billion)

The sale of PHS business operations generated revenue of ¥206.2 billion. An extraordinary gain was recorded based on the difference between the net proceeds of the transfer (taking into account repayments of interest-bearing debt and other factors) and the value recorded on the consolidated balance sheet against equity in the net assets of the PHS business.

Impairment losses (¥23.4 billion)

The book value of some undersea cables and other underutilized assets was written down to the amount deemed recoverable, resulting in an extraordinary loss on asset impairment of ¥23.4 billion.

(g) Income before income taxes and minority interests

Income before income taxes and minority interests in the fiscal year ended March 2006 amounted to ¥180.6 billion, a decrease of ¥112.9 billion compared with the previous year.

(h) Income taxes and tax adjustments

Total income taxes, which comprised corporation, resident, and enterprise taxes totaling ¥61.1 billion, together with an income tax credit that resulted in higher deferred taxes of ¥74.5 billion, were ¥101.5 billion less than in the previous year. This mainly reflected loss carryforwards and tax relief items inherited as a result of the merger with POWEREDCOM, which had the effect of reducing taxes ¥65.0 billion.

(i) Minority interests

Minority interests in consolidated subsidiaries, which are principally profits that revert to minority shareholders of Okinawa Cellular Telephone Company, were ¥3.4 billion in the fiscal year ended March 2006. This represented a decline of ¥1.3 billion compared with the previous year, due mainly to the fact that the figure of ¥4.8 billion recorded for the fiscal year ended March 2005 included first-half profits attributable to minority shareholders of DDI Pocket Inc.

(j) Net income

Net income in the fiscal year ended March 2006 amounted to ¥190.5 billion, a decrease of ¥10.0 billion compared with the previous year.

Business environment outlook

The KDDI Group identifies the key prospective competitive developments in the Japanese telecoms industry as follows:

- Mobile communications market: the introduction of mobile number portability (MNP); the entry of new carriers; the increase in competition caused by the ongoing merger of communications and broadcasting technologies, as evidenced in the launch of the One Seg digital television broadcast service for mobile users
- Fixed-line communications market: the advent of fierce price competition in services targeted at corporate clients and the efforts by carriers to secure customers in the residential user segment amid the rising market penetration of FTTH services

Faced with such conditions, the KDDI Group plans to focus on reinforcing its earnings base to support future growth by continuing to respond proactively to rapidly changing market conditions and by developing businesses that cater to customer needs.

- In the mobile communications business, KDDI aims to focus on providing a more convenient and enjoyable mobile services environment for users while seeking to expand into new business areas. The major aims are to increase sales of CDMA 1X WIN mobile handsets and to provide customers with attractive pricing plans and discount services.
- In the fixed-line communications business, KDDI aims to focus on expanding its customer base by continuing to supply direct-access services, such as KDDI Metal Plus, KDDI Hikari Plus, and KDDI Hikari Direct, and by building its FTTH business based on integrated services offered in conjunction with such partners as TEPCO and cable television providers.

(4) Capital Financing and Liquidity

(a) Cash flows

Operating activities +¥575.5 bn (+¥36.8 bn year on year)

Net cash provided by operating activities in the fiscal year ended March 2006 amounted to ¥575.5 billion, which represented an increase of ¥36.8 billion compared with the previous year. An increase in notes and accounts payable was a major contributor to higher operating cash flow.

Investing activities -¥435.9 bn (-¥299.4 bn year on year)

Net cash used in investing activities in the fiscal year ended March 2006 was ¥435.9 billion, representing a year-on-year increase in cash outflow equivalent to ¥299.4 billion. Major contributory factors included the absence of proceeds from the sale of subsidiaries, which had generated a cash inflow of ¥206.2 billion in the previous year through the divestiture of PHS operations, and a rise in capital spending of ¥72.3 billion in year-on-year terms. Capital investments in the mobile communications business segment were mostly related to wireless base stations and exchange facilities designed to expand area coverage and to enhance call quality for CDMA 1X and CDMA 1X WIN services. Capital spending in the fixed-line business segment was mostly on the construction of facilities for the provision of KDDI Metal Plus and other services.

Free cash flows, which equal net cash generated by operating and investing activities, amounted to ¥139.6 billion, a decline of ¥262.5 billion compared with the previous year.

Financing activities -¥256.9 bn (+¥119.1 bn year on year)

Net cash used in financing activities in the fiscal year ended March 2006 was ¥256.9 billion, which represented a year-on-year decrease in cash outflow of ¥119.1 billion. A major contributory factor was the decrease in contracted debt repayments associated with the reduction in interest-bearing debt.

(b) Liquidity

Consolidated cash and cash equivalents totaled ¥151.0 billion at March 31, 2006, a decrease of ¥71.5 billion from the balance of ¥222.5 billion at March 31, 2005. Going forward, the KDDI Group expects the liquidity balance to vary in line with operating performance, financing needs, and internal investment levels.

The net year-on-year effect on cash and cash equivalents due to the merger of KDDI with POWEREDCOM was an increase of ¥44.7 billion.

(c) Financing

During the fiscal year ended March 2006, KDDI made two unsecured straight bond issues of ¥25.0 billion each to finance loan repayments. Both the #1 and #2 bonds were issued in September 2005. All other requirements for funds were financed from internal cash flow and bank loans. The balance of corporate bonds outstanding was ¥334.6 billion at March 31, 2006, which represented an increase of ¥6.1 billion compared with the previous year-end. The year-end balance of loans outstanding declined ¥97.4 billion, to ¥436.0 billion.

(d) Debt repayments

Contracted debt repayment totals by maturity are given below.

(yen in billions)

	Amount	Less than1yr	1-3yrs	3-5yrs	Above 5yrs
Corporate bonds	334.6	76.8	130.0	82.8	45.0
Bank borrowings	436.0	169.7	217.3	32.7	16.3
Other	0	0	—	—	—
Total	770.6	246.5	347.3	115.5	61.3

(e) Foreign exchange risk

The policy of the KDDI Group is to use forward exchange contracts, currency swaps, and other instruments as necessary to hedge foreign exchange risks associated with business transactions denominated in foreign currencies or overseas investment and financing projects, based on the balance of assets and liabilities in each currency.

(f) Financial policies

The basic policy of the KDDI Group is to secure stable, low-cost financing as required, depending on the financial status of the company and the prevailing conditions in financial markets. The company seeks the most effective means of financing wherever possible.

The KDDI Group pursues a proactive cash management policy of conserving funds within the parent company to enhance financial efficiency. The parent company undertakes the integrated management of fund surpluses or deficits at the majority of subsidiaries and actively seeks to constrain financing costs by leveraging its higher credit rating to procure funds that are then distributed to subsidiaries through a system of loans.

Consolidated interest-bearing debt totaled ¥770.6 billion at March 31, 2006. The ratio of direct to indirect financing was 43:57, and the long-term financing ratio* was 68.01%. The proportion of centralized fund procurement during the year under review was 99.02%.

Rating and Investment Information Inc. (R&I) accords KDDI a long-term senior debt rating of A.

*Total proportion of interest-bearing debt due to corporate bonds and long-term borrowings

(g) Contingent liabilities

The balance of third-party guaranteed liabilities at March 31, 2006, amounted to ¥112.8 billion.

Supplemental Data

Mobile Business

	Millions of yen					Millions of U.S. dollars
	2002	2003	2004	2005	**2006**	**2006**
Operating revenues	—	—	—	2,312,537	**2,510,395**	**21,371**
Sales outside the group	—	—	—	2,293,525	**2,484,202**	**21,147**
Telecommunications business	—	—	—	1,751,053	**1,903,427**	**16,204**
Other business	—	—	—	542,473	**580,775**	**4,943**
Sales within the group	—	—	—	19,012	**26,193**	**224**
Operating income	—	—	—	292,251	**354,439**	**3,018**
Extraordinary income (loss)	—	—	—	(252)	**(105,296)**	**(896)**
Net income	—	—	—	171,698	**145,303**	**1,237**
Free cash flows	—	—	—	190,636	**266,178**	**2,266**
EBITDA	—	—	—	548,859	**605,172**	**5,152**
Operating income margin	—	—	—	12.6%	**14.1%**	**14.1%**
EBITDA margin	—	—	—	23.7%	**24.1%**	**24.1%**

Fixed - line Business

	Millions of yen					Millions of U.S. dollars
	2002	2003	2004	2005	**2006**	**2006**
Operating revenues	651,929	601,874	623,104	596,041	**619,314**	**5,272**
Sales outside the group	—	—	529,119	494,729	**518,716**	**4,416**
Telecommunications business	607,664	556,047	484,512	451,632	**470,391**	**4,004**
Other business	44,265	45,827	44,607	43,096	**48,325**	**412**
Sales within the group	—	—	93,984	101,312	**100,598**	**856**
Operating income (loss)	30,525	60,290	16,421	(310)	**(61,309)**	**(522)**
Extraordinary income (loss)	(17,526)	(3,071)	(74,466)	(18,118)	**(9,590)**	**(82)**
Net income (loss)	4,137	32,264	(29,935)	(4,413)	**26,362**	**224**
Free cash flows	55,485	116,927	68,559	(3,066)	**(102,317)**	**(871)**
EBITDA	157,467	176,809	112,402	87,494	**41,451**	**353**
Operating income margin	4.7%	10.0%	2.6%	-0.1%	**-9.9%**	**-9.9%**
EBITDA margin	24.2%	29.4%	18.0%	14.7%	**6.7%**	**6.7%**

Other business

	Millions of yen					Millions of U.S. dollars
	2002	2003	2004	2005	**2006**	**2006**
Operating revenues	276,974	196,656	80,371	81,381	**103,503**	**881**
Sales outside the group	—	—	50,680	46,399	**57,896**	**493**
Sales within the group	—	—	29,691	34,982	**45,607**	**388**
Operating income (loss)	4,063	(1,002)	545	951	**4,381**	**37**
Extraordinary income (loss)	(12,921)	(3,007)	(4,058)	2,093	**31,298**	**266**
Net income (loss)	(11,578)	(9,868)	(3,439)	1,565	**34,861**	**297**
Operating income margin	1.5%	—	0.7%	1.2%	**4.2%**	**4.2%**

(Reference)

au Business

	Millions of yen					Millions of U.S. dollars
	2002	2003	2004	2005	**2006**	**2006**
Operating revenues	1,524,554	1,626,273	1,831,786	2,092,702	**1,117,787**	**9,516**
Sales outside the group	—	—	1,817,333	2,067,843	**1,103,558**	**9,394**
Telecommunications business	1,155,657	1,197,244	1,367,038	1,558,404	**853,112**	**7,262**
Other business	368,897	429,029	450,295	509,439	**250,446**	**2,132**
Sales within the group	—	—	14,453	24,859	**14,228**	**121**
Operating income	57,396	53,786	239,469	273,106	**932,557**	**7,939**
Extraordinary income (loss)	(155,071)	(4,250)	1	(68)	**184,643**	**1,572**
Net income (loss)	(58,713)	21,005	129,995	161,157	**111,299**	**947**
Free cash flows	15,643	96,571	207,251	132,561	**119,908**	**1,021**
EBITDA	269,127	245,092	437,651	481,387	**290,390**	**2,472**
Operating income margin	3.8%	3.3%	13.1%	13.1%	**16.6%**	**16.6%**
EBITDA margin	17.7%	15.1%	23.9%	23.0%	**26.0%**	**26.0%**

As a result of merging the TU-KA companies in October 2005, the Mobile Telecommunications Business segment was shifted to the Mobile Business segment in the third quarter of the fiscal year ended March 31, 2006. Please use figures from the former au business until September 30, 2005 as reference for figures for that fiscal year.

TU-KA business

	Millions of yen					Millions of U.S. dollars
	2002	2003	2004	2005	**2006**	**2006**
Operating revenues	358,260	318,070	274,329	231,396	**101,271**	**862**
Sales outside the group	—	—	267,929	225,682	**98,626**	**840**
Telecommunications business	286,278	255,412	223,040	192,649	**86,888**	**740**
Other business	71,982	62,658	44,890	33,034	**11,738**	**100**
Sales within the group	—	—	6,400	5,714	**2,645**	**23**
Operating income	3,784	6,200	16,304	18,431	**10,552**	**90**
Extraordinary income (loss)	—	(1,713)	1,104	(184)	**(28)**	**(0)**
Net income (loss)	(3,276)	(3,227)	8,043	10,541	**6,652**	**57**
Free cash flows	14,831	52,137	54,951	58,075	**25,740**	**219**
EBITDA	63,400	66,471	72,097	66,811	**31,453**	**268**
Operating income margin	1.1%	1.9%	5.9%	8.0%	**10.4%**	**10.4%**
EBITDA margin	17.7%	20.9%	26.3%	28.9%	**31.1%**	**31.1%**

As a result of merging the TU-KA companies in October 2005, the Mobile Telecommunications Business segment was shifted to the Mobile Business segment in the third quarter of the fiscal year ended March 31, 2006. Please use figures from the former TU-KA business until September 30, 2005 as reference for figures for that fiscal year.