

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 20-F

(Mark One)

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended March 31, 2006

OR

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

For the transition period from \_\_\_\_ to \_\_\_\_

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report \_\_\_\_

Commission file number: 0-30204

Kabushiki Kaisha Internet Initiative  
(Exact Name of Registrant as Specified in Its Charter)

**Internet Initiative Japan Inc.**

(Translation of Registrant's Name Into English)

**Japan**

(Jurisdiction of Incorporation or Organization)

Jinbocho Mitsui Bldg.  
1-105 Kanda Jinbo-cho  
Chiyoda-ku, Tokyo 101-0051, Japan  
(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Each Class

None

Name of Each Exchange On Which Registered

None

Securities registered or to be registered pursuant to Section 12(g) of the Act:

**Common Stock, no par value**  
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

**None**  
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

**As of March 31, 2006, 204,300 shares of common stock were outstanding, including 40,786 shares represented by an aggregate of 16,314,400 American Depositary Shares.**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934.

Yes  No

Note—Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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### **Cautionary Note Regarding Forward-Looking Statements**

This annual report contains forward-looking statements about us and our industry that are based on our current expectations, assumptions, estimates and projections. These forward-looking statements are subject to various risks and uncertainties. These statements discuss future expectations, identify strategies, discuss market trends, contain projections of results of our operations and our financial condition, and state other forward-looking information. Known and unknown risks, uncertainties and other factors could cause our actual results to differ materially from those contained in or suggested by any forward-looking statement. We cannot provide any assurance that our expectations, projections, anticipated estimates or other information expressed in these forward-looking statements will turn out to be correct. We do not undertake any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Important risks and factors that could cause our actual results to differ materially from our forward-looking statements are generally provided in Item 3.D. and elsewhere in this annual report on Form 20-F and include, without limitation:

- that we may not be able to achieve or sustain profitability in the near future,
- that we may not be able to compete effectively against competitors which have greater financial, marketing and other resources, and
- that we may not be able to attract and retain qualified personnel.

## **PART I**

### **Item 1. Identity of Directors, Senior Management and Advisers.**

Not required.

### **Item 2. Offer Statistics and Expected Timetable.**

Not applicable.

### **Item 3. Key Information.**

#### **A. Selected Financial Data.**

You should read the selected consolidated financial data below together with Item 5. “Operating and Financial Review and Prospects”, of this annual report on Form 20-F and our consolidated financial statements and the notes to the financial statements beginning on page F-1. The consolidated statement of operations data and per share and American Depositary Shares (“ADS”) data below for the fiscal years ended March 31, 2002, 2003, 2004, 2005 and 2006, the consolidated balance sheet data below as of March 31, 2002, 2003, 2004, 2005 and 2006 and consolidated statements of cash flows for the fiscal years ended March 31, 2002, 2003, 2004, 2005 and 2006 under operating data below are derived from our audited financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”), and audited by Deloitte Touche Tohmatsu, an independent registered public accounting firm.

## As of and for the fiscal year ended March 31,

	2002	2003	2004	2005	2006	2006	
		(millions of yen, except per share and ADS data)					(thousands of U.S. dollars, except per share and ADS data <sup>(1)</sup> )
<b>Statement of Operations Data:</b>							
<b>REVENUES:</b>							
Connectivity and value-added services revenues:							
Dedicated access	¥ 14,303	¥ 13,815	¥ 12,862	¥ 11,373	¥ 10,625	\$ 90,443	
Dial-up access	3,644	3,155	3,088	2,937	2,674	22,760	
Value-added	3,100	3,603	4,296	5,005	6,250	53,200	
Other	1,668	1,726	2,118	3,169	3,674	31,272	
Total connectivity and value-added services revenues	22,715	22,299	22,364	22,484	23,223	197,675	
Systems integration revenues, including related equipment sales	14,356	15,013	11,848	15,854	23,505	200,072	
Equipment sales	2,834	6,706	4,567	3,365	3,085	26,262	
Total revenues	39,905	44,018	38,779	41,703	49,813	424,009	
<b>COST AND EXPENSES:</b>							
Cost of connectivity and value-added services revenues	19,800	20,387	20,047	19,484	20,078	170,906	
Cost of systems integration revenues, including related equipment sales	12,314	13,090	9,852	12,200	18,120	154,243	
Cost of equipment sales	2,540	6,417	4,346	3,111	2,818	23,987	
Total cost of revenues	34,654	39,894	34,245	34,795	41,016	349,136	
Sales and marketing expenses	3,038	3,176	3,528	2,795	3,080	26,213	
General and administrative expenses	1,840	2,205	2,098	2,666	3,147	26,790	
Research and development expenses	319	414	358	199	159	1,346	
Total cost and expenses	39,851	45,689	40,229	40,455	47,402	403,485	
<b>OPERATING INCOME (LOSS)</b>	<b>54</b>	<b>(1,671)</b>	<b>(1,450)</b>	<b>1,248</b>	<b>2,411</b>	<b>20,524</b>	
<b>OTHER INCOME (EXPENSES):</b>							
Interest income	122	67	38	13	13	111	
Interest expense	(659)	(733)	(702)	(686)	(437)	(3,723)	
Other — net	(406)	(603)	1,646	2,573	3,392	28,871	
Other income (expenses) — net	(943)	(1,269)	982	1,900	2,968	25,259	
<b>INCOME (LOSS) FROM OPERATIONS BEFORE INCOME TAX EXPENSE, MINORITY INTERESTS AND EQUITY IN NET LOSS OF EQUITY METHOD INVESTEEES</b>							
	(889)	(2,940)	(468)	3,148	5,379	45,783	
<b>INCOME TAX EXPENSE</b>	<b>18</b>	<b>23</b>	<b>33</b>	<b>100</b>	<b>257</b>	<b>2,191</b>	
<b>MINORITY INTERESTS IN (EARNINGS) LOSSES OF SUBSIDIARIES</b>							
	24	153	236	(109)	(354)	(3,012)	

	As of and for the fiscal year ended March 31,						
	2002	2003	2004	2005	2006	2006	
		(millions of yen, except per share and ADS data)					(thousands of U.S. dollars, except per share and ADS data <sup>(1)</sup> )
<b>EQUITY IN NET LOSS OF EQUITY METHOD INVESTEEES:<sup>(2)</sup></b>							
Equity method net loss	¥ (5,482)	¥ (5,625)	¥ (286)	¥ (33)	¥ (14)	\$ (117)	
Impairment loss on investment, advance and deposits for Crosswave	—	(7,153)	(1,720)	—	—	—	
Total equity in net loss of equity method investees	(5,482)	(12,778)	(2,006)	(33)	(14)	(117)	
<b>NET INCOME (LOSS)</b>	<b>¥ (6,365)</b>	<b>¥ (15,588)</b>	<b>¥ (2,271)</b>	<b>¥ 2,906</b>	<b>¥ 4,754</b>	<b>\$ 40,463</b>	
<b>Per Share and ADS Data <sup>(3)</sup>:</b>							
Basic net income (loss) per share	¥ (56,627)	¥ (138,689)	¥ (14,321)	¥ 15,172	¥ 24,301	\$ 207	
Diluted net income (loss) per share	(56,627)	(138,689)	(14,321)	15,172	24,258	206	
Basic net income (loss) per ADS equivalent	(141.57)	(346.72)	(35.80)	37.93	60.75	0.52	
Diluted net income (loss) per ADS equivalent	(141.57)	(346.72)	(35.80)	37.93	60.65	0.52	
Basic weighted average number of shares	112,400	112,400	158,554	191,559	195,613		
Diluted weighted average number of shares	112,400	112,400	158,554	191,559	195,955		
Basic weighted average number of ADS equivalents (thousands)	44,960	44,960	63,422	76,624	78,245		
Diluted weighted average number of ADS equivalents (thousands)	44,960	44,960	63,422	76,624	78,382		
<b>Balance Sheet Data:</b>							
Cash and cash equivalent	¥ 11,046	¥ 3,588	¥ 12,284	¥ 5,286	¥ 13,727	\$ 116,846	
Total assets	45,263	32,064	42,737	37,116	50,705	431,605	
Short-term borrowings	3,820	4,824	6,564	4,725	4,555	38,772	
Current portion of long-term borrowings, including capital lease obligations	3,374	4,660	3,936	5,511	4,994	42,508	
Long-term borrowings, including capital lease obligations	6,262	7,092	5,188	5,869	5,271	44,865	
Convertible notes <sup>(4)</sup>	15,000	15,000	11,832	—	—	—	
Shareholders' equity (capital deficiency)	7,725	(10,004)	6,214	11,615	20,222	172,131	
<b>Operating Data:</b>							
Capital expenditures, including capitalized leases <sup>(5)</sup>	¥ 3,773	¥ 4,893	¥ 3,523	¥ 5,011	¥ 4,762	\$ 40,537	
Operating margin <sup>(6)</sup>	0.1%	(3.8)%	(3.7)%	3.0%	4.8%		
<b>Net cash provided by (used in):</b>							
Operating activities	¥ 1,161	¥ 1,582	¥ 1,923	¥ 5,238	¥ 6,559	\$ 55,830	
Investing activities	(2,457)	(7,878)	(852)	1,974	1,805	15,363	
Financing activities	(1,462)	(872)	7,669	(14,213)	39	331	

- (1) The U.S. dollar amounts represent translations of yen amounts at the rate of ¥117.48 which was the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York prevailing as of March 31, 2006.
- (2) Of total equity method net loss of ¥5,625 million for the fiscal year ended March 31, 2003, ¥5,514 million was based on unaudited financial information made publicly available by Crosswave Communications Inc. ("Crosswave") and the impairment loss on investment and deposits for Crosswave was determined to be the amount required to reduce the carrying amount of investment in and deposits for Crosswave at March 31, 2003 to zero. The audit report of Deloitte Touche Tohmatsu in respect of our financial statements as of and for the fiscal year ended March 31, 2003 was qualified as to the effects of such adjustments, if any, as might have been determined to be necessary if sufficient evidence regarding the equity method loss, the impairment loss on investment, advance to and deposits for Crosswave and the related summary information of Crosswave for the year ended March 31, 2003 was available. As described elsewhere in this annual report, Crosswave filed a voluntary petition for corporate reorganization proceedings in Japan in August 2003 and has not prepared audited financial statements for the year ended March 31, 2003 or other sufficient evidence of its results of operations to permit the independent registered public accounting firm to issue an audit report on our financial statements as of and for the year ended March 31, 2003 without such qualification.
- (3) We conducted a 1 to 5 stock split effective on October 11, 2005. The per share data is calculated based on the assumption that the stock split was made at the beginning of the fiscal year ended March 31, 2002.
- (4) In April 2000, we issued 1.75 percent unsecured convertible yen notes due March 2005 in the aggregate principal amount of ¥15,000 million. In November 2003 and June 2004, we repurchased and cancelled a portion of the aforementioned notes, in the aggregate principal amount of ¥3,168 million and ¥744 million, respectively. We redeemed the remainder of the unsecured convertible notes in March 2005.
- (5) Further information regarding capital expenditures, including capitalized leases and a reconciliation to the most directly comparable U.S. GAAP financial measure can be found below.
- (6) Operating income (loss) as a percentage of total revenues.

### Reconciliations of the Disclosed Non-GAAP Financial Measures to the Most Directly Comparable GAAP Financial Measures

#### Capital expenditures

We define capital expenditures as purchases of property and equipment plus acquisition of assets by entering into capital leases. We have included the information concerning capital expenditures because our management manages these expenditures and believes that it is useful to investors to analyze and compare companies on the basis of such investments. Capital expenditures, as we have defined it, may not be comparable to similarly titled measures used by other companies.

The following table summarizes the reconciliation of capital expenditures to purchase of property and equipment as reported in our consolidated statements of cash flows prepared and presented in accordance with U.S. GAAP.

	For the fiscal year ended March 31,				
	2002	2003	2004	2005	2006
	(millions of yen)				
Capital expenditures:					
Acquisition of assets by entering into capital leases	¥ 2,536	¥ 3,578	¥ 1,866	¥ 4,434	¥ 3,843
Purchases of property and equipment	1,237	1,315	1,657	577	919
Total capital expenditures	<u>¥ 3,773</u>	<u>¥ 4,893</u>	<u>¥ 3,523</u>	<u>¥ 5,011</u>	<u>¥ 4,762</u>

## Exchange Rates

Fluctuations in exchange rates between the Japanese yen and the U.S. dollar and other currencies will affect the U.S. dollar and other currency equivalent of the yen price of our shares and the U.S. dollar amounts received on conversion of any cash dividends, which in turn will affect the U.S. dollar price of our ADSs. We have translated some Japanese yen amounts presented in this annual report into U.S. dollars solely for your convenience. Unless otherwise noted, the rate used for the translations was ¥117.48 per U.S. \$1.00, which was the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York prevailing as of March 31, 2006, the date of our most recent consolidated balance sheet contained in this annual report. Translations do not imply that the yen amounts actually represent, or have been or could be converted into, equivalent amounts in U.S. dollars.

The following table presents the noon buying rates for Japanese yen per U.S. \$1.00 in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York:

	High	Low	Average <sup>(1)</sup>	Period-end
<b>Fiscal year ended March 31,</b>				
2002	¥134.77	¥115.89	¥125.64	¥132.70
2003	133.40	115.71	121.10	118.07
2004	120.55	104.18	112.75	104.18
2005	114.30	102.26	107.28	107.22
2006	120.93	104.41	113.67	117.48
<b>Calendar year 2006</b>				
January	¥117.55	¥113.96	¥115.48	¥116.88
February	118.95	115.82	117.86	115.82
March	119.07	115.89	117.28	117.48
April	118.66	113.79	117.07	113.79
May	113.46	110.07	111.73	112.26
June	116.42	111.66	114.63	114.51
July (through July 7, 2006)	115.65	113.98	114.93	113.98

(1) For fiscal years, calculated from the average of the exchange rates on the last day of each month during the period. For calendar year months, calculated based on the average of daily exchange rates.

The noon buying rate on July 7, 2006 was ¥113.98 per \$1.00.

## B. Capitalization and Indebtedness.

Not required.

## C. Reasons for the Offer and Use of Proceeds.

Not applicable.

## D. Risk Factors.

*You should carefully consider the following information, together with the other information contained in this annual report on Form 20-F, including our financial statements and the related notes, before making an investment decision. Any risks described below could result in a material adverse effect on our business, financial condition or results of operations.*

***We may not maintain our current level of revenues or achieve our expected revenues and profits in the future.***

Although we recorded operating income and net income in the fiscal years ended March 31, 2005 and 2006, we incurred operating losses and net losses in each of the prior six fiscal years, with the exception of positive operating income for the fiscal year ended March 31, 2002, and our accumulated deficit as of March 31, 2006 amounted to ¥29.7 billion.

As we primarily operate in the Japanese market, if the Japanese economy deteriorates or does not improve, and it results in significantly lower levels of network-related investment or corporate customers respond to conditions by putting a priority on low price rather than quality, it may make it difficult to maintain our current level of revenues or achieve our expected revenues and profits.

In addition to factors related to general economic conditions in Japan, we may not be able to maintain our current level of revenues and profits or achieve our expected levels of revenues and profits due to several other factors, including, but not limited to:

- a continuous decrease in revenues from our Internet connectivity services because of lower unit prices per bandwidth and cancellation of large accounts especially due to severe price competition,
- lower revenue growth and lower margins in our growing value-added services and systems integration, if we fail to successfully differentiate our services from those of our competitors, or experience a significant decrease in systems integration revenues from period to period due to the cancellation of one or more large projects or changes in the number of projects resulting from a seasonal fluctuation in the systems integration business in Japan,
- an increase in backbone costs due to increased volume of Internet traffic and demand for leasing backbone lines, or a decline in the profitability of connectivity services if we contract for more capacity than we actually utilize to serve our customers,
- an increase in expenses for network infrastructure, research and development and other similar investments which we may be forced to make in the future in order to remain competitive, or increased expenses relating to the leasing of additional equipment,
- an increase in outsourcing costs, especially in our systems integration, if we fail to manage outsourcing projects effectively or fail to cover outsourcing costs by raising enough revenues from outsourced projects,
- an increase in SG&A costs, such as personnel expenses, in conjunction with our expected or planned or continued business expansion, and
- a decline in the value and trading volume of our holding of available-for-sale securities from which we expect gains on sale.

Please see Item 5, “Operating and Financial Review and Prospects,” for more detailed information concerning our operations and other results.

***We may not be able to compete effectively, especially against competitors with greater financial, marketing and other resources.***

The major competitors of our connectivity and value-added services are major telecommunications carriers like NTT Communications Corporation (“NTT Communications”), KDDI Corporation (“KDDI”) and Japan Telecom Co., Ltd. (“Japan Telecom”). Especially for Internet connectivity services, price competition is still severe and may increase. For value-added services, price competition may also increase. This competition may adversely affect our revenues and profitability and may make it difficult for us to retain existing customers or attract new customers. The major competitors of our systems integration business are systems integrators like IBM Japan, NEC Corporation, Fujitsu Limited, NTT Data Corporation and their affiliates. Our major competitors have the financial resources to reduce prices in an effort to gain market share. There is strong competition among systems integrators that may adversely affect our revenues and profitability. Even though Nippon Telegraph and Telephone Corporation (“NTT”) and NTT Communications purchased shares of our company in September 2003, which resulted in the NTT Group becoming our largest shareholder, we plan to continue to operate our company separately and independently from the NTT Group, and will therefore continue to compete with the NTT Group.

Our competitors have advantages over us, including, but not limited to:

- substantially greater financial resources,
- more extensive and well-developed marketing and sales networks,
- higher brand recognition among consumers,
- larger customer bases, and
- more diversified operations which allow profits from some operations to support operations with lower profitability, such as the network services, for which we are a competitor.

With these advantages, our competitors may be better able to:

- sustain downward pricing pressure, including pressure on low-price Internet connectivity services offered to corporate customers, which are our target customers,
- develop, market and sell their services,
- adapt quickly to new and changing technologies,
- obtain new customers, and
- aggressively pursue mergers and acquisitions to enlarge their customer base and market share.

***We depend on our ability to attract and retain qualified personnel.***

Our network, services, products and technologies are complex, and as a result, we depend heavily on the continued service of our engineering, research and development, and other personnel. As our business grows, we need to hire additional engineers, research and development and other personnel. In particular, in order to continue to increase our revenues from value-added services and systems integration, we require more sales and engineering personnel to achieve our expectations. We are not sure that we will be able to keep or attract these human resources and control human resources cost adequately. Competition for

qualified engineers, research and development personnel and employees in the telecommunications service industry in Japan is intense, and there is a limited number of persons with the necessary knowledge and experience. None of our employees are bound by any employment or noncompetition agreement. The realization of any or all of these risks may result in material adverse effects on our business, financial condition and result of operations.

***Our business may be adversely affected if our network suffers interruptions, errors or delays.***

Interruptions, errors or delays with respect to our network may be caused by a number of man made or natural factors, many of which are beyond our control, including, but not limited to, damage from fire, earthquakes or other natural disasters, power loss, sabotage, computer hackers, human error, computer viruses and other similar events. Much of our computer and networking equipment and the lines that make up our network backbones are concentrated in a few locations that are in earthquake-prone areas. Any disruption, outages, or delays or other difficulties experienced by any of our technological and information systems and networks could result in a decrease in new or existing accounts, loss or exposure of confidential information, reduction in revenues and profits, costly repairs or upgrades, reputational damage and decreased consumer confidence in our business, any or all of which could have a material adverse effect on our business, financial condition and results of operations.

***The confidential customer information that we keep and manage may be leaked.***

We keep and manage confidential information and trade secrets obtained from our customers. We exercise care in protecting the confidentiality of such information and take steps to ensure the security of our network, in accordance with the law protecting personal information that came into effect in April 2005 and the requirements set by the Ministry of Internal Affairs and Communications (“MIC ”), and the Ministry of Economy, Trade and Industry. However, our network, like all Information Technology systems, is vulnerable to external attack from computer viruses, hackers or other such sources. In addition, despite internal controls, misconduct by an employee could result in the improper use or disclosure of confidential information. If any material leak of such information were to occur, we could be subject to lawsuits for damages from our customers, incur expenses associated with repairing or upgrading our security systems and suffer damages to our reputation that could result in a severe decline in new customers as well as an increase in service cancellations. The realization of these or similar risks may have a material adverse effect on our business, financial condition and result of operations.

***Business growth and a rapidly changing operating environment may strain our limited resources.***

We have limited operational, administrative and financial resources, which could be inadequate to sustain the growth we want to achieve. As the number of our customers and their Internet usage increases, as traffic patterns change and as the volume of information transferred increases, we will need to increase expenditures for our network and other facilities in order to adapt our services and to maintain and improve the quality of our services. If we are unable to manage our growth and expansion, the quality of our services could deteriorate and our business may suffer.

***If we fail to keep up with the rapid technological changes in our industry, our services may become obsolete and we may lose customers.***

Our markets are characterized by:

- rapid technological change,
- frequent new product and service introductions,

- continually changing customer requirements, and
- evolving industry standards.

If we fail to obtain access to new or important technologies or to develop and introduce new services and enhancements that are compatible with changing industry technologies and standards and customer requirements, we may lose customers.

Our pursuit of necessary technological advances may require substantial time and expense. Many of our competitors have greater financial and other resources than we do and, therefore, may be better able to meet the time and expense demands of achieving technological advances. Additionally, this may allow our competitors to respond more quickly to new and emerging technologies and standards or invest more heavily in upgrading or replacing equipment to take advantage of new technologies and standards.

***We depend on our executive officers, and if we lose the service of our executive officers, particularly Mr. Koichi Suzuki, our business and our relationships with the customers, major shareholders of IJ and other IJ Group companies and our employees could suffer.***

Our future success depends on the continued service of our executive officers, particularly Mr. Koichi Suzuki, who is our president, chief executive officer and representative director, as well as the president and chief executive officer and representative director of most of other IJ Group companies. We rely in particular on his expertise in the operation of our businesses and on his relationships with our shareholders, the shareholders of the IJ Group companies, our business partners and our employees. None of our executive officers, including Mr. Suzuki, is bound by an employment or noncompetition agreement.

***Our investments in affiliated companies may not produce the returns we expect and may require additional funding.***

As part of our business strategy and for the purpose of maintaining various strategic business relations, we have, in the past, invested in a number of companies. There can be no assurance that we will be able to maintain or enhance the value or performance of such companies in which we have invested or may invest in the future, or that we will achieve the returns or benefits sought from these investments. Our substantial investment in Crosswave, our former equity method investee, for example, became worthless due to Crosswave's commencement of corporate reorganization proceedings. In August 2003, Crosswave filed a voluntary petition for the commencement of corporate reorganization proceedings in Japan, and as a result of our equity method net loss and an impairment loss taken in respect of our investment in Crosswave, our net loss for the fiscal year ended March 31, 2003 was ¥15.6 billion, the highest net loss that we have ever experienced. We also wrote off ¥2.1 billion of loans and accounts receivable outstanding from Crosswave for the fiscal year ended March 31, 2004. We also had an impairment loss relating to our investment in Asia Internet Holding for the fiscal year ended March 2004. To the extent that these investments are accounted for by the equity-method and to the extent that the investee companies have net losses, our financial results will be adversely affected to the extent of our pro rata portion of these losses. Furthermore, we may lose all or part of our investment in these companies if their value decreases as a result of their financial performance or if these companies go bankrupt. If our interests differ from those of other investors in entities over which we do not exercise control, we may not be able to enjoy synergies with the investees and it may adversely affect our financial results or financial condition.

We have invested in affiliated companies, such as IJ Technology Inc. ("IJ-Tech") and Net Care, Inc. ("Net Care"), to expand the service offerings available to our customers. In February 2006, we invested ¥750 million in Internet Revolution Inc. ("i-revo"), a joint venture that we established with Konami Corporation, and i-revo is our equity method investee. In the joint venture agreement, we agreed that we will provide funding up to ¥90 million to i-revo between November 2006 and the end of April 2007 for its capital

investments and working capital. We may provide additional financial support in the form of loans to or additional equity investments in these affiliated companies to enhance or maintain our business synergies with these affiliated companies.

In October 2005, IJ Media Communications Inc. (“IJ-MC”), our former subsidiary, was merged into us after a portion of IJ-MC’s business was transferred to IJ-Tech and we have acquired Asia Internet Holding Co., Ltd. (“AIH”), our former equity method investee, after AIH became our wholly owned consolidated subsidiary. We may consider reorganization of other IJ Group companies in the future which may require additional investments by cash, equity or others.

***Fluctuations in the stock prices of companies in which we have invested may significantly influence our financial condition.***

We have invested in non-affiliated companies in order to further our business relationships with these companies. We recorded gross realized gains from the sale of available-for-sale securities of ¥3.2 billion for the fiscal year ended March 31, 2006 and the book value of our remaining available-for-sale securities was ¥6.8 billion at March 31, 2006, which is relatively large in relation to other items on our balance sheet. However, the book value can change significantly due to changes in the financial condition of non-affiliated companies, general economic conditions in Japan or fluctuations in the Japanese stock markets. Fluctuations in the stock prices of companies in which we have invested may have a significant effect on our financial results. As a result, we may not be able to achieve our expected gains on the sale of available-for-sale securities. In addition, should we choose to dispose of all or a portion of these shares, it is not certain that we will be able to do so on favorable terms.

***NTT, our largest shareholder, could exercise substantial influence over us in a manner which may not necessarily be in our interest or that of our other shareholders.***

NTT and its affiliates currently own 29.7% of our outstanding shares. In September 2003, we entered into a subscription agreement with NTT in which we granted to NTT pre-emptive rights to subscribe to its pro rata portion of any future issuances of shares by us in order to maintain its shareholding percentage; NTT did not exercise this pre-emptive right when we issued 12,500 additional shares in December 2005. Under this subscription agreement, we have agreed to allow NTT to nominate up to three persons as either directors or statutory auditors, subject to approval by our shareholders at our first general shareholders’ meeting after NTT’s investment. At our general shareholders’ meeting on June 24, 2004, two directors nominated from NTT Group were appointed, one of whom was nominated as an executive vice president. At our general shareholders’ meeting on June 28, 2006, our executive vice president, Mr. Fukuzo Inoue, completed his term and retired, and an other director, Mr. Takashi Hiroi was reapproved to be an outside director. As our largest shareholder, NTT may be able to exercise substantial influence over us. In addition, as part of this subscription agreement, we have agreed to collaborate with NTT in various businesses. While we intend to conduct our day-to-day operations independently of NTT and its group companies and believe that NTT also plans for us to operate independently, NTT may decide to exercise substantial influence over us in a manner which could impair our ability to operate independently. Furthermore, NTT may take actions that are in its best interests, which may not be in our interest or that of other shareholders.

***We rely greatly on other telecommunications carriers and other suppliers, and could be affected by disruptions in service or delays in the delivery of their products and services.***

We rely on telecommunications carriers such as NTT Communications, KDDI and Japan Telecom for a significant portion of our network backbone and Nippon Telegraph and Telephone East Corporation and Nippon Telegraph Telephone West Corporation and electric power companies and their affiliates for local access lines for our customers. After the transfer of operating lease agreements from Crosswave, our former equity method investee, following its filing for corporate reorganization, we now procure significant portions

of our network backbone and data center facilities pursuant to operating lease agreements with NTT Communications, our largest provider of network infrastructure. We are subject to potential disruptions in these telecommunications services and, in the event of such disruption, we may have no means of replacing these services, on a timely basis or at all.

In the Asia-Pacific region, we depend on telecommunications carriers in various countries including less-developed countries whose quality of service may not be stable or who are more susceptible to economic or political instability.

We also depend on third-party suppliers of hardware components like routers that are used in our network. We acquire certain components from limited sources, typically from Cisco Systems, Inc. A failure by one of our suppliers to deliver quality products on a timely basis, or the inability to develop alternative sources if and as required, may delay our ability to expand the capacity and scope of our network.

Any problems experienced by our telecommunications carriers and other suppliers could have a material adverse effect on our business, financial condition and results of operations.

***There are risks associated with our international business.***

By operating our network internationally, we expose ourselves to the risks of international markets and to other risks that do not exist or are less significant in Japan. One of the components of our strategy is to continue to expand our network reach through our network between the United States and Japan to maintain our network quality. In addition, we have invested in the data center businesses in South Korea. Our international business operations continue to require management attention and financial resources, both of which are in limited supply. We face significant exposure to risks in connection with our international operations, including:

- the impact of economic conditions outside Japan,
- unexpected changes in or delays resulting from regulatory requirements,
- the rate of the development of the Internet industry in countries in Asia,
- political and economic instability, and
- potential unsatisfactory financial returns from our investments in Asia, including the data center businesses in which we have invested in South Korea.

These factors could adversely affect our future international expansion and, consequently, our business, financial condition and results of operations.

***If we fail to execute our systems integration projects in a timely or satisfactory manner or if we fail to manage customer data in a professional manner, we could be sued and our reputation could suffer.***

A significant portion of our future revenue depends on systems integration projects which we, in cooperation with IJ-Tech and Net Care, have been contracted to perform. We may not be able to perform our responsibilities under these contracts to the satisfaction of our customers, or at all, if we lack a sufficient number of qualified engineers, lack sufficient task-management capabilities for software-development vendors or fail to manage customer data adequately. If we do not execute these services and projects as contracted or fail to manage customer data in a professional manner, our receipt of revenues may be delayed or lost altogether and we could be sued by our counterparties, which could in turn have an adverse impact on our reputation, results of operation and financial condition.

***Regulatory matters and new legislation could impact our ability to conduct our business.***

The licensing, construction and operation of telecommunications systems and services in Japan are subject to regulation and supervision by the MIC. We operate pursuant to licenses and approvals that have been granted by the MIC.

Our licenses have an unlimited duration, but are subject to revocation by the MIC if we violate any telecommunications laws and regulations in a manner that is deemed to harm the public interest, if we or any of our directors are sentenced to a fine or any more severe penalty under the telecommunications laws, if we employ a director who was previously sentenced to a fine or more severe penalty thereunder or if we have had a license revoked in the past. We believe our licenses and approvals are in good standing and we expect to be able to continue to fulfill the terms of our licenses and approvals to the satisfaction of the MIC. However, there can be no assurance that we will be able to do so.

Existing and future governmental regulation may substantially affect the way in which we conduct business. These regulations may increase the cost of doing business or may restrict the way in which we offer products and services. As a result of the amendment in April 2004 of the Telecommunication Business Law and deregulation including elimination of the regulatory distinction between carriers providing telecommunications services through networks owned by other telecommunication carriers and carriers which own or have long-term leases for the networks through which they offer telecommunication services, competition may increase. Furthermore, we cannot predict future regulatory changes which may affect our business. Any changes in laws, such as those described above, or regulations or MIC policy affecting our business activities and those of our competitors could adversely affect our financial condition or results of operations. For more information, see Item 4., “Business Overview — Regulation of the Telecommunications Industry in Japan”.

***We may be named as defendants in litigation, which could have an adverse impact on our business, financial condition and results of operations.***

We are involved in normal claims and other legal proceedings in the ordinary course of our business. We believe that there are no cases currently pending which would have a significant financial impact on us, but we cannot be certain that we will not be named in a future lawsuit. Any judgment against us in such a lawsuit, or in any future legal proceeding, could have an adverse effect on our business, financial condition and results of operations.

***In the event we need to raise capital, we may sell additional shares of our common stock or securities convertible into our common stock, which may cause shareholders to incur substantial dilution.***

We may raise additional funds in the future to raise additional working capital and for other financial needs. We completed private placements in June and September 2003 of an aggregate of 15,880 shares of our common stock to investors in Japan in order to raise funds for working capital and repayment of convertible notes. We issued 12,500 new shares of our common stock along with our listing on the Mothers market of the Tokyo Stock Exchange in December 2005, after conducting a 1 to 5 split of our shares of common stock in October 2005. If we choose to raise such funds from the issuance of equity shares of our common stock or securities convertible into our common stock, existing shareholders may incur substantial dilution.

**Item 4. Information on the Company.**

**A. History and Development of the Company.**

We are incorporated in Japan as a joint stock corporation under the name Internet Initiative Japan Inc. (“IIJ”). We were incorporated in December 1992 and operate under the laws of Japan. We began operations

in July 1993, making us one of the first commercial providers in Japan to offer Internet connectivity services. In February 1994, we acquired a Type II Telecommunications license, which enables us to operate our own international backbone networks. We became a public company in August 1999 with our initial public offering of American Depositary Shares (“ADSs”) on the Nasdaq National Market.

On August 20, 2003, Crosswave Communications Inc. (“Crosswave”), our former equity method investee and primary provider of data communication services, and two of its subsidiaries filed voluntary petitions with the Tokyo District Court for the commencement of corporate reorganization proceedings, which are proceedings to rehabilitate an insolvent company similar in some respects to Chapter 11 bankruptcy proceedings in the United States. As a result, we wrote-off our investment in Crosswave and no longer consider Crosswave to be an IIJ Group company. On December 15, 2003, the business operations of Crosswave including its network on which we relied to provide services for our network, were transferred to NTT Communications Corporation (“NTT Communications”). We have contracted with NTT Communications for the continued use of the network services it acquired from Crosswave.

On June 26 and September 16, 2003, we completed private placements of a total of 15,880 shares of our common stock to investors in Japan for an aggregate amount of ¥13.3 billion for working capital and repayment of our outstanding 1.75% convertible notes due on March 31, 2005. As a result of these transactions, the total number of our issued shares of common stock increased to 38,360 and shareholding of the Nippon Telegraph and Telephone Corporation (“NTT”) Group increased to 31.6%. We have also agreed with NTT that it has the right to nominate three persons to serve as either our directors or statutory auditors, subject to shareholder approval of any nomination at our first general shareholders’ meeting after NTT’s investment. In addition, we and NTT agreed to undertake efforts to jointly engage in the development of broadband and Information Technology and other related business, to expand the business relationship between us and NTT in connection with new business opportunities and to discuss secondment of employees to each other.

On October 1, 2005, IIJ Media Communications Inc. (“IIJ-MC”), our former consolidated subsidiary, was merged into us after a portion of IIJ-MC’s business was transferred to IIJ Technology Inc., our consolidated subsidiary. Asia Internet Holding Co., Ltd., our former equity method investee, became our wholly owned consolidated subsidiary, and was merged into us on October 1, 2005. In each of the mergers, we became the surviving company.

On December 2, 2005, we listed on the Mothers market of the Tokyo Stock Exchange. In connection with the listing, we issued 12,500 new shares of common stock for an amount of ¥6.0 billion. As we conducted a 1 to 5 split of our shares of common stock on October 11, 2005, the total number of our issued shares of common stock increased to 204,300.

On February 1, 2006, we established a joint venture company, Internet Revolution Inc. (“i-revo”) with Konami Corporation, with the purpose of operating comprehensive portals sites. We invested ¥750 million and hold 30.0% of the company. i-revo is our equity method investee.

Our head office is located at Jinbo-cho Mitsui Bldg., 1-105 Kanda Jinbo-cho, Chiyoda-ku, Tokyo 101-0051, Japan, and our telephone number at that location is (813) 5259-6500. Our agent in the United States is IIJ America Inc., 1211 Avenue of the Americas, Suite 2900, New York, New York 10036 and the telephone number at that location is (212) 440-8080. We have a web site that you may access at <http://www.iij.ad.jp/>. Information contained on our web site does not constitute part of this annual report on Form 20-F.

For a discussion of capital expenditures and divestitures currently in progress and those for the past three years, see “Capital Expenditures” in Item 4.B.

## B. Business Overview.

We offer a comprehensive range of Internet connectivity services and network solutions to our customers in Japan. We offer our services on one of the most advanced and reliable Internet networks available in Japan. Our services are based upon high-quality networking technology tailored to meet the specific needs and demands of our customers.

We offer, together with other companies or independently, a variety of services to our customers as part of our total network solutions. Our primary services are our Internet connectivity services, value-added services and systems integration. Our Internet connectivity services range from low-cost dial-up access to high-speed access through dedicated lines for individual and corporate customers. Our value-added services include security-related outsourcing services that protect customers' internal networks from unauthorized access and secure remote connections to internal networks, network-related outsourcing services such as provision, monitoring and maintenance of network equipment and Virtual Private Network ("VPN"), and server-related outsourcing services such as provision of e-mail and web servers and operation and management of e-mail systems, in addition to Internet data center services. Our systems integration are tailored to our customers' requirements, which include consulting, project planning, systems design, construction of network systems and systems outsourcing. We also sell a significant amount of network-related equipment to our systems integration customers as part of our provision of total network solutions.

Most of our revenues are generated in Japan and are denominated in Japanese yen. The table below provides a breakdown of the percentage of total revenues among our primary services over the past three fiscal years.

	For the fiscal year ended March 31,		
	2004	2005	2006
Connectivity services	41.1%	34.3%	26.7%
Value-added services	11.1%	12.0%	12.5%
Systems integration	30.6%	38.0%	47.2%

The variety of Internet connectivity services, value-added services and systems integration we offer enables our customers to purchase all of their Internet-related services and products through a single source. To support our services and for the convenience of our customers, we also offer a variety of hardware, software and other products, such as network equipment, which are sourced mostly from third-party vendors. We aim to be the leading supplier of total network solutions in Japan.

We have created an Internet network, that extends throughout Japan by leasing lines from telecommunications carriers. Our backbone is one of the highest capacity Internet backbones in Japan. As of July 7, 2006, we operated 13 points of presence ("POPs") for dedicated access, 17 POPs for dial-up access and 12 Internet data centers. POPs are the main points at which our customers connect to our backbone, throughout Japan. Our policy on the management of our backbone is that we upgrade the bandwidth depending on demand and with maximum cost effectiveness. Our backbone network also extends to the United States, with a total capacity of 7.2 Gbps (3 STM-16 trunk lines), and to China, with a capacity of 600 Mbps (1 STM-4 trunk line) as of July 7, 2006.

### *Total network solutions*

We are a provider of total network solutions. We provide our customers with tailored, end-to-end Internet and private network solutions. The diversity of services we offer permits each customer to purchase individual services or a bundle of services that we believe provide the most efficient, reliable and cost-effective solution for that customer's particular needs.

The primary resources that we use to provide total network solutions to our customers include:

- our Internet connectivity services,
- our line-up of value-added services, including security, network and server-related outsourcing,
- our Internet data center services,
- our systems integration, including ongoing consulting, systems design, construction, operation and management, and
- other network and application services that our group companies provide.

Our total network solutions for business users are a primary focus of our business. We consult with businesses and other customers to identify their particular needs. We then draw upon our extensive resources to address those needs.

### Internet Connectivity Services

We offer two categories of Internet connectivity services: dedicated access services and dial-up access services. Dedicated access services are based mainly on dedicated local-line connections provided by carriers between our backbone and customers. Dial-up access services mainly require customers to connect to our POPs through the publicly-switched telephone network. The Internet connectivity part of our total network solutions ranges from low-cost, entry-level dial-up connections from home personal computers to customized wide-area network solutions deploying a range of the dedicated and dial-up services listed below to connect headquarters, data centers, branch offices and mobile personnel. Currently, large telecommunications carriers such as Nippon Telegraph and Telephone East Corporation (“NTT East”) and Nippon Telegraph and Telephone West Corporation (“NTT West”) and other providers are rapidly increasing the variety of last-mile access with ADSL, fiber optic and Ethernet-based lines. Such new lines provide inexpensive high-speed, high-capacity last mile access, and we continue to introduce new variations to our Internet connectivity service to accommodate such developments.

The following table shows the number of our Internet connectivity service subscribers as of the dates indicated:

	As of March 31,				
	2002	2003	2004	2005	2006
<b>Dedicated access service contracts:</b>					
IP service:					
Low Bandwidth (64 kbps — 768 kbps)	184	147	93	89	85
Medium Bandwidth (1 Mbps — 99 Mbps)	413	473	565	660	654
High Bandwidth (100 Mbps —)	13	43	80	114	157
Total IP Service	610	663	738	863	896
IIJ T1 Standard and IIJ Economy	1,590	939	504	276	109
IIJ Data Center Connectivity Service	110	156	196	231	247
IIJ FiberAccess/F and IIJ DSL/F (Broadband Services)	1,310	3,550	5,788	9,873	13,297
Total dedicated access service contracts	3,620	5,308	7,226	11,243	14,549
<b>Dial-up access service contracts:</b>					
Under IIJ Brand	95,169	86,183	75,136	68,068	62,176
OEM	165,407	443,601	620,731	625,908	568,307
Total dial-up access service contracts	260,576	529,784	695,867	693,976	630,483

As of July 7, 2006, we mainly offered the following Internet connectivity services.

<u>Service Type</u>	<u>Summary Description</u>	<u>Pricing (excluding consumption tax)</u>
<i>Dedicated access services</i>		
IP Service	Full-scale dedicated line service with high-speed access for businesses and other network operators with demanding bandwidth requirements.	Setup and monthly fees vary according to carrier, line speed, line type and distance involved.
IIJ T1 Standard	Packaged dedicated line service offering 1.5 Mbps connection but not including certain features of full-scale IP Service such as dynamic routing and unlimited IP addresses.	Initial setup fee of ¥50,000. Monthly access fee of ¥117,000 for up to 8 IP addresses and ¥167,000 for up to 16 IP addresses.
IIJ Economy	Service for dedicated line access to the Internet with inexpensive monthly fees primarily for small- and medium-sized businesses and local and regional offices of corporate groups.	Initial setup fee of ¥40,000. Monthly access fees of ¥38,000 for 64 kbps service and ¥45,000 for 128 kbps service.
IIJ Data Center Connectivity Service	Full-scale dedicated line service for customers hosted in IIJ Data Centers, with asymmetrical speeds of upstream (from the Internet to data center) and downstream (from the data center to the Internet) transmissions.	Initial setup fee of ¥100,000. Monthly fees range from ¥400,000 to ¥10,000,000, depending on the speed of upstream transmissions.
IIJ FiberAccess/F	Service for dedicated line Internet-access using optical lines at speeds of up to 10 Mbps or 100 Mbps, targeted primarily at small- and medium-sized enterprises requiring high-capacity, high-speed transmissions. Optical fiber access is limited to “FLET’S” lines provided by NTT East and West.	Initial setup fee of ¥50,000. Monthly fees range from ¥14,000 to ¥190,000, depending on the speed of connection and the number of IP addresses allocated. Monthly fees do not include optical line charges, which are paid directly by the customer to the optical line provider.
IIJ DSL/F	Service for dedicated line Internet-access using ADSL lines at speeds of up to 47 Mbps, targeted primarily at small- and medium-sized offices and home offices. ADSL access is limited to “FLET’S” lines provided by NTT East and West.	Initial setup fee of ¥30,000. Monthly fees range from ¥9,800 to ¥49,800, depending on the number of allocated IP addresses. Monthly charges do not include ADSL charges, which are paid directly by the customer to the ADSL service provider.
IIJ DSL/A	Service for dedicated line Internet-access using ADSL lines at speeds of up to 47 Mbps, targeted primarily at small- and medium-sized offices and home offices. ADSL access is limited to ADSL services provided by ACCA Networks, Co., Ltd. (“ACCA Networks”)	Initial setup fee of ¥75,000. Monthly fees range from ¥12,000 to ¥52,000, depending on the number of allocated IP addresses. Monthly charges do not include ADSL charges, which are paid directly by the customer to the ADSL service provider.

Service Type	Summary Description	Pricing (excluding consumption tax)
IIJ ISDN/F	Service for dedicated line Internet-access using ISDN lines at speeds of up to 64 kbps, targeted primarily at small- and medium-sized offices and home offices where ADSL lines are not available. ISDN access is limited to “FLET’S” lines provided by NTT East and West.	Initial setup fee of ¥5,000. Monthly fees range from ¥4,800 to ¥6,800, depending on the number of allocated IP addresses. Monthly charges do not include ISDN charges, which are paid directly by customers to ISDN providers.
IIJ Line Management/F	Service for us to prepare optical fiber or ADSL access provided by NTT East and West for IIJ FiberAccess/F, IIJ DSL/F and IIJ ISDN/F on behalf of customers. We provide customer support functions for the access lines.	Initial setup fee range from ¥5,000 to ¥43,400. Monthly fees range from ¥2,300 to ¥44,700, depending on the optional services.
<i>Dial-up access services</i>		
IIJ Dial-up Standard	Service for corporate users permitting simultaneous Internet-access from several dial-up lines under a single contract.	Initial setup fee of ¥5,000. Monthly basic fee of ¥2,000 plus access charges of ¥10 per minute.
Enterprise Dial-up IP Service	Service for corporate users offering multiple dial-up accounts at a fixed monthly fee.	Initial setup fee of ¥20,000. Monthly basic fees range from ¥3,000 to ¥4,900 per account depending on the number of accounts.
IIJ Dial-up Advanced	Service for corporate users offering bundled low-cost dial-up accounts.	Initial setup fee of ¥5,000. Monthly basic fee of ¥10,000 for the first 50 e-mail accounts including the first two hours access per account, plus ¥5 per minute after two hours.
IIJ4U	Service for individual users, which includes Internet-access and 5 megabytes of disk space for personal Web pages and e-mail account options for multiple users. Various access options such as ISDN, ADSL and optical fiber access are available.	This service does not charge an initial setup fee. Monthly service fee of ¥800 for the first eight hours and a charge of ¥5 per minute, with a ceiling of ¥4,100.
IIJmio DSL/DF Service	Service for individual users offering Internet connectivity over ADSL at speeds of up to 47 Mbps. ADSL access is limited to “FLET’S” lines provided by NTT East and West. The IP address is changed every time a connection is made.	No initial setup fee. Monthly charge is ¥1,400. Monthly charges do not include ADSL charges, which are paid directly by the customer to NTT East and West.

Service Type	Summary Description	Pricing (excluding consumption tax)
IIJmio FiberAccess/DF Service	Service for individual users offering Internet connectivity over optical fiber network at maximum 10 Mbps or 100 Mbps. Optical fiber access is limited to "FLET'S" lines provided by NTT East and West. The IP address is changed every time a connection is made.	No initial setup fee. Monthly charges range from ¥2,000 to ¥7,000. Monthly charges do not include optical fiber access charges, which are paid directly by the customer to NTT East and West.
IIJmio DSL/SF Service	Service for individual users offering Internet connectivity over ADSL at speeds of up to 47 Mbps. ADSL access is limited to "FLET'S" lines provided by NTT East and West. A fixed IP address is provided with this service.	No initial setup fee. The monthly charge is ¥4,800. Monthly charges do not include ADSL charges, which are paid directly by the customer to NTT East and West.
IIJmio FiberAccess/DC Service	Service for individual users offering Internet connectivity over optical fiber network at speeds of up to 50 Mbps or 100 Mbps. Optical fiber access is limited to "Access Commufa" lines provided by Chubu Telecommunications Co., Inc.	No initial setup fee. The monthly charge is ¥2,000. Monthly charges do not include optical fiber access charges, which are paid directly by the customer to Chubu Telecommunications Co., Inc.
IIJmio FiberAccess/SF Service	Service for individual users offering Internet connectivity over optical fiber network at speeds of up to 10 Mbps or 100 Mbps. Optical fiber access is limited to "FLET'S" lines provided by NTT East and West. A fixed IP address is provided with this service.	No initial setup fee. The monthly charges range from ¥8,000 to ¥12,000, depending on the type of access line. The monthly charges do not include optical fiber access charges, which are paid directly by the customer to NTT East and West.
IIJmio MobileAccess Service	Service for individual users offering mobile Internet connectivity through several data communications services provided by mobile telecommunication companies.	No initial setup fee. The monthly charge is ¥300 and does not include service charges to IIJ's access points, which are paid directly by the customer to the mobile telecommunication companies.

#### ***Dedicated Access Services***

Our lineup of dedicated line access services includes: IP Service, IIJ T1 Standard, IIJ Economy, IIJ Data Center Connectivity Service, IIJ FiberAccess/F, IIJ DSL/F, IIJ DSL/A, IIJ ISDN/F and IIJ Line Management/F. The total bandwidth allocated to our dedicated access services has increased 60.8% to 194.9 Gbps as of March 31, 2006, up from 121.2 Gbps a year earlier.

**IP Service.** Our IP Service is a full-scale, high-speed access service that connects a customer's network to our network and the Internet. The service is used by corporate customers mainly for critical purposes, such as Internet connectivity for corporate headquarters or data centers. As of March 31, 2006, we had 896 contracts for our IP Service compared to 863 for our IP Service as of March 31, 2005. The customer chooses the level of service it needs based upon its bandwidth requirements. As of July 7, 2006, we offered service at speeds ranging from 64 kbps to 10 Gbps.

Our IP Service revenues, including revenues of IJ Data Center Connectivity Service, represented 16.6% of our total revenues for the fiscal year ended March 31, 2006 and 21.4% for the fiscal year ended March 31, 2005. We believe that as businesses continue to develop Internet capabilities, this service will continue to be the foundation of our total network solutions offerings.

Subscribers pay a monthly fee for the leased local access line from the customer's location to one of our POPs. The amount of this fee varies depending on the carrier used and the distance between the customer's site and our POPs. Customers subscribing to greater bandwidths use ATM (Asynchronous Transfer Mode) or an Ethernet local access line, which supports over 2 Mbps. We collect the usage fee from the customer and pay this amount to the carrier.

Although fees are charged on a monthly basis, the minimum contract length is one year. For contracts of at least three years, a 10% per month discount is given.

We also offer various IPv6-capable Internet connectivity services, namely IPv6 Tunnel, IPv6 Native and IPv6/IPv4 Dual Stack Services. In addition to corporate users, IPv6 Tunnel Service has been available to individual users. IPv6 is the next generation Internet Protocol, which allows IPv6 technology to overcome the problems, such as limited IP address availability, of IPv4, the protocol generally used. IPv6 Tunnel Service is a service to enable customers to use IPv6 technology via IPv4 access network, by encapsulating IPv6 data with IPv4 data. IPv6 Native and IPv6/IPv4 Dual Stack Services are services which provide IPv6 environment to customers without encapsulating it with IPv4 data. IPv6 technology enables customers to connect a vast range of electronic appliances and equipment, including cellular phones, AV equipment, car navigation devices and home electronics. We are the first commercial Internet Service Provider, or ISP in Japan to offer IPv6 service and our management believes that we will reap "first-mover" benefits from our initiative. In an effort to promote the dissemination and use of IPv6, we are not currently charging service fees for IPv6 Tunnel Service.

For our IP Service, we offer Service Level Agreements to our customers to better define the quality of services our customers receive. We were the first ISP in Japan to introduce this type of agreement.

We guarantee the performance of the following elements under our Service Level Agreements:

- 100% availability of our network,
- the maximum average latency, or time necessary to transmit a signal, between designated POPs, and
- prompt notification of outage or disruption.

We are able to offer these Service Level Agreements because of the high quality and reliability of our network. Our Service Level Agreements provide customers with credit against the amount invoiced for the services if our service quality fails to meet the prescribed standards.

Subscribers to our IP Service receive technical support 24 hours a day and seven days a week.

**IIJ T1 Standard.** Our IIJ T1 Standard is a connectivity service at 1.5 Mbps that we introduced in October 1999. It is a packaged dedicated line service limited to static routing and allocations of 8 or 16 IP addresses. Last-mile access must be through NTT's Digital Access 1500 or similar services from other carriers. We support this service by providing guarantees of latency rates under Service Level Agreements. As of March 31, 2006, we had 109 customers for IIJ T1 Standard and IIJ Economy. We are no longer promoting the service since customers demand for a higher speed than the one that the service provides.

**IIJ Economy.** IIJ Economy is a packaged Internet connectivity service via a dedicated line at 64 kbps or 128 kbps, targeting small- and medium-sized businesses. We support this service by providing guarantees of latency rates under Service Level Agreements. We are no longer promoting the service since customers demand for a higher speed than the one that the service provides.

**IIJ Data Center Connectivity Service.** We also provide connectivity services with respect to our data centers. Our data center connectivity services are an important part of being able to provide high-quality, high-speed, seamless service to our customers. Our connectivity services are asymmetric, meaning that transmission speeds are not the same in both directions— with the downstream transmission being faster to accommodate greater amounts of information being accessed from the Internet versus being sent to the Internet. The fee structure depends on the transmission capacity required for upstream and downstream transmissions. For downstream transmissions, we offer either 10BASE-T connectivity (10 Mbps) or 100BASE-T connectivity (100 Mbps). For upstream transmissions, we offer bandwidths from 1 Mbps to 4 Mbps for 10BASE-T connectivity and 6 Mbps to 48 Mbps for 100BASE-T connectivity. In addition to the above, we offer IPv6-capable data center services, which offer the same services using IPv6. As of March 31, 2006, we had 247 Internet data center connectivity contracts, compared with 231 as of March 31, 2005. Total contracted bandwidth for Internet data center connectivity service was 24.4 Gbps as of March 31, 2006, up from 21.7 Gbps as of March 31, 2005. We support this service by providing the same three guarantee elements, availability, maximum average latency and prompt notification of outage or disruption, as the IP Service above under Service Level Agreements.

**IIJ FiberAccess/F.** IIJ FiberAccess/F Service is a dedicated Internet-access service that uses "BFLET'S" fiber optic access lines provided by NTT East and West allowing service at maximum 10 Mbps or 100 Mbps on a best-efforts basis. The service is available in several variations (Business, Basic, Family, Mansion and others), optimizing each customer's needs in speed and connection interface. Customers can also choose the number of allocated IP addresses from: 1, 4, 8, 16, 32 and 64. We support this service by providing guarantees of latency rates under Service Level Agreements. As of March 31, 2006, we had 13,297 customers for IIJ FiberAccess/F and IIJ DSL/F.

**IIJ DSL/F and IIJ DSL/A.** IIJ DSL/F Service provides dedicated line Internet connectivity via ADSL with speeds of up to 47 Mbps. IIJ DSL/F Service is primarily targeted at small- and medium-sized offices and home offices that have access to ADSL lines provided by NTT East and West under the name of "FLET'S ADSL". We support this service by providing guarantees of latency rates under Service Level Agreements. In May 2006, we began offering IIJ DSL/A, using ADSL lines provided by ACCA Networks.

**IIJ ISDN/F.** IIJ ISDN/F Service provides dedicated line Internet-access via ISDN lines with speeds of up to 64 kbps. IIJ ISDN/F Service is primarily targeted at small-and medium-sized offices and home offices where ADSL lines are not available but have access to ISDN lines provided by NTT East and West under the name of "FLET'S ISDN".

**IIJ Line Management/F.** IIJ Line Management/F Service is a service for us to prepare optical fiber or ADSL lines provided by NTT East and West for IIJ FiberAccess/F, IIJ DSL/F and IIJ ISDN/F on behalf of customers. We provide customer support functions for the access lines.

### ***Dial-up Access Services***

We offer a variety of dial-up access services. Our dial-up access services are an important resource in offering total Internet solutions to corporate customers. Our dial-up services allow employees out of the office or frequent travelers to access our network or their own corporate networks through one of our POPs or through our roaming access points. The dial-up services are usually provided with VPN function, that is provided by our value-added services or systems integration to access customers' own corporate network securely. We also offer dial-up access service for individuals and an OEM service (where we provide services for other companies which sell those services under their own name) for other network operators, such as NTT East and NTT West.

Our main dial-up access services are our IJ Dial-up Standard, Enterprise Dial-up IP Service, IJ Dial-up Advanced, IJ4U, IJmio DSL/DF Service, IJmio FiberAccess/DF Service, IJmio DSL/SF Service, IJmio FiberAccess/DC Service, IJmio FiberAccess/SF Service and IJmio MobileAccess Service, all as described in the table above. We also provide Terminal-type Dial-up IP Service to customers, but we are no longer promoting this service.

### **Value-Added Services**

Our customers are increasingly seeking additional network-related services, in addition to Internet connectivity. We provide our customers with a broad range of value-added services and products such as security, network, server-related outsourcing services in addition to Internet data center services. Generally, the service period is for one year and customers are billed monthly. We recognize revenues for these services on a straight-line basis during the service period. Any initial set-up fees received in connection with our value-added services are deferred and recognized over the contract period or estimated average period of estimated to customers.

We believe that business customers will continue to increase their use of the Internet as a business tool and will increasingly rely on an expanding range of value-added services to enhance productivity, reduce costs and improve service reliability.

Our value-added services include:

- ***Security-related outsourcing services.*** As of July 7, 2006, we offered seven main security-related outsourcing services that protect customers' internal networks from unauthorized access and secure remote connections to internal networks: IJ DDoS Solution Service, IJ Security Premium, IJ Security Standard, IJ Security Lite, IJ Security Scan Service, IJ Network Intrusion Detection Service and IJ Secure Remote Access. We were the first ISP in Japan to provide firewall services, which we first offered in 1994.

*IJ DDoS Solution Service.* In October 2005, we began offering IJ DDoS Solution Service to protect customers' internal networks from distributed denial of service ("DDoS") attacks, a type of unauthorized access from Internet. The fee depends on the type of service that we provide and the initial fee starts at ¥650,000 and the monthly fee starts at ¥498,000.

*IJ Security Premium.* In July 2000, we began offering IJ Security Premium, a high value-added firewall operation and management service based on Firewall-1, a product which we license from Check Point Software Technologies Ltd. The service combines and requires contracting for both Firewall Management Service and Firewall Rental Service. For Firewall Management Service, the initial setup fee is ¥200,000 and the monthly fee ranges from ¥150,000, depending on the redundancy of firewall equipment. For Firewall Rental Service, the initial setup fee ranges from ¥200,000 and the monthly fee ranges from ¥67,000

depending on a number of factors including the number of users and packet filtering performance. The fees for Firewall Rental Service are multiplied by the number of firewall equipment if the customer requires redundancy.

*IIJ Security Standard.* In October 1999, we began offering Security Standard Service pursuant to which we install and manage an around-the-clock operation of firewall systems. The initial setup fee ranges from ¥100,000, to ¥300,000, and the monthly fee ranges from ¥50,000, to ¥130,000 depending on a number of factors including the number of users, packet filtering performance and 3DES (VPN) (an encryption technology) performance. Since February 2001, a VPN option is available for this service with an initial cost of ¥20,000 and a monthly fee of ¥10,000 per computer.

*IIJ Security Lite.* In December 2002, we began offering IIJ Security Lite, an economical version of a managed firewall service with limited features of operation and maintenance targeting small- and medium-sized enterprises. The initial setup fee ranges from ¥30,000 to ¥50,000, and the monthly fee ranges from ¥25,000 to ¥35,800.

*IIJ Security Scan Service.* In March 2002, we began offering IIJ Security Scan Service, a package of services targeting small- and medium-sized enterprises to identify security weaknesses in order to prevent illicit access from external networks and to avert virus infection of in-house servers. It is available in two forms: regular monthly scans and one-time spot checks. The form of service can be selected to meet the specific needs of the customer, such as checks for protocol and network configuration or for vulnerability to specific illegal network intrusion. The service was developed with NRI Secure Technologies Ltd., a Japanese security assessment and auditing solutions provider. For the regular monthly scan service, the initial charge is ¥5,000. The monthly charge for scanning is ¥25,000 for one IP address, and ¥24,000 will be added for every additional IP address. For the spot scan service, the basic charge for scanning one IP address is ¥30,000, and ¥29,000 will be added for every additional IP address.

*IIJ Network Intrusion Detection Service.* In April 2001, we began offering IIJ Network Intrusion Detection Service, which offers around-the-clock, non-stop network monitoring and intrusion-detection capabilities, as well as packet information for analyzing detected illicit accesses. The initial cost for the service is ¥300,000, and the monthly fee starts from ¥300,000, depending on the customer's traffic volume.

*IIJ Secure Remote Access.* IIJ Secure Remote Access is a packaged service combining the IIJ Dial-up Advanced with ID Gateway, which controls remote access to in-house servers protected by firewalls. In addition to the 50 dial-up accounts covered by the base rate, the service ensures a secure remote environment by controlling accessible servers and utilization protocols for each dial-up account. In May 2002, IIJ Secure Remote Access was upgraded by adding a remote VPN function. The upgrade enables remote users to transmit and receive data with encryption, offering a secure enterprise network environment with a greater variety of access options, such as connections from overseas via local ISPs. In June 2005, IIJ Secure Remote Access was upgraded by adding an Authentication Service Link Option, which enables customers to use a greater variety of authentication methods.

- *Network-related outsourcing services.* As of July 7, 2006, we offered six main network-related outsourcing services, including provision, monitoring and maintenance of network equipment and VPN to connect customers' branch and remote offices: IIJ Internet-LAN Service, IIJ SMF-VPN, IIJ Managed VPN Pro Service, IIJ VPN Standard, SEIL Rental Service and IIJ NetLightning.

*IIJ Internet-LAN Service.* IIJ Internet-LAN Service is a service which provides connectivity among a company's branch and remote offices. With this service, customers can use functions provided by Wide-area Ethernet over the Internet.

*IIJ SMF-VPN.* IIJ SMF-VPN is a service which uses IIJ SEIL Management Framework ("SMF") which provides remote configuration and monitoring features of SEIL Series routers at customer remote sites from central management servers at IIJ and the customer's main office or data center. The technology is patent granted. When a customer at a remote site connects the router to the circuit, the router is automatically configured and connected to the network. System integrators utilizing this technology can reduce configuration and maintenance costs at the remote site.

*IIJ Managed VPN Pro Service.* IIJ Managed VPN Pro Service is a service which provides connectivity among a company's branch and remote offices, utilizing SEIL Series or other routers.

*IIJ VPN Standard.* IIJ VPN Standard is a service which provides Internet VPN connectivity among a company's branch and remote offices based on encryption technology. IIJ rents out encryption equipment at customer sites, configures the equipment for the customer and provides remote monitoring of the encrypted sessions. Initial cost for the service starts from ¥30,000, and monthly fees start from ¥6,900 depending on the equipment features.

*SEIL Rental Service.* We rent routers for connection to the Internet and provide configuration, management and monitoring services. We provide SEIL Series or CISCO routers depending on customer requirements.

*IIJ NetLightning.* IIJ NetLightning is a service based on Netli, Inc.'s technology that improves web application performance. By utilizing this service, end users can access customer websites faster, without any settings, and customers can thereby reduce the cost of placing mirror sites.

- ***Server-related outsourcing services.*** As of July 7, 2006, we offered twelve main server-related outsourcing services including provision of e-mail and web services and operation and management of e-mails systems: IIJ Mail Gateway Service, IIJ Post Office Service, IIJ Mail Box Service, e-mail distribution services, IIJ Web Standard, web hosting services, IIJ Download Site Service, IIJ URL Filtering Service, IIJ Document Exchange Service, DNS services, streaming services and IIJ*mio* Safety Mail Service.

*IIJ Mail Gateway Service.* In November 2002, we renovated IIJ Mail Gateway Service to expand the service from large corporate customers to other corporate segments. The service has three options. The first one is virus protection to check the viruses on incoming and outgoing e-mails. The second one is audit to detect the keyword set in advance on the outgoing e-mails. The third one is antispam to check spam for incoming e-mails, which we started to provide in October 2004. Customers can take all or a selection of the options. The initial cost is ¥10,000, and the monthly fee ranges from ¥30,000 to ¥70,000 for the first 50 e-mail accounts and an additional fee per account after the first 50 e-mail accounts ranges from ¥200 to ¥850.

*IIJ Post Office Service.* IIJ Post Office Service is an e-mail operation outsourcing service performed by our e-mail server, enabling a customer to allocate and maintain a number of e-mail accounts under its own domain name for its employees, members or other relevant users. The customer can administer e-mail accounts online through our customer support Web interface. In December 2002, we added a virus checking option for incoming and outgoing

e-mails and an “audit option” to check the content of outgoing e-mails and suspend the ones containing keywords specified in advance. In addition, we added a spam checking option which we started to provide in October 2004 for no additional charge to customers contracting the virus checking option or an “audit option”.

IIJ Mail Box Service. IIJ Mail Box Service is also an e-mail operation outsourcing service performed by our e-mail server. Unlike IIJ Post Office Service, customers do not have to obtain their own domain names. A customer can administer e-mail accounts online through our customer support Web interface.

E-mail distribution services. We offer other e-mail outsourcing services, such as services for e-mail distribution to large numbers of e-mail addresses and mailing list functions.

IIJ Web Standard. The IIJ Web Standard allows customers to use their own domain names while providing them with up to 200 megabytes of web hosting space. By limiting specifications, the pricing of the service is kept to a minimum ¥5,000 per month. Additionally, careful traffic management of the storage space ensures a high-performance web-server environment for users is ensured. This service mainly targets small- and medium-sized enterprises.

Web hosting services. We offer other web hosting services, such as customized web hosting services and functions to distribute computer files using our ftp servers.

IIJ Download Site Service. IIJ Download Site Service is a hosting service dedicated to high-volume content downloads from the Internet. The service started on a trial basis in November 2001, and the full-fledged service was launched in February 2002. A dedicated hosting server and dedicated bandwidth are established for each contract to ensure constant stable performance. With disk capacity of 500 megabytes per contract on our hosting servers, access is provided at a maximum transmission bandwidth per contract of up to 80 Mbps. The initial charge for the service is ¥50,000. The monthly charge ranges between ¥60,000 and ¥340,000, depending upon the bandwidth. In April 2003, we added the option of 1 Gbps maximum transmission speed for an additional fee.

IIJ URL Filtering Service. IIJ URL Filtering Service is a service enabled by the use of IIJ’s proxy server which blocks access to websites deemed inappropriate. The initial cost for the service is ¥30,000, and the monthly fee is ¥40,000 as a basic fee plus an additional fee depending on the number of users in the customer’s internal network.

IIJ Document Exchange Service. This service is an online storage service with which customers can upload files onto IIJ’s storage server and share them with authorized users. The initial cost is ¥40,000 and the monthly fee is ¥20,000, which includes 1GB of disk space and 50 accounts. The fee for each additional set of 10 accounts is ¥3,000, and each 1GB of additional disk space is ¥10,000 per month.

DNS services. We offer domain name related services that consist of domain name administration services and domain name server outsourcing services. Domain names such as “.jp”, “.com”, “.net” and “.org” are available.

Streaming services. We offer Internet streaming services for live broadcasts over the Internet, as well as streaming server hosting services.

***IIJmio Safety Mail Service.*** IIJmio Safety Mail Service, launched in December 2001, is a standard e-mail service with an anti-virus function for individual users. The service employs the InterScan VirusWall developed by Trend Micro Incorporated, and features POP/SMTP over SSL which provides secure e-mail transmission by encrypting the e-mail transmission between the users and our mail server, in addition to SMTP authentication, which ensures a higher level of encryption and authorization than what is currently available for general use. In February 2005, we started to provide spam check function without an additional charge. There is no initial charge for IIJmio Safety Mail Service and the monthly charge is ¥500.

- ***Internet data center services.*** Our Internet data center services include three primary services which are typically bundled together for our customers: IIJ data center facility services, IIJ data center connectivity services and management and monitoring services. Our Internet data center facility services are co-location services which allow companies to house their servers and routers off-site on our premises. Our Internet data center facilities are leased from third parties such as NTT Communications and are equipped with robust security systems, 24-hours-a-day non-stop power supplies and fire extinguishing systems, and have earthquake-resistant construction and high-speed Internet connectivity with IIJ backbones. We also offer basic monitoring and maintenance services for the equipment. This service enhances reliability because we provide 24-hours-a-day monitoring and have specialized maintenance personnel and facilities. We offer management and monitoring services tailored to our customers' requirements.
- ***Customer support and help desk solutions.*** We provide comprehensive customer support and help desk solutions that include network monitoring and trouble-shooting services. Most of our customer support services are provided as an integral part of other services we sell.
- ***IP Phone.*** We began IP Phone service for individual users of IIJ4U and IIJmio in May 2003, and for corporate users who are using IIJ's Internet connectivity services through NTT FLET'S network in December 2003. The telephone service is provided via NTT FLET'S network and customers can make telephone calls with other users connected to NTT FLET'S network or legacy telephones by interconnection with the Publicly Switched Telephone Network, the legacy telephone network.
- ***IIJ EPC Network Service.*** IIJ EPC Network Service is a service to provide network and server systems for our customers to use Radio Frequency Identification Tag ("RFID"). We offer three types of services. "Premium" is a service to provide customized systems for our customers. "Standard" is a service to provide our systems at our data centers and "Trial" is a service to provide RFID functions to our customers for their trial usage.

### **Systems Integration**

We offer systems integration tailored to our customers' requirements, which include consulting, project planning, systems design, construction of network systems and systems and operations outsourcing. Our systems integration mainly focus on Internet business systems and Intranet and Extranet corporate information systems. We have built a strong record in various business fields.

Examples of systems integration are:

- connecting over a hundred locations such as gas stations, bank branches and retail shops via Internet-VPN, transmission of data over the Internet with an encryption feature and our proprietary SEIL Series routers and SMF,

- voice over IP systems to transmit voice among customer branch offices over Internet,
- outsourcing of large scale e-mail servers or systems to detect or delete e-mails with viruses or spam or record all of e-mails incoming to and outgoing from customers,
- construction of wireless local area network (“LAN”),
- online brokerage systems for securities firms,
- outsourcing of websites for online businesses,
- re-construction of overall corporate network systems suited to increased traffic data, and
- consultation on corporate network security.

The fee structure of our systems integration is based upon the complexity and scale of the project. We bill our customers for these services on a fixed-fee basis and recognize the revenue when the network systems and equipment are delivered and accepted by the customer. Maintenance, monitoring and operating service revenues are recognized ratably over the separate contract period, which is generally for one year.

In the planning phase of a systems integration project, we form special project management teams formulated for every new assignment from the customer. We analyze and design the customer’s network and systems with three engineering focuses: reliability, flexibility and extendibility.

In the network systems construction phase, we procure equipment such as servers and manage application development and software programming tasks which are outsourced to third parties. Network systems construction usually incorporates many of our other connectivity and value-added services.

In the operation phase, by utilizing data center facilities directly linked to our network, we provide a range of outsourcing services, which take maximum advantage of the Internet system, network operation and management know-how of the IJ Group companies. Rather than simply looking after the customer’s content, we take care of the customer’s entire computing environment and provide around-the-clock operation and management services, as well as custom-designed monitoring systems. These outsourcing services enable customers to free themselves from the burden of operating the network systems, which demands professional operation and maintenance to ensure prompt and flexible responses to unexpected system problems.

We also provide our customers with basic, easy-to-order systems integration, which we refer to as IBPS, including provision of network resources such as network equipment, data storage systems, network monitoring and systems operation management, on demand and on a monthly basis, therefore enabling our customers to launch their internal network system securely and cost effectively.

### **Equipment Sales**

In addition to the Internet connectivity and value-added services and systems integration, we sell our network equipment for connection to the Internet and usage of additional features, which was developed in-house.

**SEIL Series.** We started to sell our high-end routers SEIL Series, which was developed in-house, in October 2001 through sales agents. The series includes four types, SEIL/TURBO, SEIL/plus, SEIL/neu 128 and SEIL DOCK 2. SEIL/TURBO has a high throughput and enhanced VPN features and is placed in customer’s main office or data center when a customer connects its branch and remote offices. SEIL/plus is

suitable for broadband connection and is placed mainly in customer's branch and remote offices. SEIL/neu 128 is suitable for ISDN or 64 k/128 kbps leased line based Internet connection. SEIL DOCK 2 is equipment to provide a back-up feature to customers. By combining SEIL/TURBO and other SEIL Series routers, we are able to provide Internet-VPN solutions connecting corporate branches and remote offices of medium and small enterprises. In addition, we provide rental services for these routers directly to customers.

We also sell third-party equipment to meet the one-stop needs of our customers.

## Network

Our network is one of our most important assets. We have developed and currently operate a high-capacity network that has been designed to provide reliable, high-speed, high-quality Internet connectivity services.

We are able to achieve and maintain high speeds through our advanced network architecture, routing technology and load balancing that optimize traffic on our multiple Internet connections.

The primary components of our network are:

- our backbone, which includes leased lines and network equipment, such as advanced Internet routers,
- Points of Presence ("POPs") in major metropolitan areas in Japan,
- Internet data centers, and
- a network operations center ("NOC").

## Backbone

### Leased lines

Our network is anchored by our extensive Internet backbone in Japan and between Japan and the United States. As of July 7, 2006, we had a total capacity of 7.2 Gbps between Japan and the United States and 600 Mbps between Japan and China. We use our expertise in developing and operating our network to organize and connect these leased lines to form a backbone that has substantial transmission capacity.

We lease high-capacity, high-speed digital transmission lines in Japan from various carriers. The table below shows our backbone cost.

### Backbone Cost

	For the fiscal year ended March 31,				
	2002	2003	2004	2005	2006
Backbone cost (thousand yen)	¥5,656,116	¥5,235,517	¥4,719,638	¥3,550,885	¥3,516,322

### Network upgrades

As a policy, we put a high priority to maintain the quality of our networks and continuously examine the necessity of upgrades of our networks.

### *Network equipment*

We use advanced equipment in our network. Our primary routers in our network are Cisco routers. The size of our routers varies depending on the number of customers and volume of traffic served by our POPs. At each POP we connect our dedicated line and dial-up access routers to Cisco backbone routers which then transmit and receive information throughout our network. We primarily lease our network equipment under capital lease arrangements.

**Points of Presence.** POPs are the main points at which our customers connect to our backbone. We provide Internet connectivity from our POPs to commercial and residential customers through leased lines and dial-up connections over local exchange facilities. As of July 7, 2006, we had 13 primary POPs which allow for dedicated access and include the main Internet backbone routers that form our network. As of the same date, we also had 17 POPs for dial-up access. The number of POPs for dial-up access include one POP that can be accessed from anywhere in Japan with the minimum local telephone charge.

Many of our POPs are located in, or in close physical proximity to, “carrier hotels”. Carrier hotels are facilities where we and other major carriers and ISPs have POPs. These are mainly located at facilities of various carriers in Japan like NTT Communications, KDDI Corporation (“KDDI”) and Japan Telecom Co., Ltd. We lease the physical space from these carriers or use such space under other arrangements with terms ranging from one to two years and terminable by either party on three to six months’ notice. We maintain our routers and other networking equipment at these POPs. Our POPs are in, or in close proximity to, the same buildings in which the switches and routers of these carriers and ISPs are located enabling quick and easy interconnection of our equipment with theirs.

**Internet Data Centers.** We operate twelve Internet data centers which we use to offer our value-added data center services, three in Tokyo, two in Yokohama, and one each in Osaka, Sapporo, Sendai, Kawaguchi, Nagoya, Kyoto and Fukuoka. These data centers are specifically designed for application hosting, co-location services and high capacity access to our networks. All of these data centers are leased from NTT Communications, CRC Solutions Corp. and KDDI.

These data centers have 24-hours-a-day, seven-days-a-week operations and security and are equipped with uninterruptible power supplies and backup generators, anti-seismic damage precautions, fire suppression equipment and other features to optimize our ability to offer high-quality services through these data centers.

In addition, we have invested in data center development outside Japan. We have entered into the “i-Heart” joint venture with Samsung Corp., which operates in Korea with a total investment by us of ¥89 million in May 2000.

**Network operations center and technical and customer support.** Our NOC in Tokyo operates 24 hours a day and seven days a week. From our NOC, we monitor the status of our network, the traffic on the network, the network equipment and components and many other aspects of our network including our customers’ dedicated access lines leased from carriers. From our NOC, we monitor our networks to ensure that we meet our commitments under our Service Level Agreements.

### **Our Group Companies**

We offer our services directly and together with our group companies. Our group companies work closely together in providing total network solutions to our customers. We collaborate on the development of various services and products and market our services and products together as a group. However, our group companies specialize in different aspects of the Internet and networking. Our customers’ main point of

contact is IIJ itself. We then draw upon the resources and special capabilities of the group companies to offer total Internet solutions.

The table below sets out our group companies, including our subsidiaries and principal equity method investees and our direct and indirect ownership of each of them as of July 7, 2006:

Company Name	Proportion of ownership and voting interest
IIJ Technology Inc.	72.1%
IIJ America Inc.	97.6%
Net Care, Inc.	59.3%
IIJ Financial Systems Inc.	72.1%
Internet Multifeed Co.	29.4%
atom Co., Ltd.	40.0%
Internet Revolution Inc.	30.0%

***IIJ Technology Inc.***

IIJ Technology Inc. (“IIJ-Tech”) is an important element in our provision of total network solutions to our customers. IIJ-Tech is incorporated under the laws of Japan. IIJ-Tech provides comprehensive network systems integration and consulting services, focusing on design, operation, and consulting for corporate networks (LANs, enterprise networks, Intranets) and their security systems. IIJ-Tech assists customers in creating private IP networks, such as Intranets or virtual private networks, that securely isolate internal network traffic from public Internet traffic and provide each site on the private IP network access to other sites as well as to the Internet. IIJ-Tech can integrate an organization’s multiple sites in different locations in Japan.

On April 27, 2004, IIJ-Tech completed a private placement of 10,000 shares of common stock to us and other shareholders for an approximate aggregate amount of ¥1,000 million. We accepted most of the placement. Our ownership increased from 64.1% to 69.0% during the fiscal year ended March 31, 2005.

In October 2005, IIJ-Tech issued 1,235 new shares of common stock to IIJ Media Communications Inc. (“IIJ-MC”) when a portion of IIJ-MC’s business was transferred to IIJ-Tech. As IIJ-MC was merged into us, the new shares of IIJ-Tech were succeeded to us and our ownership increased from 69.0% to 72.1%.

IIJ-Tech had sales of approximately ¥18,441 million for the fiscal year ended March 31, 2006. As of March 31, 2006, IIJ-Tech had 214 full-time employees, and 32 were seconded from us.

***IIJ America Inc.***

IIJ America Inc. (“IIJ-A”) is a U.S.-based ISP, catering mostly to U.S.-based operations of Japanese companies. IIJ-A is incorporated under the laws of the state of California.

IIJ-A had revenues of \$9,371 thousand for the fiscal year ended December 31, 2005. As of March 31, 2006, IIJ-A had 22 employees, 4 of whom were seconded from us.

***Net Care, Inc.***

Net Care, Inc. (“Net Care”) provides a broad array of support services, from monitoring and troubleshooting to network operations and an end-user help desk.

On April 27, 2006, our board of directors approved purchase of 450 shares of Net Care from its minority shareholders. We purchased the shares on April 28, 2006. As a result, our ownership increased from 57.0% to 59.3%.

Net Care had sales of approximately ¥2,367 million for the fiscal year ended March 31, 2006. As of March 31, 2006, Net Care had 165 employees, 12 of whom were seconded from us.

#### ***IIJ Financial Systems Inc.***

IIJ Financial Systems Inc. (“IIJ-FS”) is a company wholly owned by IIJ-Tech, whose business was acquired from Yamatane Co., Ltd. in October 2004. IIJ-FS provides integration and operation of security systems.

IIJ-FS had revenues of ¥2,624 million for the fiscal year ended March 31, 2006. As of March 31, 2006, IIJ-FS had 73 employees.

#### ***Internet Multifeed Co.***

Internet Multifeed Co. (“Multifeed”) provides location and facilities for directly connecting high-speed Internet backbones with content servers to make distribution on the Internet more efficient. Multifeed is incorporated under the laws of Japan. Its technology was developed jointly with the NTT Group. Multifeed launched new IX (Internet eXchange — where major ISPs exchange network traffic) services named JPNAP in Tokyo in May 2001 and expanded the service to Osaka in December 2001.

Multifeed had sales of approximately ¥2,376 million for the fiscal year ended March 31, 2006. As of March 2006, Multifeed had 23 full-time employees, and 4 employees were seconded from us.

#### ***atom Co., Ltd.***

atom Co., Ltd. (“atom”), which is incorporated under the laws of Japan, is primarily a web-page design company that aims to define new forms of design work using digital technology in all network-based aspects of design from content production to graphic design.

atom had sales of approximately ¥797 million for the fiscal year ended March 31, 2006. As of March 31, 2006, atom had 65 employees, 1 of whom was seconded from us.

#### ***Internet Revolution Inc.***

On February 1, 2006, we and Konami Corporation established a joint venture company, Internet Revolution Inc. (“i-revo”) to operate comprehensive sites. We invested ¥750,000 thousand in i-revo and owned 30% ownership as March 31, 2006. We account i-revo as an equity method investee in our consolidated financial statements.

i-revo had sales of approximately ¥3 million for the fiscal year ended March 31, 2006. As of March 31, 2006, i-revo had 34 employees, 10 of whom was seconded from us.

#### **Capital Expenditures**

The table below shows our capital expenditures, which we define as amounts paid for purchases of property and equipment plus acquisition of assets by entering into capital leases, for the last three years.

	<b>For the fiscal year ended March 31,</b>		
	<b>2004</b>	<b>2005</b> (millions of yen)	<b>2006</b>
Capital expenditures, including acquisition of assets by entering into capital leases	¥3,523	¥5,011	¥4,762

Our future capital expenditures are difficult to predict given the rapid changes and uncertainties in our business environment. Most of our capital expenditures relate to the expansion and improvement of our existing network, including the installation of the routers and servers necessary to offer services on our network.

We have not made any material divestitures in the current or past three fiscal years. We recorded losses on disposal of property and equipment of ¥110 million, ¥144 million and ¥119 million for the fiscal years ended March 31, 2004, 2005 and 2006, respectively. The losses for the fiscal years ended March 31, 2004 and 2005 were mainly due to disposal of back-office systems and telephone rights. The loss for the fiscal year ended March 31, 2006 was mainly due to disposal of software, such as for back-office systems.

### **Seasonality**

See Item 5.D., “Trend Information — Factors Affecting Our Future Financial Results — Systems integration revenues, including related equipment sales revenues”.

### **Sales and Marketing**

Our sales headquarters are in Tokyo. We also have branches in Osaka, Nagoya, Sapporo, Sendai, Toyota, Toyama, Hiroshima, Fukuoka and Okinawa in order to cover the major metropolitan areas in which the majority of large Japanese companies operate. As of March 31, 2006, we had approximately 200 people working in sales and marketing.

We organize our sales personnel into four distinct, separate divisions, Product and Marketing, Operation Management Coordination Division and Strategic Sales. In addition, we have nine branch offices.

Sales Divisions consists of the following:

- Three of Divisions focus on our total network solutions and work with large corporate clients, including telecommunications carriers and ISPs, financial institutions, manufacturers, government institutions, universities and other schools, or focus on the expansion of sales agents for our services and network equipment. In order to provide total network solutions, personnel in our sales divisions work closely with other IJ Group companies such as IJ-Tech as well as with other important service providers.
- One Division focuses on total network solutions and works with governmental institutions.

Our Product and Marketing mainly makes and conducts promotion plans on our products and services. Operation Management Coordination Division handles administrative issues. Strategic Sales is responsible for the planning and management on the sales figures, processes and other information.

## **Customers**

We have approximately 6,500 business and other institutional customers and approximately 630,000 individual subscribers, which includes individuals subscribing to OEM services, as of March 31, 2006. Our main customers continue to be major corporations, including ISPs.

## **Research and Development**

We have always focused on advancing the use of networking technologies, including the Internet, in Japan. Many of our engineers regularly participate in industry organizations and government-sponsored research projects such as researching new Internet protocol standards, namely Internet Protocol Version 6 (IPv6). These engineers have continued to develop innovative services, applications and products, many of which have set the standard for the Internet industry in Japan. In addition to our efforts to develop innovative services, we have engaged in the research and development of new basic technology since the establishment of IJ Research Laboratory in 1998.

Our research and development expenses averaged less than 1.0% of total revenues for the past three consecutive years. For the fiscal years ended March 31, 2006, 2005 and 2004, our research and development expenses were ¥158 million, ¥199 million and ¥358 million, respectively, most of which was personnel expense. The level of research and development expenditures is low in relation to our total costs primarily because we do not engage in extensive research and development of new technologies and products that require large investments. Rather, as noted above and as set forth in more detail below, we are intensively engaged in research and development related to our ongoing business. We focus on monitoring developments in the industry and in developing new and innovative services and applications by using and modifying existing technologies and products.

As of March 31, 2006, we had approximately 100 people working in our research and development organization, including the staff in IJ Research Laboratory. Our research and development staff works very closely with our sales and marketing personnel and technical engineers to ensure that our research and development efforts are closely aligned with the demands of our customers.

### ***Research and Development Organization***

We have organized our research and development staff to promptly and effectively address the rapidly changing technological environment of the Internet. Research and development on practical applications of new and developing technologies is the responsibility of the Applied Research and Development Department.

*IJ Research Laboratory.* We established the IJ Research Laboratory in April 1998 to engage in the research and development of new basic network technologies. Through the IJ Research Laboratory, we participate in various research and development activities in cooperation with organizations from the private and academic sectors to promote the deployment and implementation of IPv6. The output of the joint undertaking with WIDE project is distributed freely in order to promote the introduction of IPv6 on a worldwide scale. IPv6 is designed to solve problems inherent in the current version of IP, which is IPv4, such as IP address space depletion. In addition, IPv6 is expected to provide new network features such as ubiquitous networking.

*Applied Research and Development Department.* Applied Research and Development Department engages in the research and development of technologies to be applied to our services and solutions, collects information on, evaluates on the new technology and conducts business expansion based on the technology IJ Research Laboratory developed.

### ***Research and Development Strategy***

Our primary research and development objective is to continue to develop innovative services, applications and products that will meet the current and future demands of our customers and that will continue to be at the forefront of the Internet industry in Japan. In furtherance of this objective, our research and development efforts currently are focused on a variety of projects, including:

- continued improvement of our SEIL router and SEIL Management Framework, systems which we developed specifically to be integrated into IJJ's network-related services,
- research relating to the methodology of configuration of routers and other servers,
- research relating to behavior of Internet routing systems,
- software development for management of border gateway protocol, or BGP, which is protocol that allows routers to exchange routing information on the TCP/IP network,
- research for Internet traffic monitoring and management,
- development of software and evaluation of hardware relating to improving the operations of routers located on our customers' premises, and
- research and development of IPSec, which is a secure version of IP that provides secure communication channels over the Internet.

A second research and development objective is to continue participating in or otherwise closely monitoring the new products, developments and initiatives of manufacturers and standards-setting and research groups. Through these efforts, we seek to ensure that we have timely and effective access to new technologies and that we implement these technologies effectively. Because the rate of change in technology relevant to our business is so rapid, we believe that the sophistication and experience of our research and development personnel is an important part of our success.

### **Proprietary Rights**

Although we believe that our success is more dependent upon our technical, marketing and customer service expertise than our proprietary rights, we rely on a combination of trademark and contractual restrictions to establish and protect our technology.

### ***Licenses***

For us to provide certain services to our customers, we have been a licensee under agreements with other suppliers, such as Check Point Software Technologies Ltd., WatchGuard Technologies, Inc., Trend Micro Incorporated, RSA Security Inc., NRI Secure Technologies, Ltd. and MX Logic, Inc.

We have purchased licenses from the companies in accordance with customer demands for our services.

### **Trademarks**

We have applied for trademark registrations of our corporate name, “Internet Initiative Japan Inc.” and certain other corporate and product names in Japan, the United States and certain European countries. As of July 7, 2006, 35 registrations have been granted, with 6 pending applications.

### **Patents**

We have applied for patent registrations in relation to our technology in Japan and the United States. As of July 5, 2006, 4 registrations have been granted, with 6 pending applications. The latest acquired patent is for centralized network management system originally developed by us and is implemented in one of our competitive services, SMF (SEIL Management Framework).

### **Legal Proceedings**

We are involved in normal claims and other legal proceedings in the ordinary course of business. Except as noted below, we are not involved in any litigation or other legal proceedings that, if determined adversely to us, we believe would individually or in the aggregate have a material adverse effect on us or our operations.

In December 2001, a class action complaint alleging violations of the federal securities laws was filed against us in the United States District Court for the Southern District of New York, naming as defendants IJJ; Koichi Suzuki, our President, Chief Executive Officer and Representative Director; Yasuhiro Nishi, our former Director, Chief Financial Officer and Chief Accounting Officer; and the Goldman Sachs Group Inc. and Morgan Stanley (formerly, Morgan Stanley Dean Witter, Inc.), both of which served as underwriters of our initial public offering. Similar complaints have been filed against over 300 other issuers that have had initial public offerings since 1998, and all such actions have been included in a single coordinated proceeding in the Southern District of New York. An amended complaint was filed on April 24, 2002. The amended complaint alleges, among other things, that the underwriters of our initial public offering (i) entered into certain alleged compensation arrangements with the underwriters’ clients, such as undisclosed commissions or tie-in agreements to purchase stock in the after-market, and (ii) engaged in manipulative practices to artificially inflate the price of our stock in the after-market subsequent to the initial public offering. The IJJ defendants are named in the amended complaint pursuant to Sections 11 and 15 of the Securities Act of 1933, as amended, and Sections 10(b) and 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934, as amended, on the basis of an alleged failure to disclose the underwriters’ alleged misconduct. The complaint seeks unspecified damages. On July 15, 2002, we joined in an ‘omnibus’ motion to dismiss the amended complaint filed by the issuers and individuals named in the various coordinated cases. In June 2003, we approved a settlement with the plaintiffs in this matter.

We, along with the settling issuer defendants, filed a motion seeking the court’s preliminary approval of the settlement. The court granted preliminary approval of the settlement on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005. A settlement fairness hearing took place on April 24, 2006. If the court determines that the settlement is fair to the class members, the settlement will be approved.

The settlement releases us and the individual defendants from liability for the conduct alleged in the action. Under the settlement, we agreed to assign away, not assert, or release certain potential claims we may have against our underwriters. As to financial impact on us, the settlement provides that the class members will be guaranteed \$1 billion dollars in recoveries by the insurers of the issuers. In addition to IJJ’s portion of the proposed settlement, some of the continuing legal expenses incurred in connection with the partial

settlement would be borne by our insurer based on the settlement agreement and an individual agreement between us and our insurer. Consequently, we believe that there will be no significant financial impact on us as a result of this matter.

### **Regulation of the Telecommunications Industry in Japan**

The Ministry of Internal Affairs and Communications (“MIC”) regulates the Japanese telecommunications industry. Carriers, including us, are regulated by the MIC primarily under the Telecommunications Business Law.

#### **The Telecommunications Business Law**

The Telecommunications Business Law, which became effective in 1985, was established for the purpose of privatization and deregulation in telecommunications business. After several amendments, the Telecommunications Business Law was considerably amended in July 2003. The amendments to the Telecommunications Business Law, which came into force on April 1, 2004, include, among other things:

- the elimination of the classification of Type I Carriers and Type II Carriers;
- deregulation of regulations on charges and terms and conditions for providing services by Carriers; and
- the introduction of certain terminal-equipment-supplier’s declaration system regarding technical standard conformity.

The Prior Telecommunications Business Law stipulated that the Carriers shall be classified as either Type I Carrier or Type II Carrier, and imposed regulations in accordance with such classification of Carriers. Prior Type I Carriers, such as NTT East, NTT West, provided telecommunications services by establishing their own telecommunications circuit facilities. Prior Type II Carriers, including us, engaged in the businesses of telecommunications circuit resale and the provision of Internet services by using the telecommunications facilities of Type I Carriers.

However, from the viewpoint of encouraging telecommunications carriers to carry out diverse business, etc, the Telecommunications Business Law was amended so as to abolish the classification of Type I Carriers and Type II Carriers, and thereupon the rules pertaining to services (i.e., start-up, abolition, charges and tariffs, etc.) were deregulated in principle while establishing rules to protect the users, and the rules pertaining to infrastructure were reviewed as necessary while maintaining the basic framework stipulated under the prior Telecommunications Business Law. For example, (i)the approval system for business entries and withdrawals was replaced by a registration/notification system, (ii)regulations pertaining to service offerings, tariff setting and interconnection between carriers were liberalized, (iii)regulations to protect service users such as announcement of withdrawal, explanation of important matters on services and swift processing of complaints were introduced, and (iv)an authorization system allowing priority usage of public utilities conducive to facilitation of circuit facilities deployment was introduced.

The following table summarizes changes by the amendment above in some of the major regulatory requirements applicable to telecommunications carriers:

*(Before Amendment)*

	Type I Carriers		Type II Carriers	
		Special Type II	General Type II	
Start-up of services	Permission from MIC required	Registration with MIC required	Notification to MIC required	
Rates and charges	Notification* to MIC required	Notification to MIC required	Unregulated	
Share acquisition by foreign investors	Unregulated**	Unregulated	Unregulated	

\* Type I Carriers which operate Category I Designated Telecommunications Facilities are required to receive MIC approval for their Interconnection charges.

\*\* Prior notification is required under the Foreign Exchange and Foreign Trade Law. This is not applicable to purchasers of ADSs. A one-third foreign ownership restriction is applicable only to NTT (which was changed from a 20% foreign ownership restriction on November 30, 2001).

*(After Amendment)*

	Telecommunications Carriers	
	Registration required	Registration exempted
Start-up of services	Registration with MIC required*	Notification to MIC required****
Rates and charges	Notification to MIC required**	Unregulated
Share acquisition by foreign investors	Unregulated***	Unregulated

Before the amendments to the Telecommunications Business Law, we were classified as a Special Type II Carrier. After the amendments, we are deemed by the effect of Supplementary Provisions to the amended Telecommunications Business Law to have filed the notification to MIC under the amended Telecommunications Business Law. In practice, we filed an actual notification to MIC in April 2004 according to the request of MIC.

\* Applicable to telecommunications carriers which install certain large scale circuit facilities unless an exemption applies as designated by the applicable ministerial ordinance of MIC from the viewpoint of the scale of the telecommunications circuit facilities and the scope of areas where such telecommunications circuit facilities are installed.

\*\* Applicable to universal services and services which have the control power over the market provided by the telecommunications carriers which install what is called the "bottle-neck facilities".

Telecommunications carriers which operate Category I Designated Telecommunications Facilities are required to receive MIC approval for their Interconnection terms and charges.

\*\*\* Prior notification is required under the Foreign Exchange and Foreign Trade Law for acquisition of shares of telecommunications carriers to which registration for start-up services is applicable. This is not applicable to purchasers of ADSs. A one-third foreign ownership restriction is applicable only to NTT.

\*\*\*\* Currently, carriers which meet the following two requirements established by the ministerial ordinance of MIC are exempted from registration with MIC: (i) areas of installation of terminal-related transmission facilities are limited to only within a single municipal (city, town or village) and (ii) areas of installation of relay-related transmission facilities are limited to only within a single prefecture.

## **Regulations of telecommunications carriers**

The following regulations apply to telecommunications carriers defined in the Telecommunication Business Law.

### ***Start-up of Services***

- Carriers with registration

Registration with the MIC required for telecommunications carriers which exceed criteria established by MIC's ordinance in relation to the scale of the telecommunications circuit facilities and the scope of areas where such telecommunications circuit facilities are installed.

- Other Carriers

Notification to the MIC required for telecommunications carriers other than the above. We do business under this category.

### ***Charges and Tariffs***

- Unregulated, in general. The requirement that standard terms and conditions be applied equally to all users was repealed.
- Prior notification to the MIC required for Basic Telecommunications Services (universal services such as basic fee, local call and emergency telecommunication service) and Designated Telecommunications Services (i.e., services which have the controlling power over the market provided by the telecommunications carriers which install what is called the "bottle-neck facilities"). Among the Designated Telecommunications Services, the telecommunications services to be specified by MIC at least once a year will be subject to price cap regulations, under which carriers will be required to obtain approval from the MIC if a proposed change of charge exceeds the price cap. Providing these telecommunications services other than pursuant to the terms and conditions notified to the MIC is prohibited, unless minor exceptions apply.

### ***Articles of Interconnection Agreements***

- Unregulated, in general.
- Approval from the MIC required for Category I Designated Telecommunications Facilities.
- Prior notification to the MIC required for Category II Designated Telecommunications Facilities.

### ***Telecommunications Facilities of Carriers.***

- A telecommunications carrier that owns telecommunications circuit facilities must maintain its telecommunications facilities (except telecommunications facilities stipulated in MIC's ordinances as those having a minor influence on the users' benefit in the cases of damage or failure thereof) in conformity with the technical standards provided in the applicable MIC's ordinances. Such Carriers shall confirm itself that said telecommunications facilities are in compliance with such technical standards specified in the applicable MIC's ordinances.

- A telecommunications carrier that provides Basic Telecommunications Services must maintain their telecommunications facilities for provision of their Basic Telecommunications Services in conformity with the technical standards provided in the applicable MIC's ordinances.
- Telecommunications Carriers that own telecommunications circuit facilities or provide Basic Telecommunications Services must establish their own administrative rules in accordance with MIC's ordinances in order to secure the reliable and stable provision of telecommunications services. These administrative rules must regulate the operation and manipulation of telecommunications facilities and the safeguarding, inspecting and testing regarding the construction, maintenance and administration of telecommunications facilities, etc. as provided for by the ministerial ordinance of MIC. Such administrative rules must be submitted to the MIC prior to the commencement of operations, and changes must be submitted to the MIC after they are implemented without delay.

***Order to Improve Business Activities***

- The Minister for MIC may, if it is deemed that business activities of a telecommunications carrier falls under the inappropriate items set forth in the Telecommunications Business Law, insofar as necessary to ensure the users' benefit or the public interest, order said telecommunications carrier to take actions to improve operations methods or other measures.

***Right of Way Privilege for Authorized Carriers***

- Authorization on the entire or a part of a carrier's telecommunications business by MIC for the privileged use of land or other public utilities for circuit facilities deployment is required. Right of Way privilege is available to carriers irrespective of registration.

***Merger, Business Transfer or Divestiture of Carriers***

- Post facto notification to MIC without delay is required.

***Business Suspension, Abolition or Dissolution of Carriers***

- Post facto notification to MIC without delay is required. Prior announcement of withdrawals to service users is required in accordance with MIC's ordinance.

***Foreign Capital Participation***

- Unregulated. Prior notification is required under the Foreign Exchange and Foreign Trade Law for acquisition of shares of telecommunications carriers to which registration for start-up services is applicable. This is not applicable to purchasers of ADSs. The one-third foreign ownership restriction is applicable only to NTT.

**C. Organizational Structure.**

The information required by this item is in " — Our Group Companies" above.

**D. Property, Plants and Equipment.**

The information required by this item is in " — Network" above.

#### **Item 4A. Unresolved Staff Comments**

None.

#### **Item 5. Operating and Financial Review and Prospects.**

##### **A. Operating Results.**

*You should read the following discussion of our financial condition and results of operations together with Item 3.A. of this annual report on Form 20-F and our consolidated financial statements and the notes to those financial statements beginning on page F-1 of this annual report. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of factors including but not limited to those in Item 3.D. of this annual report on Form 20-F.*

##### **Overview**

We are a leading provider of a comprehensive range of Internet connectivity services and network solution services in Japan. We were founded in December 1992 and began offering Internet connectivity services commercially in July 1993. We were one of the first commercial ISPs in Japan.

Our primary sources of revenues are connectivity services, value-added services, systems integration and equipment sales. Connectivity services consist of dedicated Internet-access services and dial-up Internet-access services. For value-added services, we provide services such as network security services, mail and web server hosting services, managed router services and Internet data center services. For systems integration, we provide systems development and integration for business-to-business and business-to-consumer-networks, and outsourcing projects. For equipment sales, we provide equipment as part of our provision of total network. Substantially all of our revenues are from our customers in Japan, and we are the main point of contact for customers for these various services.

Total revenues were ¥38.8 billion, ¥41.7 billion and ¥49.8 billion for the fiscal years ended March 31, 2004, 2005 and 2006, respectively. The increases in revenues for each of the two years ended March 31, 2006 as compared to the previous fiscal years mainly reflect an increase in value-added services and systems integration revenues.

Operating income for the fiscal year ended March 31, 2006 was ¥2.4 billion, an improvement from operating income of ¥1.2 billion for the fiscal year ended March 31, 2005 and operating loss of ¥1.4 billion in the fiscal year ended March 31, 2004. The improvement compared to the previous year is mainly due to an increase in relatively higher-margin value-added services and systems integration.

Net income for the fiscal year ended March 31, 2006 was ¥4.8 billion, an improvement from net income of ¥2.9 billion for the fiscal year ended March 31, 2005, and a net loss of ¥2.3 billion for the year ended March 31, 2004. The improvement in net income is mainly due to an increase in operating income and an increase in gains from the sale of available-for-sale securities.

We have also generated cash in the last three fiscal years from sales of equity. On June 26 and September 16, 2003, we completed private placements of a total of 15,880 shares of our common stock to investors in Japan for an aggregate amount of ¥13.3 billion for working capital and repayment of our outstanding 1.75% convertible notes due on March 31, 2005. As a result of these transactions, the total number of our issued shares of common stock increased to 38,360 and the Nippon Telegraph and Telephone (“NTT”) Group’s total shareholding increased to 31.6%. On March 31, 2005, we redeemed the remainder of

our 1.75% convertible notes due March 2005 using our cash and cash equivalents as well as available-for-sale securities.

On December 2, 2005, we listed on the Mothers market of the Tokyo Stock Exchange (“TSE”). In connection with the listing, we issued 12,500 new shares of common stock for an amount of ¥6.0 billion. As we conducted a 1 to 5 stock split on October 11, 2005, the total number of our issued shares of common stock increased to 204,300.

In order to provide our customers with total network solutions, we provide our services directly or by working together with the subsidiaries and affiliates of IJ Group. We refer to our subsidiaries and certain affiliates as our group companies, and we have invested heavily in and exercise significant influence over these companies. We consolidate the results of operations of four subsidiaries included among our group companies — IJ Technology Inc. (“IJ-Tech”), IJ America Inc. (“IJ-A”), Net Care, Inc. (“Net Care”) and IJ Financial Systems Inc. We account for our investments in the affiliated companies by the equity method.

There have been significant changes in the scope of our consolidated subsidiaries and equity method affiliates in the last three fiscal years. On August 20, 2003, Crosswave Communications Inc. (“Crosswave”), our former equity method investee, filed a voluntary petition for the commencement of corporate reorganization proceedings in Japan and accordingly, we no longer had the ability to exercise significant influence over the operating and financial policies of Crosswave thereafter. For the fiscal year ended March 31, 2003, we wrote off our equity method investment as well as a ¥5.0 billion security deposit advanced to Crosswave in connection with financing provided by four Japanese commercial banks. In December 2003, Crosswave transferred its business operations to NTT Communications Corporation. We further wrote off ¥1.7 billion of outstanding loans extended to Crosswave and ¥0.4 billion of accounts receivable owned to us by Crosswave in the fiscal year ended March 31, 2004.

On October 1, 2005, IJ Media Communications Inc. (“IJ-MC”), our former consolidated subsidiary, was merged into us after a portion of IJ-MC’s business was transferred to IJ-Tech, our consolidated subsidiary. Asia Internet Holding Co., Ltd. (“AIH”), our former equity method investee, became our wholly owned consolidated subsidiary, and was merged into us on October 1, 2005. In each of the mergers, we were the surviving company.

On February 1, 2006, we established a joint venture company, Internet Revolution Inc. (“i-revo”), with Konami Corporation, with the purpose of operating comprehensive portal sites. We invested ¥750 million and hold 30.0% of the company. i-revo is an equity method investee.

For a discussion of factors affecting our future financial results, see “Item. 5.D. Trend Information”.

## Results of Operations

As an aid to understanding our operating results, the following tables show items from our statement of operations for the periods indicated in millions of yen amounts (or thousands of U.S. dollars) and as a percentage of total revenues.

	Fiscal year ended March 31,						(thousands of U.S. dollars)
	2004	2005		2006			
	(millions of yen except for percentage data)						
<b>REVENUES:</b>							
Connectivity and value-added services revenues:							
Dedicated access	¥12,862	33.2%	¥11,373	27.3%	¥10,625	21.3%	\$ 90,443
Dial-up access	3,088	8.0	2,937	7.0	2,674	5.4	22,760
Value-added	4,296	11.1	5,005	12.0	6,250	12.5	53,200
Other	2,118	5.4	3,169	7.6	3,674	7.4	31,272
Total connectivity and value-added services	22,364	57.7	22,484	53.9	23,223	46.6	197,675
Systems integration, including related equipment sales	11,848	30.5	15,854	38.0	23,505	47.2	200,072
Equipment sales	4,567	11.8	3,365	8.1	3,085	6.2	26,262
Total revenues	38,779	100.0	41,703	100.0	49,813	100.0	424,009
<b>COST AND EXPENSES:</b>							
Cost of connectivity and value-added services:							
Backbone cost	4,720	12.2	3,551	8.5	3,516	7.0	29,931
Local access line cost	3,500	9.0	4,040	9.7	4,558	9.2	38,801
Other connectivity cost	1,422	3.7	1,361	3.3	815	1.6	6,941
Depreciation and amortization	3,135	8.1	2,938	7.0	2,721	5.5	23,160
Other	7,270	18.7	7,594	18.2	8,468	17.0	72,073
Total cost of connectivity and value-added services	20,047	51.7	19,484	46.7	20,078	40.3	170,906
Cost of systems integration, including related equipment sales:							
Cost of equipment sales related to systems integration							
Other	1,546	4.0	1,759	4.2	3,591	7.2	30,568
Other	8,306	21.4	10,441	25.0	14,529	29.2	123,675
Total cost of systems integration	9,852	25.4	12,200	29.2	18,120	36.4	154,243
Cost of equipment sales	4,346	11.2	3,111	7.5	2,818	5.7	23,987
Total cost of revenues	34,245	88.3	34,795	83.4	41,016	82.4	349,136
Sales and marketing	3,528	9.1	2,795	6.7	3,080	6.2	26,213
General and administrative	2,098	5.4	2,666	6.4	3,147	6.3	26,790
Research and development	358	0.9	199	0.5	158	0.3	1,346
Total cost and expenses	40,229	103.7	40,455	97.0	47,401	95.2	403,485
<b>OPERATING INCOME (LOSS)</b>	<b>(1,450)</b>	<b>(3.7)</b>	<b>1,248</b>	<b>3.0</b>	<b>2,411</b>	<b>4.8</b>	<b>20,524</b>
<b>OTHER INCOME (EXPENSES):</b>							
Interest income	38	0.1	13	0.0	13	0.0	111
Interest expense	(702)	(1.9)	(686)	(1.6)	(437)	(0.9)	(3,723)
Foreign exchange gains (losses)	(7)	(0.0)	6	0.0	3	0.0	30
Net gain on other investments	1,413	3.7	2,439	5.9	3,198	6.5	27,219
Other — net	240	0.6	128	0.3	191	0.4	1,622
Other income — net	982	2.5	1,900	4.6	2,967	6.0	25,259
<b>INCOME (LOSS) FROM OPERATIONS BEFORE INCOME TAX EXPENSE, MINORITY INTERESTS AND EQUITY IN NET LOSS OF EQUITY METHOD INVESTEEES</b>	<b>(468)</b>	<b>(1.2)</b>	<b>3,148</b>	<b>7.6</b>	<b>5,379</b>	<b>10.8</b>	<b>45,783</b>

	Fiscal year ended March 31,										
	2004		2005				2006		(thousands of U.S. dollars)		
	(millions of yen except for percentage data)										
INCOME TAX EXPENSE	¥	33	0.1%	¥	100	0.2%	¥	257	0.5%	\$	2,191
MINORITY INTERESTS IN (EARNINGS) LOSSES OF SUBSIDIARIES		236	0.6		(109)	(0.3)		(354)	(0.7)		(3,012)
EQUITY IN NET LOSS OF EQUITY METHOD INVESTEES:											
Equity method net loss		(286)	(0.8)		(33)	(0.1)		(14)	(0.0)		(117)
Impairment loss on advance to Crosswave		(1,720)	(4.4)		—	—		—	—		—
Total equity in net loss of equity method investees		(2,006)	(5.2)		(33)	(0.1)		(14)	(0.0)		(117)
NET INCOME (LOSS)	¥	(2,271)	(5.9)%	¥	2,906	7.0%	¥	4,754	9.6%	\$	40,463

**Year Ended March 31, 2006 Compared to the Year Ended March 31, 2005**

*Total revenues*

Our total revenues increased 19.4% to ¥49.8 billion for the fiscal year ended March 31, 2006 from ¥41.7 billion for the previous fiscal year. These increases were primarily due to an increase in value-added services and systems integration revenues.

*Connectivity and value-added services revenues.* Revenues from connectivity services and value-added services, which comprise our dedicated access, dial-up access, value-added services and other services, increased 3.3% to ¥23.2 billion for the fiscal year ended March 31, 2006 from ¥22.5 billion for the previous fiscal year.

- *Dedicated access.* Revenues from dedicated access services decreased 6.6% to ¥10.6 billion for the fiscal year ended March 31, 2006 from ¥11.4 billion for the previous fiscal year. This decrease reflected a decrease of revenues of ¥468 million from the interconnection of IIJ's network with AIH, our former equity method investee, which resulted from the consolidation of AIH's revenues following the merger of AIH into IIJ. The decrease is also due to the decline in unit price per bandwidth.
- *Dial-up access.* Revenues from dial-up access services decreased 9.0% to ¥2.7 billion for the fiscal year ended March 31, 2006 from ¥2.9 billion for the previous fiscal year. This decrease was primarily the result of declining revenues from services for individuals such as IIJ4U Service. The revenues from IIJ4U decreased by ¥0.1 billion from the previous fiscal year.
- *Value-added services.* Our value-added services revenues increased 24.9% to ¥6.2 billion for the fiscal year ended March 31, 2006 from ¥5.0 billion for the previous fiscal year. This increase was mainly due to a steady increase in revenues from solutions such as data center services, security and e-mail related outsourcing services and network related solutions such as SEIL and SEIL Management Framework, along with projects to connect customers' multiple operational sites. The steady increase is affected by an increase in demand for outsourcing services by corporate customers.
- *Other.* Other revenues, which included rental fees for network equipment, customer support service, and sale of Wide-area Ethernet services, amounted to ¥3.7 billion for the fiscal year ended March 31, 2006, a 15.9% increase from the previous fiscal year. The increase was mainly

due to a continuous increase in sales of Wide-area Ethernet services which increased by 43.8% compared to the previous fiscal year.

*Systems integration revenues.* Our revenues from systems integration, which include equipment sales related to systems integration, increased 48.3% to ¥23.5 billion for the fiscal year ended March 31, 2006 from ¥15.9 billion for the previous fiscal year. The increase was mainly due to a significant increase in one-time revenues from the design and construction of large-scale network systems for corporate customers and a continuous increase in recurring revenues from the operation and maintenance of the systems.

*Equipment sales.* Our equipment sales decreased 8.3% to ¥3.1 billion for the fiscal year ended March 31, 2006 from ¥3.4 billion for the previous fiscal year.

#### *Total cost of revenues*

Total cost of revenues increased 17.9% to ¥41.0 billion for the fiscal year ended March 31, 2006 from ¥34.8 billion for the previous fiscal year. The increase was mainly because cost of systems integration revenues increased corresponding with the significant increase in systems integration revenues, while the cost of connectivity and value-added services revenues slightly increased compared to the previous fiscal year.

*Cost of connectivity and value-added services revenues.* Cost of connectivity and value-added services revenues increased 3.0% to ¥20.1 billion for the fiscal year ended March 31, 2006 from ¥19.5 billion for the previous fiscal year. The gross margin in connectivity and value-added services revenues increased to 13.5% for the fiscal year ended March 31, 2006 from 13.3% for the previous fiscal year. This increase is mainly a result of an increase in revenues from relatively higher-margin value-added services and a decrease in backbone costs. Local access line costs increased due to steady revenue growth in Wide-area Ethernet services. Backbone costs decreased 1.0% to ¥3.5 billion for the fiscal year ended March 31, 2006 from ¥3.6 billion for the previous fiscal year. Local access line costs increased 12.8% to ¥4.6 billion from ¥4.0 billion for the previous fiscal year.

*Cost of systems integration revenues.* Our cost of systems integration revenues increased 48.5% to ¥18.1 billion for the fiscal year ended March 31, 2006 from ¥12.2 billion for the previous fiscal year. The gross margin in systems integration revenues was 22.9% for the fiscal year ended March 31, 2006, compared to 23.0% for the previous fiscal year. Revenues from the construction of large-scale network systems, that has a lower-margin compared to systems operation and maintenance increased.

*Cost of equipment sales.* Our cost of equipment sales decreased 9.4% to ¥2.8 billion for the fiscal year ended March 31, 2006 from ¥3.1 billion for the previous fiscal year. The gross margin in equipment sales increased to 8.7% for the fiscal year ended March 31, 2006 from 7.5% for the previous fiscal year.

#### *Total costs and expenses*

Total costs and expenses, which includes total cost of revenues, sales and marketing expenses, general and administrative expenses and research and development expenses, increased 17.2% to ¥47.4 billion for the fiscal year ended March 31, 2006 from ¥40.5 billion for the previous fiscal year. The increase in total costs and expenses was primarily a result of an increase in the cost of systems integration, sales and marketing expenses and general and administrative expenses.

*Sales and marketing.* Sales and marketing expenses increased 10.2% to ¥3.1 billion for the fiscal year ended March 31, 2006 from ¥2.8 billion for the previous fiscal year. The increase was mainly due to an increase in advertising expenses, personnel expenses and outsourcing expenses that increased along with the business expansion.

*General and administrative.* General and administrative expenses increased 18.1% to ¥3.1 billion for the fiscal year ended March 31, 2006 from ¥2.7 billion for the previous fiscal year. The increase was mainly due to increases in personnel expenses and rent expenses. The increase in rent expenses is mainly due to an expansion of the office for the administrative section, necessitated by an enhancement of administrative function.

*Research and development.* Research and development expenses decreased 20.5% to ¥158 million for the fiscal year ended March 31, 2006 from ¥199 million for the previous fiscal year. The decrease is primarily due to reduced development expenses relating to SEIL Series.

#### *Operating income*

As a result of the foregoing factors, operating income increased 93.3% to ¥2.4 billion for the fiscal year ended March 31, 2006 from ¥1.2 billion for the previous fiscal year.

#### *Other income (expenses), net*

Net other income of ¥3.0 billion was recorded for the fiscal year ended March 31, 2006 compared to ¥1.9 billion for the previous fiscal year.

*Interest income.* Interest income was ¥13 million for the fiscal year ended March 31, 2006, almost flat compared to ¥13 million for the previous fiscal year.

*Interest expense.* Interest expense, comprised of interest expense in respect of bank borrowings, convertible notes and capital lease obligations, amounted to ¥437 million for the fiscal year ended March 31, 2006 compared to ¥686 million for the previous fiscal year. Interest expense decreased due to an absence of interest payment related to the convertible notes that we redeemed in March 2005.

*Foreign exchange gains (losses).* Foreign exchange gain amounted to ¥3 million for the fiscal year ended March 2006 compared to gain of ¥6 million for the previous year.

*Net gain on other investments.* For the fiscal year ended March 31, 2006, we recorded gain on other investments of ¥3.2 billion, which included gains of ¥3.2 billion generated by the sale of certain available-for-sale securities, compared to gains of ¥2.4 billion for the previous year.

*Other-net.* For the fiscal year ended March 31, 2006, we recorded other income of ¥191 million, most of which is dividend income of ¥120 million for the fiscal year ended March 31, 2006, compared to income of ¥128 million for the previous year.

#### *Income from operations before income tax expense, minority interests and equity in net loss of equity method investees*

We recorded income from operations before income tax expense, minority interests and equity in net loss of equity method investees of ¥5.4 billion for the fiscal year ended March 31, 2006 compared to income from operations before income tax expense, minority interests and equity in net loss of equity method investees of ¥3.1 billion for the fiscal year ended March 31, 2005. The improvement primarily reflects the increase in operating income and the increase of gain from the sale of available-for-sale securities.

#### *Income tax expense*

For the fiscal year ended March 31, 2006, we recorded an income tax expense of ¥257 million compared to an income tax expense of ¥100 million for the previous fiscal year. The income tax expense for

the fiscal year ended March 31, 2006 increased mainly due to the reserve for tax contingencies related to the usage of tax operating loss carryforwards by IJ-A and income taxes payable related to taxable income of our consolidated subsidiaries.

#### *Minority interests in earnings of subsidiaries*

Minority interests in earnings of subsidiaries increased by ¥245 million to ¥354 million for the fiscal year ended March 31, 2006. Earnings of subsidiaries increased mainly due to improved performance of IJ-Tech and Net Care.

#### *Equity in net loss of equity method investees*

Equity method net loss decreased to ¥14 million for the fiscal year ended March 31, 2006 from ¥33 million for the previous fiscal year. Although equity method net income was recorded in Internet Multifeed Co., equity method net loss was recorded in our new equity method investee, i-revo.

#### *Net income*

Net income for the fiscal year ended March 31, 2006 was ¥4.8 billion compared with ¥2.9 billion for the previous fiscal year. The improvement primarily reflects the increase in operating income and the increase of gain from the sale of available-for-sale securities.

### **Year Ended March 31, 2005 Compared to the Year Ended March 31, 2004**

#### *Total revenues*

Our total revenues increased 7.5% to ¥41.7 billion for the fiscal year ended March 31, 2005 from ¥38.8 billion for the previous fiscal year. These increases were primarily due to an increase in systems integration revenues.

*Connectivity and value-added services revenues.* Revenues from connectivity services and value-added services, which comprise our dedicated access, dial-up access and value-added services and other services, increased 0.5% to ¥22.5 billion for the fiscal year ended March 31, 2005 from ¥22.4 billion for the previous fiscal year.

- *Dedicated access.* Revenues from dedicated access services decreased 11.6% to ¥11.4 billion for the fiscal year ended March 31, 2005 from ¥12.9 billion for the previous fiscal year. This decrease reflected decreasing unit prices as a result of both the cancellation by a regional electric power company's telecom service arm and general price competition. Decreased revenues from IP Service, IJ T1 Standard and IJ Economy were partially offset by increased revenues from our IJ FiberAccess/F Service mainly due to the expansion of usage of broadband line for multi-site connectivity within corporate customers.
- *Dial-up access.* Revenues from dial-up access services decreased 4.9% to ¥2.9 billion for the fiscal year ended March 31, 2005 from ¥3.1 billion for the previous fiscal year. This decrease was primarily the result of declining revenues from IJ4U Service, offset partially by dial-up access services provided on an OEM basis mainly due to the increased number of contracts within the individual customers as OEM brand.
- *Value-added services.* Our value-added services revenues increased 16.5% to ¥5.0 billion for the fiscal year ended March 31, 2005 from ¥4.3 billion for the previous fiscal year. This increase reflected steady growth in Internet data center services, virtual private network services, and security-related services, in part as a result of focusing sales efforts on outsourcing services.

- *Other.* Other revenues, which included rental fees for network equipment, customer support service, and sale of Wide-area Ethernet services, amounted to ¥3.2 billion for the fiscal year ended March 31, 2005, a 49.7% increase from the previous fiscal year. This reflected increasing sales of Wide-area Ethernet services.

*Systems integration revenues.* Our revenues from systems integration, which include equipment sales related to systems integration, increased 33.8% to ¥15.9 billion for the fiscal year ended March 31, 2005 from ¥11.8 billion for the previous fiscal year. This increase largely reflected increases in systems integration contracts and monthly recurring revenues from operational outsourcing services, mainly due to the increase in number of systems integration cases utilizing broadband lines to connect multi-sites within corporate customers, and continuous acquisition of operational outsourcing contracts of the newly built systems.

*Equipment sales.* Our equipment sales decreased 26.3% to ¥3.4 billion for the fiscal year ended March 31, 2005 from ¥4.6 billion for the previous fiscal year. The decrease in equipment sales revenues reflected our efforts to focus on higher margin systems integration, since equipment sales do not include added values to raise higher margin, such as construction of systems, setting and project management.

#### *Total cost of revenues*

Total cost of revenues increased 1.6% to ¥34.8 billion for the fiscal year ended March 31, 2005 from ¥34.2 billion for the previous fiscal year. Although cost of connectivity and value-added services revenues decreased as a result of our cost reduction efforts, cost of systems integration revenues increased corresponding the increase in systems integration revenues.

*Cost of connectivity and value-added services revenues.* Cost of connectivity and value-added services revenues decreased 2.8% to ¥19.5 billion for the fiscal year ended March 31, 2005 from ¥20.0 billion for the previous fiscal year. The gross margin in connectivity and value-added services revenues increased to 13.3% for the fiscal year ended March 31, 2005 from 10.4% for the previous fiscal year. This increase is mainly a result of decreases in international backbone costs and domestic backbone costs due to price competition among backbone providers, exceeding the price competition within Internet connectivity services we provide to our customers. Local access line costs increased due to steady revenue growth in Wide-area Ethernet services. Backbone costs decreased 24.8% to ¥3.6 billion for the fiscal year ended March 31, 2005 from ¥4.7 billion for the previous fiscal year. Local access line costs increased 15.4% to ¥4.0 billion from ¥3.5 billion for the previous fiscal year.

*Cost of systems integration revenues.* Our cost of systems integration revenues increased 23.8% to ¥12.2 billion for the fiscal year ended March 31, 2005 from ¥9.9 billion for the previous fiscal year. The gross margin in systems integration revenues increased to 23.0% for the fiscal year ended March 31, 2005 from 16.8% for the previous fiscal year, due to our efforts to focus on higher margin systems integration such as operational outsourcing services, network design and consultation services.

*Cost of equipment sales.* Our cost of equipment sales decreased 28.4% to ¥3.1 billion for the fiscal year ended March 31, 2005 from ¥4.3 billion for the previous fiscal year. The gross margin in equipment sales increased to 7.5% for the fiscal year ended March 31, 2005 from 4.8% for the previous fiscal year, mainly due to decrease in revenues from lower margin equipment sales.

### *Total costs and expenses*

Total costs and expenses, which includes total cost of revenues, sales and marketing expenses, general and administrative expenses and research and development expenses, increased 0.6% to ¥40.5 billion for the fiscal year ended March 31, 2005 from ¥40.2 billion for the previous fiscal year. The increase in total costs and expenses was primarily a result of an increase in the cost of systems integration and general and administrative expenses.

*Sales and marketing.* Sales and marketing expenses decreased 20.8% to ¥2.8 billion for the fiscal year ended March 31, 2005 from ¥3.5 billion for the previous fiscal year. The decrease was primarily due to the absence of write-off of accounts receivable from Crosswave amounting to ¥396 million in the fiscal year ended March 31, 2004, and decrease in personnel expenses by ¥117 million mainly due to enhancement of technical and administrative functions by reallocation of human resources to engineering and administrative organizations.

*General and administrative.* General and administrative expenses increased 27.0% to ¥2.7 billion for the fiscal year ended March 31, 2005 from ¥2.1 billion for the previous fiscal year. The increase was mainly due to the disposal and impairment loss in property and equipment and telephone rights amounting to ¥243 million, and increase in personnel expenses by ¥152 million mainly due to enhancement of technical and administrative functions by reallocation of human resources to engineering and administrative organizations for the fiscal year ended March 31, 2005.

*Research and development.* Research and development expenses decreased 44.4% to ¥199 million for the fiscal year ended March 31, 2005 from ¥358 million for the previous fiscal year. The decrease is primarily due to reduced development expenses relating to IPv6 technology and our originally developed network equipment, SEIL Series.

### *Operating income (loss)*

As a result of the foregoing factors, operating income was ¥1.2 billion for the fiscal year ended March 31, 2005, compared to an operating loss of ¥1.4 billion for the previous fiscal year.

### *Other income (expenses), net*

Net other income of ¥1.9 billion was recorded for the fiscal year ended March 31, 2005 compared to ¥1.0 billion for the previous fiscal year.

*Interest income.* Interest income decreased to ¥13 million for the fiscal year ended March 31, 2005 from ¥38 million for the previous fiscal year. The decrease is mainly due to decreased average amount of monthly dollar-denominated deposits during the fiscal year ended March 31, 2003, and absence of interest income related to advances to Crosswave in the previous fiscal year.

*Interest expense.* Interest expense, comprised of interest expense in respect of bank borrowings, convertible notes and capital lease obligations, amounted to ¥686 million for the fiscal year ended March 31, 2005 compared to ¥702 million for the previous fiscal year. Interest expense decreased due to a decrease in interest expense for convertible notes reflecting repurchases of a portion of convertible notes before the maturity.

*Foreign exchange gains (losses).* Foreign exchange gain amounted to ¥6 million for the fiscal year ended March 2005 compared to loss of ¥6 million for the previous year due to depreciation of yen to dollar in the fiscal year ended March 31, 2005.

*Gain (loss) on other investments.* For the fiscal year ended March 31, 2005, we recorded gain on other investments of ¥2.4 billion, which included gains of ¥2.5 billion generated by the sale of certain available-for-sale securities, compared to gains of ¥1.4 billion for the previous year, mainly generated by the sale of our stake in DLJdirect SFG Securities Inc. The income was partially offset by losses of ¥0.2 billion on the write down of investments in marketable and nonmarketable securities to reflect declines in value considered to be other than temporary for the fiscal year ended March 31, 2005.

*Other-net.* For the fiscal year ended March 31, 2005, we recorded other income of ¥0.1 billion, most of which is dividend income of ¥0.1 billion for the fiscal year ended March 31, 2005, compared to income of ¥0.2 billion for the previous year.

*Income (loss) from operations before income tax expense, minority interests and equity in net loss of equity method investees*

We recorded income from operations before income tax expense, minority interests and equity in net loss of equity method investees of ¥3.1 billion for the fiscal year ended March 31, 2005 compared to a loss from operations before income tax expense, minority interests and equity in net loss of equity method investees of ¥0.5 billion for the fiscal year ended March 31, 2004. This improvement was largely the result of the improvement in operating income and increase in other income due to gains of ¥2.5 billion generated by the sale of certain available-for-sale securities.

*Income tax expense*

For the fiscal year ended March 31, 2005, we recorded an income tax expense of ¥100 million compared to an income tax expense of ¥33 million for the previous fiscal year. This increase was due to a new enterprise tax going into effect in the fiscal year ended March 31, 2005.

*Minority interests in (earnings) losses of subsidiaries*

Minority interests in earnings of subsidiaries increased by ¥345 million to ¥109 million for the fiscal year ended March 31, 2005. Earnings of subsidiaries increased mainly due to improved performance of IIJ-Tech.

*Equity in net loss of equity method investees*

Equity in net loss of equity method investees consist of equity method net loss in our equity method investees and impairment loss on advance to Crosswave.

Equity method net loss decreased to ¥33 million for the fiscal year ended March 31, 2005 from ¥286 billion for the previous fiscal year. This decrease was mainly due to the absence of a large equity method net loss from AIH reflecting the deterioration in its operating result for the previous year.

Impairment loss on advance to Crosswave for the fiscal year ended March 31, 2005 no longer existed compared to the impairment loss of ¥1.7 billion for the fiscal year ended March 31, 2004, as we had written off our equity investment in and loans and advances to Crosswave entirely.

*Net income (loss)*

Net income for the fiscal year ended March 31, 2005 was ¥2.9 billion compared with a net loss of ¥2.3 billion for the previous fiscal year. The improvement primarily reflects the improvement in operating income, increase in other income and absence of impairment loss related to Crosswave.

## Application of Critical Accounting Policies

In reviewing our financial statements, you should consider the sensitivity of our reported financial condition and results of operations to changes in the conditions and assumptions underlying the estimates and judgments made by our management in applying critical accounting policies.

The preparation of financial statements requires the use of estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the periods presented. Actual results may differ from these estimates, judgments and assumptions. Note 1 to our consolidated financial statements includes a summary of the significant accounting policies used in the preparation of our financial statements. Certain accounting policies are particularly critical because of their significance to our reported results and because of the possibility that future events may differ significantly from the conditions and assumptions underlying the estimates used and judgments made by our management in preparing our financial statements.

We have discussed the development and selection of critical accounting policies and estimates with our board of directors, and the board of directors has reviewed the disclosure relating to these, which are included in this "Operating and Financial Review and Prospects." For all of these policies, we caution that future events rarely develop exactly as forecast, and even the best estimates may require adjustment.

### *Useful lives of property and equipment*

Property and equipment, net recorded on our balance sheet was ¥10,299 million at March 31, 2006, representing 20.3% of our total assets. The values of our property and equipment, including purchased software and property and equipment under capital leases, are recorded in our financial statements at acquisition cost, and are depreciated or amortized on a straight-line basis over the shorter of the lease term or estimated useful life of the asset. Our total depreciation and amortization expenses for the fiscal years ended March 31, 2004, 2005 and 2006 were ¥3,909 million, ¥4,109 million and ¥4,207 million, respectively.

We estimate the useful lives of property and equipment in order to determine the amount of depreciation and amortization expense to be recorded in each fiscal year. We determine the useful lives of our assets at the time the assets are acquired and base our determinations on expected use, experience with similar assets, established laws and regulations as well as taking into account anticipated technological or other changes. Estimated useful lives at March 31, 2006, were as follows:

<u>Item</u>	<u>Useful Lives</u>
Data communications, office and other equipment	2 to 15 years
Leasehold improvements	3 to 15 years
Purchased software	5 years
Capitalized leases	4 to 7 years

If technological or other changes were to occur more rapidly or in a different form than anticipated or new laws or regulations are enacted or the intended use changes, the useful lives assigned to these assets may need to be shortened, or we may need to sell or write off the assets, resulting in recognition of increased depreciation and amortization or losses in future periods. Our losses on disposal of property and equipment for the fiscal years ended March 31, 2004, 2005 and 2006 were ¥110 million, ¥144 million and ¥119 million, respectively. The loss on disposal of property and equipment for the fiscal year ended March 31, 2005 was mainly related to the relocation of branch offices and disposal of telephone rights as a result of a decrease in revenues from dial-up access services. The loss on disposal of property and equipment for the fiscal year ended March 31, 2006 was mainly related to disposal of software, such as back-office systems.

A one-year change in the useful life of these assets would have increased or decreased depreciation expense by approximately ¥1.4 billion and ¥0.9 billion, respectively.

Ordinary maintenance and repairs are charged to income as incurred. Major replacements and improvements are capitalized. When properties are retired or otherwise disposed of, the property and related accumulated depreciation accounts are relieved of the applicable amounts and any differences are included in operating cost and expenses.

We determined the useful lives of customer relationship intangible assets recognized during the fiscal year ended March 31, 2006 as indefinite.

#### *Impairment of long-lived assets*

Long-lived assets consist primarily of property and equipment, including capitalized leases, and goodwill and intangible assets. We perform an impairment review for our long-lived assets, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. This analysis is separate from our analysis of the useful lives of our assets, but it is affected by some similar factors. Factors that we consider important which could trigger an impairment review include, but are not limited to, the impact of the following trends or conditions:

- significant decline in the market value of an asset,
- current period operating cash flow loss,
- introduction of competing technologies or services,
- significant underperformance of expected or historical cash flows,
- significant or continuing decline in subscribers,
- changes in the manner or use of an asset,
- disruptions in the use of network equipment under capital lease arrangements, and
- other negative industry or economic trends.

When we determine that the carrying amount of specific assets may not be recoverable based on the existence or occurrence of one or more of the above or other factors, we estimate the future cash inflows and outflows expected to be generated by the assets over their expected useful lives. We estimate the sum of expected undiscounted future cash flows based upon historical trends adjusted to reflect our best estimate of future market and operating conditions. If the sum of the expected undiscounted future net cash flows is less than the carrying value of the assets, we record an impairment loss based on the fair values of the assets. Such fair values may be based on established markets, independent appraisals and valuations or discounted cash flows. If actual market and operating conditions under which assets are used are less favorable or shorter than those projected by management, resulting in reduced cash flows, additional impairment charges for assets not previously written-off may be required. There was no impairment loss for long-lived assets for the fiscal years ended March 31, 2004 and 2006. An impairment loss of ¥26 million on telephone rights was recorded for the fiscal year ended March 31, 2005 because NTT reduced the price of telephone rights by 50 percent after March 1, 2005. There was no impairment loss for long-lived assets, including goodwill and intangible assets other than the telephone rights above, for the fiscal year ended March 31, 2005.

#### *Allowance for doubtful accounts and uncollectible contractual prepayments*

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. At March 31, 2005 and 2006, we maintained allowances for doubtful accounts of ¥449 million and ¥114 million, respectively. Management specifically analyzes accounts and loans receivable including historical bad debts, customer concentrations, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowances for doubtful accounts. If the financial condition of our customers or debtors were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. For the fiscal year ended March 31, 2006, the reversal of allowance of ¥0.1 million was recorded reflecting the increase in market price of securities held in pledge for our advance to i-Heart, Inc.

#### *Deferred tax assets*

To date, our deferred tax assets have been offset by a valuation allowance. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize the deferred tax assets in the future in excess of the net recorded amount, an adjustment to the valuation allowance and deferred tax benefit would increase income in the period such determination was made.

#### *Valuation of investments*

Our investment in securities is significant, and the valuation of such investments, requires us to make judgments using information that is generally uncertain at the time, such as assumptions regarding future financial conditions and cash flows. As at March 31, 2006, we had investments in securities classified as other investments in the amount of ¥8,021 million. We routinely assess the impairment of our investments by considering whether any decline in value is other-than-temporary. The factors we consider are:

- the length of time and the extent to which the market value has been less than cost,
- the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment, and
- our intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. If a decline in value occurs and is deemed to be other-than-temporary, an impairment loss will be recorded to write-down the carrying value of the investment to fair value. If, after taking into account these considerations, the decline is judged to be other than temporary, the cost basis of the individual security is written down to a new cost basis and the amount of the write-down is accounted for as a realized loss.

Our unrealized loss on an investment in marketable equity security relates to a U.S. telecommunication equipment supplier. The fair value of the investment is approximately 3% less than its cost. The duration of the unrealized loss position was less than 6 months. Based on our ability and intent to hold the investment for a reasonable period of time sufficient for a recovery of fair value, we do not consider the investment to be other-than-temporary impaired at March 31, 2006.

Losses on write-down of investments in certain nonmarketable securities included in other income were ¥230 million and ¥30 million for the years ended March 31, 2004 and 2006, respectively. Losses on write-down of investments in certain marketable and nonmarketable securities included in other income were

recognized to reflect the declines in value considered to be other than temporary, totaled ¥34 million and ¥118 million, respectively, for the year ended March 31, 2005.

In addition to investments in securities, we also have investments in equities and loans for which we have significant influence over the investee's operations and financial policies and are accounted for by the equity method. For other than temporary declines in the value of such investments below the carrying amount, the investment is reduced to fair value and an impairment loss is recognized.

#### *Pension benefits costs*

Employee pension benefit costs and obligations are dependent on certain assumptions including discount rate, retirement rate and rate of increase in compensation levels, which are based upon current statistical data, as well as expected long-term rate of return on plan assets and other factors. Specifically, the discount rate and expected long-term rate of return on assets are two critical assumptions in the determination of periodic pension cost and pension liabilities. Assumptions are evaluated at least annually and when events occur or circumstances change which could have a significant effect on these critical assumptions. In accordance with U.S. GAAP, actual results that differ from the assumptions are accumulated and amortized over future periods. Therefore, actual results generally affect recognized expenses and the recorded obligations for pensions in future periods. While management believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect our pension obligations and future expenses.

We used a discount rate of 2.0% for the pension plan as of March 31, 2006. The discount rate was determined by using the market yield of Japanese Government Bonds with a term matched against the average remaining service period of employees.

We used an expected long-term rate of return on pension plan assets of 2.1% as of March 31, 2006. To determine the expected long-term rate of return on pension plan assets, we consider a combination of historical returns and prospective return assumptions derived from pension trust funds' managing company. The actual return on pension plan for the year ended March 31, 2006 was 7.9%.

The following table illustrates the sensitivity to a change in the discount rate and the expected return on pension plan assets, while holding all other assumptions constant, for our pension plan as of March 31, 2006.

Change in Assumption	Pre-Tax PBO	Pension Expense (millions of yen)	Equity (Net of Tax)
50 basis point increase/decrease in discount rate	(115)/129	(20)/24	12/(14)
50 basis point increase/decrease in expected return on assets	—	—/5	—/(3)

#### **New Accounting Standards**

In December 2004, the FASB issued revised SFAS No. 123 (Revised 2004), "Share-Based Payment" ("SFAS No. 123R") which replaces the existing SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires compensation expense for stock options and other share-based payment to be measured and recorded based on the instruments' fair value. SFAS No. 123R is effective for the fiscal period beginning after June 15, 2005. The Company will adopt SFAS No. 123R and the related FASB Staff Positions ("FSP") on April 1, 2006 by using modified prospective application, which requires recognizing expenses for options granted prior to the adoption date equal to the fair value of unvested amounts over the remaining vesting period. The portion of these options' fair value attributable to vested awards prior to the adoption of SFAS No. 123R is never recognized. As all existing granted stock-based awards of the Company have vested, the adoption of

SFAS No. 123R will not have any impact on the Company's consolidated financial position or results of operations.

In November 2005, the FASB issued FSP No. 115-1 and No. 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," on the basis of the EITF's consensus on Issue 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments". FSP No. 115-1 and No. 124-1 addresses the determination as to when an investment is impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. FSP No. 115-1 and No. 124-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP No. 115-1 and No. 124-1 is effective for reporting periods beginning after December 15, 2005. The adoption of FSP No. 115-1 and No. 124-1 did not have a material effect on the Company's financial position or results of operations.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs-an amendment of ARB No. 43, Chapter 4" ("SFAS No. 151") which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and also requires that the allocation of fixed production overhead be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 will not have a material impact on the Company's consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets-amendment of APB Opinion No. 29" ("SFAS No. 153"). The statement addresses the measurement of exchanges of nonmonetary assets and eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material impact on the Company's consolidated financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections-a replacement of APB opinion No. 20 and SFAS No. 3" ("SFAS No. 154"). SFAS No. 154 requires that changes in accounting principle are retrospectively applied by applying the new accounting principle as of the beginning of the first period presented as if that principle had always been used, although APB opinion No. 20 required that changes in accounting principle are applied cumulatively in the period of change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In July 2005, the FASB issued FSP APB No.18-1, "Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence" ("FSP APB No. 18-1"). FSP APB No. 18-1 requires that an investor's proportionate share of an investee's equity adjustments for other comprehensive income is offset against the carrying value of the investment at the time significant influence is lost. FSP APB No. 18-1 is effective for reporting periods beginning after July 12, 2005. The adoption of FSP APB No. 18-1 did not have a material impact on the Company's consolidated financial position or results of operations.

## **B. Liquidity and Capital Resources.**

### **Liquidity and Capital Requirements**

Our principal capital and liquidity needs in recent years have been for capital expenditures for the development, expansion and maintenance of our network infrastructure, lease payments, payment of

principal and interest on outstanding borrowings, investments in current and former group companies and, other working capital.

*Capital expenditures.* Our capital expenditures relate primarily to the development, expansion and maintenance of our network. The table below shows our capital expenditures, which we define as amounts paid for purchases of property and equipment plus acquisition of assets by entering into capital leases, for the last three years.

	For the fiscal year ended March 31,		
	2004	2005	2006
		(millions of yen)	
Capital expenditures, including acquisition of assets by entering into capital leases	¥3,523	¥5,011	¥4,762

Most of our capital expenditures relate to the expansion and improvement of our existing network, including the installation of the routers and servers necessary to offer services on our network.

We have not made any material divestitures in the current or past three fiscal years. We recorded a loss on disposal of property and equipment of ¥110 million, ¥144 million and ¥119 million for the fiscal years ended March 31, 2004, 2005 and 2006, respectively. The loss for the fiscal year ended March 31, 2004 was mainly related to the relocation of headquarter. The loss for the fiscal year ended March 31, 2005 was mainly due to the relocation of branch offices and disposal of telephone rights. The loss for the fiscal year ended March 31, 2006 was mainly due to disposal of software, such as back-office systems.

*Lease payments.* We have operating lease agreements with telecommunications carriers and others for the use of connectivity lines, including our domestic and international backbone as well as local access lines that customers use to connect to IJ's network. The leases for our domestic backbone are generally either non-cancelable for a minimum one-year lease period or cancellable during a lease period of three years, with a significant penalty for cancellation (35 percent). The leases for our international backbone connectivity during one-year lease period are substantially non-cancelable. We also lease office premises and certain office equipment under non-cancelable operating leases which expire on various dates through the year 2008 and also lease network operation centers under non-cancelable operating leases.

Lease expenses related to backbone lines for the fiscal years ended March 31, 2004, 2005 and 2006, amounted to ¥4,720 million, ¥3,551 million and ¥3,516 million, respectively. Lease expenses for local access lines for the fiscal years ended March 31, 2004, 2005 and 2006, which are only attributable to dedicated access revenues, amounted to ¥3,500 million, ¥4,040 million and ¥4,558 million, respectively. Other lease expenses for the fiscal years ended March 31, 2004, 2005 and 2006, amounted to ¥3,787 million, ¥ 3,304 million and ¥3,654 million, respectively.

We conduct our connectivity and other services by using data communications and other equipment leased under capital lease arrangements. The fair values of the assets at the execution of the capital lease agreements and accumulated depreciation amounted to ¥13,252 million and ¥6,336 million at March 31, 2005 and ¥14,459 million and ¥6,820 million at March 31, 2006.

As of March 31, 2006, future lease payments under non-cancelable operating leases, including the aforementioned non-cancelable connectivity lease agreements (but excluding dedicated access lines which we charge outright to customers), and capital leases were as follows:

	Payment due by period				
	(millions of yen)				
	Total contractual amount	Less than 1 year	1 to 3 years	4 to 5 years	More than 5 years
Connectivity lines operating leases	¥ 27	¥ 27	¥ —	¥ —	¥ —
Other operating leases	2,839	1,377	1,317	90	55
Capital leases	8,489	3,262	4,314	877	36
Total minimum lease payments	<u>¥ 11,355</u>	<u>¥ 4,666</u>	<u>¥ 5,631</u>	<u>¥ 967</u>	<u>¥ 91</u>

(1) See note 7 to the consolidated financial statements included in this annual report.

*Payments of principal and interest on outstanding borrowings.* We require cash for payments of interest and principal on our outstanding borrowings.

**Short-term borrowings.** As of March 31, 2006, our short-term borrowings consisted of bank overdrafts of ¥4.6 billion. The weighted average interest rate of our short-term borrowings was 1.375%. We decreased our short-term borrowings by ¥0.2 billion. We also had an unused balance of ¥3.2 billion in borrowings as of March 31, 2006 under our bank overdraft agreements.

**Long-term borrowings.** As of March 31, 2006, we had ¥2.3 billion of outstanding long-term borrowings, including current portions, which consisted of: unsecured, variable-rate loans from banks of ¥0.3 billion with a weighted average interest rate of 2.206%; unsecured, fixed-rate loans from banks of ¥0.6 billion with a weighted average interest rate of 1.710%; unsecured, variable-rate loans from banks of ¥1.2 billion with a weighted average interest rate of 1.130% and secured, fixed-rate installment loan from a leasing company of ¥0.2 billion with an interest rate of 2.55%. We entered into interest rate swap contracts to manage our interest rate exposure resulting in a fixed interest rate for a portion of our long-term debt. The effective weighted average interest rate for ¥1.2 billion of the long-term loans outstanding at March 31, 2006 after giving effect to such swap agreements was 1.781%.

Annual maturities of long-term borrowings outstanding as of March 31, 2006, were as follows:

Fiscal year ending March 31	Millions of yen	Thousands of U.S. dollars
2007	¥ 1,990	\$ 16,939
2008	290	2,469
Total	<u>¥ 2,280</u>	<u>\$ 19,408</u>

**Collateral for borrowings.** Substantially all of our short-term and long-term borrowings are made under agreements which, as is customary in Japan, provide that under certain conditions the banks may require us to provide collateral or guarantees with respect to the borrowings. We did not provide banks with any collateral for outstanding loans as of March 31, 2006. Our primary banking relationships are with Sumitomo Mitsui Banking Corporation, Mizuho Corporate Bank, Ltd., Bank of Tokyo-Mitsubishi UFJ, Ltd. and Mitsubishi UFJ Trust and Banking Corporation. The banks are also shareholders and customers of ours. Our loans from a leasing company are secured by a first priority pledge against a claim for the guarantee deposits of ¥1.1 billion.

**Payable under securities loan agreement.** Since August 2004, we have been a party to a securities loan agreement with a certain Japanese financial institution. The available-for-sale securities loaned to the financial institution were ¥1.2 billion, and the cash received in return was ¥1.0 billion as of March 31, 2006. These transactions were accounted for as secured borrowings and the cash received was recorded as payable under the securities loan agreement and securities lent were recorded as other investments. The agreement requires us to provide certain marketable securities as collateral at the commencement of the transaction. We are required to make a partial payment or receive additional borrowings depending on the market value of

securities pledged. We paid the interest on the payables with a variable rate. The interest rate was 0.37 percent as of March 31, 2006.

*Investments in current and former group companies.* In the past, we have made substantial investments in current and former group companies. We may need to provide additional investment in our group companies to enhance or maintain our business synergy with our affiliated companies in the future. See Item 4.B., “— Our Group Companies” for information on investment in equity method investees.

*Working capital needs.* Our principal working capital requirements are for operating lease payments for our domestic and international backbone and local access lines. We also require working capital requirements for personnel expenses, office rents and other operating expenses.

### **Capital Resources**

We seek to manage our capital resources and liquidity to provide adequate funds for current and future financial obligations. We have traditionally met our capital and liquidity requirements through cash flows from operating activities, long-term and short-term borrowings from financial institutions and from the issuance of convertible bonds, capital leases and issuances of equity securities. At March 31, 2006, we had cash of ¥13.7 billion and available-for-sale securities of ¥6.8 billion. We had ¥11.8 billion of unsecured 1.75% convertible notes due in March 2005 at March 31, 2004. At March 31, 2005, we fully redeemed the convertible notes. We expect that cash from operating activities, any proceeds from the sale of available-for-sale securities, our other sources of liquidity will be sufficient to meet our requirements through the year ending March 31, 2007.

*Short-term and long-term Borrowings.* Short-term and long-term borrowings provide us with an important source for maintaining adequate level of working capital and acquisition of fixed assets. See — Payments of principal and interest on outstanding borrowings.

*Cash flows from operating activities.* We generated ¥6.6 billion by operating activities for the year ended March 31, 2006. See — Cash Flows.

*Capital Leases.* Capital leases also provide us with an important source of financing. See note 7 to our consolidated financial statements included in this annual report on Form 20-F.

*Issuances of Equity Securities.* On June 26 and September 16, 2003, we completed private placements of a total of 15,880 shares of our common stock to investors in Japan for an aggregate amount of ¥13.3 billion for working capital and repayment of our outstanding 1.75% convertible notes due March 31, 2005. On December 2, 2005, we listed on the Mothers market of the TSE. In connection with the listing, we issued 12,500 new shares of common stock for an amount of ¥6.0 billion.

### **Cash Flows**

We had cash of ¥13.7 billion at March 31, 2006 compared to ¥5.3 billion at March 31, 2005.

The following table presents information about our cash flows during the fiscal years ended March 31, 2004, 2005 and 2006:

	Fiscal year ended March 31,		
	2004	2005 (millions of yen)	2006
Net cash provided by operating activities	¥ 1,923	¥ 5,238	¥ 6,559
Net cash provided by (used in) investing activities	(852)	1,974	1,805
Net cash provided by (used in) financing activities	7,669	(14,212)	39
Effect of exchange rate changes on cash	(44)	2	38
Net increase (decrease) in cash and cash equivalent	8,696	(6,998)	8,441
Cash at beginning of the year	3,588	12,284	5,286
Cash at end of the year	<u>¥ 12,284</u>	<u>¥ 5,286</u>	<u>¥ 13,727</u>

#### ***Year Ended March 31, 2006 as Compared to the Year Ended March 31, 2005***

Net cash provided by operating activities was ¥6.6 billion for the fiscal year ended March 31, 2006 compared to ¥5.2 billion for the previous fiscal year. The increase of net cash provided by operating activities for the fiscal year ended March 31, 2006 consisted of an increase of ¥0.9 billion in net income from continuing operations adjusted for non-cash income and expenses such as depreciation and amortization, gains on other investments, and equity method net loss, and an increase of ¥0.4 billion changes in operating assets and liabilities (cash provided). This improvement in cash provided by operating activities mainly resulted from the increase in operating income before depreciation and amortization which was derived from an increase in revenues from value-added services and systems integration and the decrease in the backbone costs.

Net cash provided by investing activities was ¥1.8 billion for the fiscal year ended March 31, 2006 compared to ¥2.0 billion provided by investing activities for the previous fiscal year. The decrease of net cash provided by investing activities for the fiscal year ended March 31, 2006 reflected primarily an increase of ¥0.3 billion in purchases of property and equipment, ¥0.7 billion in purchase of short-term and other investments, and ¥0.8 billion in investment in an equity method investee. The increase of cash used was partly offset by an increase of ¥0.6 billion in proceeds from sales and redemption of short-term and other investments, including certain available-for-sale securities and an increase of ¥0.5 billion in refund of guarantee deposits.

Net cash provided by financing activities was ¥39 million for the fiscal year ended March 31, 2006 compared to ¥14.2 billion used in financing activities for the previous fiscal year. The increase of net cash provided by financing activities for the fiscal year ended March 31, 2006 primarily reflected a redemption of convertible notes of ¥11.1 billion that was recorded in the previous fiscal year, proceeds of ¥6.0 billion from the issuance of common stock along with our listing on the Mothers market of the TSE, and an increase of ¥2.4 billion in proceeds from security loan agreement. The increase was partly offset by an increase of ¥4.8 billion in repayments of securities loan agreement, a decrease of ¥1.3 billion in proceeds from issuance of long-term borrowings, and an increase of ¥1.1 billion in repayments of long-term borrowings.

#### ***Year Ended March 31, 2005 as Compared to the Year Ended March 31, 2004***

Net cash provided by operating activities was ¥5.2 billion for the fiscal year ended March 31, 2005 compared to ¥1.9 billion for the previous fiscal year. The increase of net cash provided by operating activities for the fiscal year ended March 31, 2005 consisted of an increase of ¥2.5 billion in net income from continuing operations adjusted for non-cash income and expenses such as depreciation and amortization, loss (gains) on other investments, and equity method net loss, and an increase of ¥0.8 billion changes in operating assets and liabilities (cash provided). This improvement in cash provided by operating activities mainly resulted from the increase in operating income before depreciation and amortization which was derived from the decrease in the cost of connectivity and value-added services such as international backbone costs and

domestic backbone costs, and the improvement in profitability of systems integration. A decrease of approximately ¥1.2 billion in the payment of international and domestic backbone cost was attributable to a decline in their unit price and a decrease in backbone lines resulting from the integrations of some network operation centers.

Net cash provided in investing activities was ¥2.0 billion for the fiscal year ended March 31, 2005 compared to ¥0.9 billion used in investing activities for the previous fiscal year. The increase reflected primarily the absence of the ¥1.7 billion advance to Crosswave in the previous fiscal year. Purchase of property and equipment decreased to ¥0.6 billion for the year ended March 31, 2005 from ¥1.7 billion for the previous fiscal year, though the acquisition of assets by entering into capital lease increased. Proceeds from the sale of investments increased to ¥3.0 billion primarily derived from the sale of certain available-for-sale securities for the year ended March 31, 2005 from ¥2.2 billion primarily derived from the sale of our investment in DLJ direct SFG Securities Inc., for the previous fiscal year. We paid ¥0.4 billion for acquiring the securities systems development and operation business from Yamatane in order to initiate a business relationship with Yamatane's customer base for the fiscal year ended March 31, 2005.

Net cash used in financing activities was ¥14.2 billion for the fiscal year ended March 31, 2005 compared to ¥7.7 billion provided by financing activities for the previous fiscal year. Net cash used in financing activities for the fiscal year ended March 31, 2005 included repurchase and redemption of convertible notes of ¥11.8 billion. Net cash used in financing slightly offset by ¥1.7 billion in cash provided by financing activities raised through a securities loan agreement with a Japanese financial institution. Net cash provided by financing activities for the fiscal year ended March 31, 2004 included proceeds from the issuance of common stock of ¥13.3 billion and long-term borrowings of ¥2.3 billion. Of the ¥2.3 billion of long-term borrowings, ¥1.0 billion was from refinancing outstanding long-term borrowings, ¥1.0 billion was existing short-term borrowings converted into long-term borrowings and ¥0.3 billion was newly financed.

### **Contingencies**

We did not have any material contingent liabilities as of March 31, 2006.

### **C. Research and Development, Patents and Licenses, etc.**

See the information in Item 4.B., "Business Overview — Research and Development."

### **D. Trend Information.**

#### **Factors Affecting Our Future Financial Results**

We expect that the following are the most significant factors likely to affect our financial results and those of our consolidated subsidiaries. You should also consult Item 3.D., "Risk Factors" and the other portions of this annual report on Form 20-F for additional factors affecting our financial results.

#### **Revenues**

We derive our revenues primarily from recurring monthly fees from our Internet connectivity services and our value-added services, as well as one-time project fees and monthly operating fees from systems integration services. We have been enhancing and will continue to enhance our Internet connectivity services through the introduction of a greater variety of access options and bandwidth options, by expanding our value-added services and systems integration under our total network solutions strategy, and by focusing our efforts on capturing market share in high-end corporate markets that are most attractive to us.

### *Connectivity and value-added services revenues*

Connectivity and value-added services revenues consist of our dedicated access services revenues, our dial-up access services revenues, our value-added services revenues and other services revenues. Our connectivity and value-added services revenues accounted for 46.6% of our revenues for the fiscal year ended March 31, 2006, 53.9% for the fiscal year ended March 31, 2005, and 57.7% of our revenues for the fiscal year ended March 31, 2004. As our connectivity services customers tend to use our value-added services or systems integration services as their network needs develop, connectivity services are also important for the growth of our value-added services or systems integration business.

#### *Dedicated access services*

Dedicated access services accounted for 21.3% of our revenues for the fiscal year ended March 31, 2006, 27.3% for the fiscal year ended March 31, 2005, and 33.2% for the fiscal year ended March 31, 2004. Dedicated access service revenues depend on the size of our customer base, the average contracted bandwidth and unit price of our services. The market for dedicated access services is generally following two trends:

- *Increased contracted bandwidth.* Total contracted bandwidth for dedicated access services including Internet Data Center Connectivity Services increased to 194.9 Gbps for the fiscal year ended March 31, 2006 from 121.2 Gbps for the previous fiscal year. In addition, average contracted bandwidth for our IP Service jumped to approximately 112 Mbps for the fiscal year ended March 31, 2006 from 54 Mbps for the previous fiscal year. The number of IP Service contracts for the bandwidth over 100Mbps increased to 157 for the fiscal year ended March 31, 2006 from 114 for the fiscal year ended March 31, 2005. This increase is mainly due to an increase in customers' demand for higher bandwidth for their Internet connectivity. The average revenues per contract for IP Service was approximately ¥0.6 million at the end of March 2006, compared to the revenues per contract of ¥0.8 million at the end of March 2005. Though we do not expect that revenue per contract come to a growing trend for the fiscal year ending March 31, 2007 due to the continuing competition, we believe that customer demand for higher bandwidth will continue as the use of broadband by corporate customers expands, and we will try to acquire new customers and increase the bandwidth of existing customers as well as maintain the quality of our services and differentiate them from those of our competitors.
- *Increased demand for broadband services.* Demand for broadband services, IJ FiberAccess/F and IJ DSL/F are increasing rapidly as the services are coming to be used to connect corporate branches and remote offices. The services uses ADSL lines at maximum 47 Mbps speed or optical lines at maximum 10 Mbps or 100 Mbps as access lines. The number of contracts for IJ FiberAccess/F and IJ DSL/F increased to 13,297 for the fiscal year ended March 31, 2006 from 9,873 for the fiscal year ended March 31, 2005. We also expect that it will also contribute to the increase of value-added services and systems integration revenues as usage and implementation of these connectivity services will increase the demand for value-added services such as security services and network systems integration.

#### *Dial-up access services*

Dial-up access services, which include both services for corporate customers and individual users, accounted for 5.4% of our revenues for the fiscal year ended March 31, 2006, 7.0% for the fiscal year ended March 31, 2005, and 8.0% for the fiscal year ended March 31, 2004. Dial-up service revenues depend on the size of our customer base and pricing. The size of our customer base depends primarily on the popularity of OEM services, and the attractiveness of our service offerings which is measured primarily by the quality of

service provided to subscribers and our ability to attract new customers by offering remote access solutions in combination with dial-up access and security services.

Although we also market some services under the IIJ name, due to our limited brand name recognition among consumers not familiar with the Internet and our limited marketing budget, a primary focus of our efforts to increase our revenues from individual consumers is our range of OEM services. For example, Excite Japan markets and sells Internet connectivity services to individual customers under their own names but provides such services through our Internet network infrastructure.

#### *Value-added services revenues*

Our value-added services consist of network security services, data center facility services and operation and management services. For the fiscal year ended March 31, 2006, value-added services revenues increased to ¥6,250 million from ¥5,005 million for the fiscal year ended March 31, 2005 and from ¥4,296 million for the fiscal year ended March 31, 2004. The increase is primarily due to the increasing demand for these services from our corporate connectivity customers.

The growth of these services is primarily due to the increase in demand for security services and network outsourcing services such as e-mail and web server hosting services. We expect that business customers will continue to increase their usage of Internet as a business tool and will increasingly rely on an expanding range of value-added services to enhance productivity, reduce costs and improve service reliability. As a result, we expect our revenue from value-added services to grow.

#### *Other.*

Other revenues, which included rental fees for network equipment, customer support service, and sale of Wide-area Ethernet services accounted for 7.4% of our revenues for the fiscal year ended March 31, 2006, 7.6% for the fiscal year ended March 31, 2005, and 5.4% for the fiscal year ended March 31, 2004.

#### *Systems integration revenues, including related equipment sales revenues*

We are currently targeting systems integration to drive growth in revenues and operating income. Systems integration revenues, including related equipment sales revenues for the fiscal year ended March 31, 2006 increased by 48.3% from the previous fiscal year. The increase is primarily due to the steady increase in outsourced operation revenues, which are monthly recurring revenues, and in one-time revenues due to the provision of a wider range of consulting, network and system design, project management, implementation of integration compared to the past, such as system utilizing broadband lines to connect customers' shops or branches with lower cost and higher speeds, or consulting on network design and operation, and network security. The increase in revenues is primarily due to the increasing demand for these services from our connectivity customers.

Due to the increase in monthly recurring revenues from outsourcing operations, we expect the revenues from systems integration will continue show a steady increase annually, though the one-time systems integration has the trend of seasonal fluctuation in the fiscal year. The primary seasonal variations in systems integration revenues appear to relate to budgetary cycles of Japanese companies and typically result in greater revenues from systems integration at the end of the fiscal year as companies attempt to complete large systems integration projects during those periods. Systems integration revenues can fluctuate significantly, in accordance with the absence or addition of a single large order, and are accordingly difficult to forecast.

#### *Other equipment sales revenues.*

Our other equipment sales revenues consist primarily of sales of networking and other related equipment, other than that provide in connection with our systems integration services. Other equipment sales revenues can fluctuate significantly, in accordance with the absence or addition of a single large order, and are accordingly difficult to forecast.

#### *Additional factors affecting revenues*

A number of other factors may affect demand for our services and in turn our revenues, including overall increases in business usage of Internet and network solutions and our range of service offerings.

- *Increase in business usage.* Our revenues will be affected by the extent and speed with which businesses in Japan exploit the Internet and network solutions to their full potential, including, for example, electronic transactions between businesses and expanding the range of devices that access the Internet. Such services require high-quality and high-capacity connectivity services for both businesses and individuals. Such services also require provision of total network solutions including various Internet connectivity services, systems integration and other value-added services which we believe we are well positioned to provide. The degree of business usage will also depend upon a variety of factors including:
  - technological advances, reliability of security systems and users' familiarity with and confidence in new technologies,
  - the rate at which Japanese companies in certain industries significantly increase their Internet usage, particularly the financial, manufacturing and retail segments, and
  - corporate budgets for expenditures for information technologies, including Internet-related items.
- *Range of service offerings.* To increase our revenues from business users, we have increased the access and connectivity options to include fiber optic lines and ADSL lines. We have also completed our multi-site Internet data centers and expanded our service offerings to include systems management and monitoring. We believe these steps will allow us to sell a greater variety of services to our high-end corporate users and to capture a greater amount of the current growth and demand. However, we will still be strongly dependent on increasing acceptance of our services by large Japanese companies and by increases in their Information Technology budgets. We expect Internet usage to continue to grow rapidly in Japan and that businesses will continue to diversify their uses of the Internet. Our ability to offer a broad range of services to meet our customers' demands will significantly influence our future revenues.
- *Synergies between connectivity services, value-added services and systems integration.* Most of our systems integration customers become Internet connectivity service customers as well, and we expect these relationships to continue. As part of our systems integration business, we offer solution services for corporate information network systems, consulting, project planning, system design and systems/operation outsourcing or Internet VPN solution services which combines the FLET'S Internet connectivity services with the SEIL, adopted by customers who have multiple locations, such as branches, offices and factories. The number of contracts concerning these services is steadily increasing and we seek to enlarge these network integration services with relatively high gross margin services. The ability to introduce a wide range of services, including solutions necessary to build corporate information network

systems, like disaster recovery services and Internet VPN, Voice over IP (VoIP), SEIL and the network service operating system SMF, wireless LAN, is an important competitive factor.

### ***Costs and expenses***

Costs and expenses include cost of connectivity and value-added services revenues, cost of systems integration revenues and equipment sales, sales and marketing, general and administrative and research and development expenses.

#### *Cost of connectivity and value-added services revenues*

Our primary cost of connectivity services and value-added services revenues is the leasing fees that we pay for the leased lines which comprise our network and for the dedicated local access lines that our subscribers use to connect with our network. Other primary components of our costs are depreciation and amortization of capital leases for network equipment, personnel and other expenses for technical and customer support staff and network operation center costs. Most of our network equipment is leased rather than purchased to take advantage of the financing provided by a capital lease arrangement.

We have invested heavily in the past few years in developing and expanding our network, however, due to a decrease in procurement prices for international backbone lines, our costs have decreased as a result. For the fiscal year ended March 31, 2006, our leased line and other connectivity costs were equal to ¥8.9 billion or 38.3% of our connectivity and value-added services revenues. For the previous fiscal year, these costs were equal to ¥9.0 billion, or 45.9% of our connectivity and value-added services revenues.

- *Backbone cost.* Backbone cost decreased to ¥3.5 billion for the fiscal year ended March 2006 from ¥3.6 billion for the fiscal year ended March 2005. We do not expect that our backbone cost will increase significantly as compared with recent fiscal years.
- *Dedicated local access line costs.* We collect dedicated local access line fees from subscribers and pay these fees over to the carriers. Dedicated local access line costs increased to ¥4.6 billion for the fiscal year ended March 2006 from ¥4.0 billion for the fiscal year ended March 2005. Other connectivity costs were ¥0.8 billion for the fiscal year ended March 2006 compared to ¥1.4 billion for the previous fiscal year.

Depreciation and amortization cost decreased to ¥2.7 billion for the fiscal year ended March 2006 from ¥2.9 billion for the fiscal year ended March 2005. Capital expenditures for the fiscal year ended March 2006 decreased to ¥4.8 billion from ¥5.0 billion for the fiscal year ended March 2005. We do not expect that the depreciation and amortization will change significantly compared with recent fiscal years.

#### *Costs of systems integration revenues and equipment sales*

Our cost of systems integration revenues and equipment sales generally increases or decreases in tandem with systems integration revenues and equipment revenues. In addition, as we incur significant systems integration costs up front in connection with the provision of new types of systems integration service or commencement of a systems integration project, our margins tend to improve as the number of our customers grows and to the extent we provide ongoing systems integration work for existing customers. The main determinant of whether our costs will be high relative to our revenues is whether we are able to generate significantly higher margin systems integration work. To do so, we must generate systems integration work that relies more heavily on our engineering and technological expertise instead of systems integration work that primarily focuses on the delivery of networking equipment. By doing more planning, designing and engineering-related work rather than just equipment procurement, we believe that not only will we be able to increase our margins, but we will also be able to increase customer satisfaction and our subscriber retention

and repeat business rates because we will be able to provide our customers with advanced and cost-effective total Internet solutions.

Our IBPS systems integration services started to generate higher margins for the fiscal year ended March 2004, as most of the time and expense required for development of this service has been already incurred.

Over the long term, we seek to improve gross margins through systems integration sales. The gross margin for systems integration services was 22.9% for the fiscal year ended March 31, 2006 in comparison with 23.0% for the fiscal year ended March 31, 2005. We seek to retain our systems integration customers as our customers for higher-margin consulting, operation and maintenance, software development and upgrades included in systems integration.

#### *Sales and marketing*

Our sales and marketing expenses consist primarily of costs related to marketing and general advertising, written-off accounts receivable, sales and marketing and personnel expenses. Our sales and marketing expenses will increase to the extent that we expand our operations and increase our sales and marketing activities. We expect the sales and marketing expenses will increase for the fiscal year ending March 31, 2007 in accordance with our business expansion.

#### *General and administrative*

Our general and administrative expenses include primarily expenses associated with our management, accounting, finance and administrative functions, including personnel expenses. Our general and administrative expenses will increase to the extent that we grow our business and add staff. We expect the general and administrative expenses will increase for the fiscal year ending March 31, 2007 in accordance with our business expansion.

#### *Research and development*

Our research and development expenses include primarily expenses associated with personnel expenses related to research and development activities. Our research and development expenses will increase to the extent that we expand our research and development activities. We expect the research and development expenses will increase for the fiscal year ending March 31, 2007 in accordance with our business expansion.

#### *Other income (expenses)*

Our other income and expenses include, interest income and expenses and other items such as foreign exchange gains or losses, impairment losses on available-for-sale securities and gain on sale of other investments.

- *Interest expense.* Most of our interest expense is from bank borrowing and capital leases. Interest income and interest expenses are also affected by the fluctuation of market interest rates and our total amount of outstanding borrowings. As we increase capital leases or borrowings in order to finance further development of our backbone and data centers and for other investments, interest expenses will also increase.
- *Impairment losses.* We also hold other investments, including available-for-sale securities. The book value of other investments are affected by the fluctuation in the market price or the decrease in fair values of non-marketable investments. If a decrease below cost in the market

price or fair value of an investment is judged to be other than temporary, we will have impairment losses on other investments.

- *Gain on sale of other investments.* Gain on sales of other investment is mostly raised from a sale of available-for-sale securities. We expect that we will continue a sale of available-for-sale securities to raise the gain for the fiscal year ending March 31, 2007.

#### E. Off-Balance Sheet Arrangements.

We do not have any off-balance sheet arrangements as is defined for purposes of Item 5.E. of Form 20-F.

#### F. Tabular Disclosure of Contractual Obligations.

The following table shows our contractual payment obligations under our agreements as of March 31, 2006:

Contractual Obligations	Payments due by period (in million of yen)				
	Total	less than 1 year	1-3 years	3-5 years	more than 5 years
Long-term debt obligations	¥ 2,280	¥ 1,990	¥ 290	¥ —	¥ —
Capital lease obligations	8,489	3,262	4,314	877	36
Operating lease obligations	2,866	1,404	1,317	90	55
Purchase obligations <sup>(1)</sup>					
Other long-term liabilities reflected on our balance sheet					
Total <sup>(2)(3)</sup>	¥ 13,635	¥ 6,656	¥ 5,921	¥ 967	¥ 91

(1) Represents agreements to purchase goods and services that are enforceable and legally binding on us and that specify all significant terms including fixed or minimum quantities to be purchased, fixed, minimum or variable price provisions, and the approximate timing of the transactions.

(2) In addition to the above, we plan to contribute ¥155 million to our pension plan for the fiscal year ending March 31, 2007. In February 2006, we invested ¥750 million in Internet Revolution Inc. (“i-revo”), a joint venture that we established with Konami Corporation and in the joint venture agreement, we agreed that we will provide funding up to ¥90 million to i-revo between November 2006 and the end of April 2007 for its capital investment and working capital.

(3) The table above does not include obligations for interest payments on debt.

## Item 6. Directors, Senior Management and Employees.

### A. Directors and Senior Management.

The following table provides information about our directors, executive officers and statutory auditors as of July 7, 2006:

Name	Position	Date of birth	Current term expires	Initial date of appointment as director, executive officer or statutory auditor	Number of IIJ shares owned as of July 7, 2006
Koichi Suzuki	President, Chief Executive Officer and Representative Director	Sept. 3, 1946	June 2007	Dec. 1992	12,515
Toshiya Asaba	Executive Vice President	June 12, 1962	June 2007	June 1999	*
Yoshiaki Hisamoto	Executive Vice President	Dec. 14, 1954	June 2008	June 2006	—
Hideshi Hojo	Senior Managing Director	Dec. 22, 1957	June 2007	June 2000	*
Takamichi Miyoshi	Director	May 5, 1963	June 2008	June 2002	*
Akihisa Watai	Director, Chief Financial Officer and Chief Accounting Officer	Sept. 30, 1965	June 2008	June 2004	—
Hiroyuki Hisashima	Director	Oct. 11, 1959	June 2007	June 2005	*
Kazuhiro Tokita	Director	Apr. 25, 1969	June 2007	June 2005	*
Yasuro Tanahashi	Director	Jan. 4, 1941	June 2008	June 2004	—
Takashi Hiroi	Director	Feb. 13, 1963	June 2008	June 2004	—
Yoshifumi Nishikawa	Director	Aug. 3, 1938	June 2007	June 2005	—
Junnosuke Furukawa	Director	Dec. 5, 1935	June 2007	June 2005	—
Senji Yamamoto	Director	Apr. 14, 1946	June 2008	June 2006	—
Junichi Tate	Standing Statutory Auditor	Nov. 6, 1949	June 2008	June 2006	—
Masaki Okada	Statutory Auditor	Jan. 9, 1959	June 2008	June 2004	—
Masaaki Koizumi	Statutory Auditor	Oct. 4, 1964	June 2008	June 2004	—
Hirofumi Takahashi	Statutory Auditor	Sep. 1, 1939	June 2009	June 2005	*

\* Owns less than 1% of outstanding shares of IIJ's common stock.

**Koichi Suzuki** has been our president and representative director since April 1994, and has over 20 years of experience in the computer and communications industries. In addition, Mr. Suzuki is chairman of IIJ Technology Inc. ("IIJ-Tech"), and representative director of Net Care, Inc. ("Net Care") and Internet Multifeed Co. ("Multifeed"). He also serves as chairman of IIJ America Inc. ("IIJ-A") and a director of atom Co., Ltd. and i-Heart, Inc. From December 1992 to April 1994, Mr. Suzuki was a director of IIJ. Prior to joining us, Mr. Suzuki was employed at Japan Management Association where he served as a general manager.

**Toshiya Asaba** has served as an executive vice president and division director of the Network Service Department since April 2006. Mr. Asaba was a managing director of IIJ from June 2002 to June 2004. Mr. Asaba was an executive vice president and division director of the Solution Department from June 2004 to March 2006. Mr. Asaba is also a director of IIJ-A, Multifeed and NTT Resonant Inc. From April 1995 to June 1999, Mr. Asaba was a general manager of the Network Engineering Division. Mr. Asaba joined us in 1992. Mr. Asaba has over ten years of Internet experience including three years of Internet-related research experience and seven years of Internet backbone engineering experience, including network design, routing and traffic management.

**Yoshiaki Hisamoto** has served as an executive vice president and as division director of the Administrative Department since June 2006. Mr. Hisamoto joined Nippon Telegraph and Telephone Public

Corporation in April 1978 and was a senior manager of the Global Business Department and Corporate Planning Department of NTT Communications Corporation (“NTT Communications”). Mr. Hisamoto was general manager of the Accounts and Finance Department of NTT Communications.

**Hideshi Hojo** has served as senior managing director of IJ since June 2006 and as division director of the Sales Department since August 2003. Mr. Hojo is also a director of Net Care and Internet Revolution Inc. From February 1998 to June 2000, Mr. Hojo acted as general manager of the Sales Division, from June 2000 to June 2002, as a director and from June 2002 to August 2003, as managing director and division director of the Sales & Marketing Department. Mr. Hojo joined us in 1996. Prior to joining us, Mr. Hojo had 16 years of experience in the field of sales working for the Itochu Group.

**Takamichi Miyoshi** has served as a director of IJ since June 2002 and as director and general manager of the Strategy Planning Division since June 2004. Mr. Miyoshi is a director of Multifeed. Mr. Miyoshi joined us in April 1993. From October 1994, Mr. Miyoshi acted as general manager of the Network Operations and Systems Administration Division.

**Akihisa Watai** has served as a director, chief financial officer and chief accounting officer since June 2004. Mr. Watai joined The Sumitomo Bank, Limited (currently Sumitomo Mitsui Banking Corporation) in April 1989 and was temporarily transferred to IJ from August 1996. In February 2000, Mr. Watai joined IJ permanently and has been general manager of the Finance Division since April 2004.

**Hiroyuki Hisashima** has served as a director since June 2005 and has been division director of the Applied Research and Development Department since April 2006. Mr. Hisashima was general manager of the Technology Department since April 2004. Mr. Hisashima is a director of IJ-Tech. Mr. Hisashima joined us in May 1996. Prior to joining us, Mr. Hisashima had 12 years of experience in the field of software development.

**Kazuhiro Tokita** has served as a director since June 2005 and has been division director of the Solution Department since April 2006. Mr. Tokita was a deputy division director of the Sales Department since April 2005. Mr. Tokita is a director of IJ-Tech. Mr. Tokita joined us in May 1995. Prior to joining us, Mr. Tokita was employed at Yasuda Kasai Systems Co., Ltd (Currently Sampo Japan Systems Solutions Inc.) .

**Yasurou Tanahashi** has served as an outside director of IJ since June 2004. Mr. Tanahashi was a representative director & president of NS Solutions Corporation, an affiliated company of Nippon Steel Corporation from April 2000 and has been chairman of NS Solutions Corporation since April 2003.

**Takashi Hiroi** has served as an outside director of IJ since June 2004. Mr. Hiroi joined Nippon Telegraph and Telephone Corporation (“NTT”) in April 1986 and has been a senior manager of the Corporate Management Strategy Division of NTT since May 2005.

**Yoshifumi Nishikawa** has served as an outside director of IJ since June 2005. Mr. Nishikawa has been president and representative director of Japan Post Corporation since January 2006 and was an Advisor to Sumitomo Mitsui Financial Group, Inc.

**Junosuke Furukawa** has served as an outside director of IJ since June 2005. Mr. Furukawa has been a director, member of the board & senior advisor of The Furukawa Electric Co., Ltd. since March 2004. From

June 1995 to June 2003, Mr. Furukawa was President & CEO of The Furukawa Electric Co., Ltd. and from June 2003 to March 2004, Mr. Furukawa was Chairman & CEO of The Furukawa Electric Co., Ltd.

**Senji Yamamoto** has served as a director of IJ since June 2006. Mr. Yamamoto has been vice chairman and representative director of IJ-Tech and president and representative director of IJ Financial Systems Inc. since June 2006. From June 2000 to October 2005, Mr. Yamamoto was President and CEO of Sony Communication Network Corporation.

**Junichi Tate** has been a standing statutory auditor of IJ since June 2006. Mr. Tate was a staff general manager of Corporate Planning Department No.2 of Dai-Ichi Life Insurance Company.

**Masaki Okada** has been a statutory auditor of IJ since June 2004. Mr. Okada has been admitted to the Dai-ni Tokyo Bar Association and joined Ishii Law Office in April 1988. Mr. Okada has been a partner in Ishii Law Office since April 1997.

**Masaaki Koizumi** has been a statutory auditor of IJ since June 2004. Mr. Koizumi is a Japanese Certified Public Accountant and joined Eiwa & Co. (Currently Azsa & Co.) in October 1987. Mr. Koizumi retired from Azsa & Co. in September 2003 and established Koizumi CPA Office in October 2003.

**Hirofumi Takahashi** has been a statutory auditor of IJ since June 2005. Mr. Takahashi joined us in August 2002 as an Advisor. Prior to joining us, Mr. Takahashi was chairman of Shinko Investment Trust Management. He had nearly 40 years of experience in securities companies.

## **B. Compensation.**

For the fiscal year ended March 31, 2006, the aggregate compensation we paid or accrued for all of our executive officers, directors and statutory auditors was approximately ¥347 million. Presently, our executive officers, directors and statutory auditors are not entitled to pension, retirement or similar benefits. For a description of our stock option and warrant issuances to directors and employees, see Item 6.E. In the shareholders' meeting held on June 28, 2006, the retirement benefit to Mr. Hideki Matsushita, the standing statutory auditor who retired following the shareholders' meeting, was approved.

## **C. Board Practices.**

Directors are elected at a general meeting of shareholders, and the normal term of office of a director is two years, although they may serve any number of consecutive terms. We do not have audit or remuneration committees, a standard practice in Japan. We do not have any service contracts with any of our directors providing for benefits upon termination of employment.

In accordance with the requirements of the Corporation Law of Japan, our Articles of Incorporation provide for not more than three statutory auditors. Statutory auditors, of whom at least half must be from outside of the company, are elected at a general meeting of shareholders, and the normal term of office of a statutory auditor is four years, although they may serve any number of consecutive terms. Statutory auditors are under a statutory duty to oversee the administration of our affairs by the directors, to examine our financial statements and business reports to be submitted by the Board of Directors to the general meetings of shareholders and to report their opinions thereon to the shareholders, and to oversee accounting firms which audit our financial statements. They are required to attend meetings of the Board of Directors and to express their opinions if necessary, but they are not entitled to vote. Statutory auditors also have a statutory duty to provide their report on the audit report prepared by our independent certified public accountants to the board of statutory auditors, which must submit its audit report to the Board of Directors and/or the general meetings of shareholders. The board of statutory auditors will also determine matters relating to the duties of the statutory auditors, such as audit policy and methods of investigation of our affairs.

Nasdaq Marketplace Rule 4350(a)(1) provides that a foreign private issuer may follow its home country practice in lieu of the requirements of Rule 4350, provided that such foreign private issuer discloses in its annual reports filed with the Securities and Exchange Commission each requirement of Rule 4350 that it does not follow and describes the home country practice followed by the issuer in lieu of such requirements.

Nasdaq Marketplace Rule 4350(c) requires that (i) a majority of the board of directors be independent directors as defined in Rule 4200(a)(15), (ii) independent directors have regularly scheduled meetings at which only they are present, (iii) compensation of the chief executive officer and other executive officers be determined, or recommended to the board of directors for determination, either by a majority of the independent directors or by a compensation committee comprised solely of independent directors, and (iv) director nominees be selected, or recommended for selection by the board of directors, either by a majority of the independent directors or by a nominations committee comprised solely of independent directors, in accordance with the nominations process set forth in a formal written charter or board resolution. For large Japanese companies under the Company Law of Japan (“Large Japanese Companies”), including us, which employ a corporate governance system based on a board of statutory auditors, Japan’s Company Law has no independence requirement with respect to directors. As discussed above, the task of overseeing management and accounting firms is assigned to the statutory auditors, who are separate and independent from the company’s management. Large Japanese Companies, including us, are required to have at least 50% “outside” statutory auditor who must meet additional independence requirements under the Company Law. An outside statutory auditor is defined in the Company Law as a statutory auditor who had not served as a director, manager or any other employee of the company or any of its subsidiaries at any time prior to the appointment. Currently, we have four outside statutory auditors.

Nasdaq Marketplace Rule 4350(d) requires that (i) each issuer have adopted a formal written audit committee charter meeting the requirements of Rule 4350(d)(1) and (ii) the issuer have an audit committee of at least three members who are independent as defined under Rule 4200(a)(15), meet the independence criteria set forth in Rule 10A-3(b)(1) under the U.S. Securities Exchange Act of 1934 and satisfy certain other criteria. Like a majority of Japanese companies, we employ the statutory auditor system as described above. Under this system, the board of statutory auditors is a legally separate and independent body from the board of directors. The function of the board of statutory auditors is similar to that of independent directors, including those who are members of the audit committee, of a U.S. company: to monitor the performance of the directors, and review and express an opinion on the method of auditing by the company’s accounting firm and on such accounting firm’s audit reports, for the protection of the company’s shareholders. Large Japanese Companies, including us, are required to have at least three statutory auditors. Currently, we have four statutory auditors. In addition, as discussed above, our statutory auditors serve a longer term than our directors. With respect to the requirements of Rule 10A-3 under the U.S. Securities Exchange Act of 1934 relating to listed company audit committees, we rely on an exemption under paragraph (c)(3) of that rule which is available to foreign private issuers with boards of statutory auditors meeting certain criteria.

Nasdaq Marketplace Rule 4350(f) provides that each issuer provide for a quorum as specified in its by-laws for any meeting of holders of common stock, which shall be at least 33 1/3% of the outstanding shares of the issuer’s voting common stock. We provide for a quorum as specified in the Articles of Incorporation for any meeting of holders of common stock, which shall be at least one-third of our outstanding shares of the voting common stock.

Nasdaq Marketplace Rule 4350(g) provides that each issuer solicit proxies and provide proxy statements for all meetings of shareholders and provide copies of such proxy solicitation to Nasdaq. Currently a Japanese company whose shares are listed on the securities exchanges defined in the Securities and Exchange Law, including us, may, but is not required to, solicit proxies for meetings of shareholders. If such a Japanese company solicits proxies for a meeting of shareholders, it is required to provide proxy

statements and documents for reference as provided for in the Securities and Exchange Law and provide copies of such proxy statements and documents for reference to the Kanto Local Finance Bureau.

Nasdaq Marketplace Rule 4350(h) provides that each issuer conduct appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis and that all such transactions be approved by the issuer's audit committee or another independent body of the board of directors. Following the requirements of the Company Law of Japan, we require a director to obtain the approval of the Board of Directors in order for such director to accept a transfer of a product or any other asset of IJJ, to transfer a product or any other asset of such director to IJJ, to receive a loan from IJJ, or to effect any other transaction with IJJ, for himself or a third party.

Nasdaq Marketplace Rule 4350(i) provides that shareholder approval be obtained prior to the issuance of designated securities under subparagraph (A), (B), (C) or (D) of Rule 4350(i). Where a Japanese joint stock company (Kabushiki-Gaisha), issues common shares or other shares, stock acquisition rights or bonds with stock acquisition rights under the Commercial Code of Japan, it is necessary for the board of directors to determine the conditions of issuance; provided, however, that this shall not apply if the Articles of Incorporation provide that such conditions shall be determined by the shareholders' meeting. Currently, IJJ's Articles of Incorporation do not provide for any such exception. Additionally, if the company issues such securities to persons other than shareholders (in case of common shares or other shares) at a specially favorable issue price or (in case of stock acquisition rights or bonds with stock acquisition rights) on specially favorable conditions, even when there are provisions related thereto in the Articles of Incorporation, some matters related to such issuance shall be resolved by special resolution of the shareholders' meeting.

The rights of ADR holders, including their rights relating to corporate governance practices, are provided in the deposit agreement which is an exhibit to this annual report.

#### LIMITATION OF LIABILITIES OF SOME OUTSIDE DIRECTORS AND SOME OUTSIDE STATUTORY AUDITORS

We have entered into an agreement with four of our outside directors, Mr. Yoshifumi Nishikawa, Mr. Junnosuke Furukawa, Mr. Yasurou Tanahashi and Mr. Takashi Hiroi, and two of our outside statutory auditors, Mr. Masaki Okada and Mr. Masaaki Koizumi that limits their liabilities to us for damages suffered by us due to their acts taken in good faith and without gross negligence, amounting to ¥ 10 million or the aggregate of the amounts set forth in Article 425 paragraph 1 of the Corporation Law of Japan, whichever is higher.

#### **D. Employees.**

As of March 31, 2006, we had 987 employees, including employees of our consolidated subsidiaries, and we had 969 employees as of March 31, 2005 and 919 employees as of March 31, 2004. Approximately 70% of these employees were in our engineering division, 20% in our sales division and 10% in our administrative division for each of the most recent three fiscal years.

Except for 22 employees in the United States employed by our subsidiary, IJJ-A, all of our employees work in Japan.

We have never experienced any labor disputes and consider our labor relations to be good. To our knowledge, none of our employees is a member of any union.

#### **E. Share Ownership.**

The information on share ownership required by this item is in Item 6.A. above.

## Stock Option Plan

- *June 2001 Stock Option Plan.* In June 2001, we implemented a stock option plan under which options to acquire a total of 1,975 shares or 790,000 ADS equivalents, or approximately 1.8% of total outstanding shares on that date, were granted to 44 directors and employees on August 2, 2001. The option exercise price for the shares was determined by setting the price 5% above the 30-days average of the closing market prices beginning 45 days prior to the date of the grant which was ¥403,661 per share and has been adjusted to ¥334,448 as a result of issuances of common shares. The options are exercisable at various times from two years to ten years from the date of grant.
- *April 2000 Stock Option Plan.* In April 2000, we implemented a stock option plan under which our directors and employees were granted options to acquire a total of 1,475 shares or 590,000 ADS equivalents, or approximately 1.2% of total outstanding shares on that date. The options were granted to 34 directors and employees on May 31, 2000. The option exercise price was determined by setting the price at 5% above the 30-day moving average of closing market prices beginning 45 days prior to the date of grant, which was 2,611,112 per share and has been subsequently adjusted to ¥2,163,418 as a result of issuances of common shares. The options are exercisable at various times from two years to ten years from the date of grant.
- *March 2001 Warrant Issuance.* On March 31, 2001, certain directors of IIJ were provided with 375 warrants exercisable for shares of common stock of IIJ-Tech. Each warrant is exercisable for one share of common stock up to seven or eight years from the date of grant at an exercise price of ¥300,000 and was purchased for 1% of the exercise price.

We conducted a 1 to 5 stock split effective on October 11, 2005. The numbers of shares and the option exercise prices for the two stock option plans above are calculated based on the assumption that the stock split was made at the time of implementation.

## Employee Stock Purchase Plan

We have an employee stockholding association that holds 1,317 shares of common stock, or 0.6% of our outstanding shares, as of March 31, 2006. The association provides designated employees with the opportunity to purchase shares at market value. Shares are held in the name of the employee stock purchase program until the employee resigns or retires. The representative of the employee shareholders' association exercises voting rights in accordance with the instructions of each employee shareholder.

## Item 7. Major Shareholders and Related Party Transactions.

### A. Major Shareholders.

The following table shows information regarding beneficial ownership of our common stock as of July 7, 2006 by each shareholder known by us to own beneficially more than 5% of our common stock and all directors and executive officers as a group. We are not required by Japanese law to disclose beneficial ownership of our common stock. As explained in "Reporting Requirements of Shareholders—Report of Substantial Shareholdings" in Item 10.B. of this annual report on Form 20-F, any person who becomes, beneficially and solely or jointly, a holder of more than 5% of our outstanding common stock must file a report with the relevant local finance bureau of the Ministry of Finance. The information in this table is based upon our shareholders of record and reports filed with the Financial Services Agency and U.S. Securities and Exchange Commission.

	Shares of common stock outstanding, beneficially owned as of July 7, 2006	
	Number	Percentage
Nippon Telegraph and Telephone Corporation and affiliates <sup>(1)</sup>	60,675	29.7%
Koichi Suzuki	12,515	6.1
Itochu Corporation	10,430	5.1
Directors and executive officers as a group <sup>(2)</sup>	13,300	6.5

(1) Includes Nippon Telegraph and Telephone Corporation (“NTT”), which owns 50,475 shares, or 24.7%, and NTT Communications Corporation (“NTT Communications”), which owns 10,200 shares, or 5.0%. NTT acquired ownership of its shares, and NTT Communications acquired additional shares on September 16, 2003.

(2) Includes Koichi Suzuki’s holding which is also separately set forth above. No other director or executive officer is a beneficial owner of more than 5%.

Our major shareholders have the same voting rights as other holders of our common stock. Under our share subscription agreement with NTT, we have agreed that NTT has the contractual right to nominate up to three persons to serve as either directors or statutory auditors subject to approval by our shareholders at the first meeting of shareholders after NTT’s investment. We are not controlled directly or indirectly by any other entity and are not aware of any arrangement to effect a change in control of us.

According to our register of shareholders, as of March 31, 2006, there were 5,458 holders of common stock of record worldwide. As of March 31, 2006, The Bank of New York, depository for our ADSs, held approximately 20.0% of the outstanding common stock on that date. According to The Bank of New York, as of March 31, 2006, there were eight ADR holders of record with addresses in the United States. Because some of these shares were held by brokers or other nominees, the number of record holders with addresses in the United States might not fully show the number of beneficial owners in the United States. Of the 204,300 shares of common stock outstanding as of March 31, 2006, 40,786 shares were held in the form of 16,314,400 ADSs.

## B. Related Party Transactions.

*NTT-affiliated Companies.* Since April 1, 2005 through March 31, 2006, we have paid ¥5,837 million for international and domestic backbone and local access line costs to NTT-affiliated companies such as NTT Communications, Nippon Telegraph and Telephone East Corporation (“NTT East”) and Nippon Telegraph and Telephone West Corporation (“NTT West”). In addition, we paid ¥1,969 million for co-location costs and telecommunication expenses to NTT Communications, NTT East and NTT West and paid ¥270 million for other costs, mainly outsourcing costs to NTT Communications, NTT East and NTT West. We received payments of ¥1,395 million for OEM services, Internet connectivity services and operation fees for data centers from NTT Communications, NTT East and NTT West. On an ongoing basis in the ordinary course of business, we pay NTT-affiliated companies for international and domestic backbone and local access line costs and for co-location costs and telecommunications expenses and receive payments from NTT-affiliated companies for OEM services, Internet connectivity services and operating fees for data centers. We do not have any outstanding loans between NTT and its affiliated companies and us.

*Transactions with equity method affiliates.* In the ordinary course of business, we have various sales, purchase and other transactions with companies which are owned 20% to 50% by us and are accounted for by the equity method. Account balances and transactions with such 20% to 50% owned companies as of and for the fiscal year ended March 31, 2006 are presented as follows:

	millions of yen
Accounts receivable	¥ 253
Accounts payable	17
Revenues	1,286
Costs and expenses	656

As of March 31, 2006, we had loans to certain equity method investees of which the carrying amount, net of valuation allowance was ¥35 million.

In January 19, 2006, we entered into a joint venture agreement regarding the establishment and management of Internet Revolution Inc. (“i-revo”) with Konami Corporation. In the agreement, we committed an additional contribution for capital investment or working capital to i-revo of up to ¥90 million for the period from November 2006 to April 2007.

Except as described above, since March 31, 2005, there has been no transaction with or loan between us or any of our subsidiaries and:

- any enterprise that directly or indirectly controls, is controlled by, or is in common control with us or any of our subsidiaries,
- any director, officer, statutory auditor or family member of any of the preceding or any enterprise over which such person directly or indirectly is able to exercise significant influence,
- any individual shareholder directly or indirectly having significant influence over us or any of our subsidiaries or a family member of such individual or any enterprise over which such person directly or indirectly is able to exercise significant influence, or their respective family members or enterprises over which they exercise significant influence, or
- any unconsolidated enterprise in which we have a significant influence or which has a significant influence over us.

*Crosswave.* Prior to the year ended March 31, 2003, we accounted for Crosswave Communications Inc. (“Crosswave”) under the equity method. As a result of Crosswave’s commencement of corporate reorganization, the amounts of transactions with Crosswave as of and for the fiscal year ended March 31, 2004 are presented as follows:

	<u>millions of yen</u>
Revenues	¥1,196
Costs and expenses	4,816

Revenues from Crosswave consisted principally of dedicated Internet connectivity services, monitoring services and sales of network systems.

Our sale of network systems to Crosswave amounted to ¥28 million for the fiscal year ended March 31, 2004. Related cost of purchased equipment sold amounted to ¥27 million.

Cost and expenses incurred from transactions with Crosswave mainly consisted of the cost of dedicated high-speed data communication services.

### **C. Interests of Experts and Counsel.**

Not applicable.

## **Item 8. Financial Information.**

### **A. Consolidated Statements and Other Financial Information.**

#### **Financial Statements**

The consolidated financial statements required by this item begin on page F-1.

## Legal or Arbitration Proceedings

The information on legal or arbitration proceedings required by this item is in Item 4.B.

## Dividend Policy

Due to our accumulated deficit and shareholders' capital deficiency, we are accordingly unable to legally make and currently has no plans for dividend distributions.

## B. Significant Changes.

Except as otherwise disclosed in this annual report on Form 20-F, there has been no significant change in our financial condition since March 31, 2006, the date of our last audited financial statements.

## Item 9. The Offer and Listing.

### A. Offer and Listing Details.

American Depositary Shares ("ADSs") representing our common stock have been quoted on the Nasdaq National Market since August 4, 1999 under the symbol "IIJJ". The current ADS/share ratio is 400 ADSs per 1 share of our common stock. Our shares of common stock have been quoted on the Mothers market of the Tokyo Stock Exchange ("TSE") since December 2, 2005 under the stock code number "3774".

The following table shows, for the periods indicated, the high and low price of our ADSs and shares of common stock on the Mothers market of the TSE for the periods indicated:

Fiscal year ended/ending March 31,	Nasdaq (per ADS)		Mothers market of the TSE (per share of common stock)	
	High	Low	High	Low
2002	\$11.88	\$4.25		
2003	7.34	1.80		
2004	14.10	1.41		
2005	6.24	2.11		
First Quarter	6.24	3.19		
Second Quarter	3.87	2.23		
Third Quarter	6.02	2.11		
Fourth Quarter	5.26	3.33		
2006	14.88	3.04	¥584,000	¥409,000
First Quarter	13.93	3.04		
Second Quarter	11.12	7.31		
Third Quarter	14.88	8.45	548,000	484,000
Fourth Quarter	12.99	8.67	584,000	409,000
2007				
First Quarter 2006	10.65	6.41	517,000	296,000
<b>Month</b>				
January 2006	12.71	9.95	584,000	420,000
February 2006	12.99	9.70	544,000	428,000
March 2006	9.98	8.67	458,000	409,000
April 2006	10.65	9.35	517,000	425,000
May 2006	10.40	7.47	456,000	326,000
June 2006	8.18	6.41	385,000	296,000

- 
- (1) Price data are based on prices throughout the sessions for each corresponding period at each stock exchange.
  - (2) The high and low price of our shares of common stock on the Mothers market of the TSE for the fiscal year ended March 31, 2006 and the third quarter of the fiscal year ended March 31, 2006 show the high and low price for the period on and after December 2, 2005, when we listed on the Mothers market of the TSE.

**B. Plan of Distribution.**

Not applicable.

**C. Markets.**

ADS representing our common stock have been quoted on the Nasdaq National Market since August 4, 1999 under the symbol "IIJI". Our shares of common stock have been quoted on the Mothers market of the TSE since December 2, 2005 under the stock code number "3774".

**D. Selling Shareholders.**

Not applicable.

**E. Dilution.**

Not applicable.

**F. Expenses of the issue.**

Not applicable.

**Item 10. Additional Information.**

**A. Share Capital.**

Not required.

**B. Memorandum and Articles of Association.**

**Objects and Purposes in Our Articles of Incorporation**

Article 2 of our Articles of Incorporation states our objects and purposes:

- Telecommunications business under the Telecommunications Business Law,
- Processing, mediation and provision of information and contents by using telecommunications networks,
- Agency for the management business such as the management of networks and the management of information and telecommunications systems,
- Planning, consulting service, development, operation and maintenance of or for information and telecommunications systems,
- Development, sales, lease and maintenance of computer software,

- Development, sales, lease and maintenance of telecommunications machinery and equipment,
- Telecommunications construction,
- Agency for non-life insurance,
- Research, study, education and training related to the foregoing, and
- Any and all businesses incidental or related to the foregoing.

### **Provisions Regarding Our Directors**

There is no provision in our Articles of Incorporation as to a director's power to vote on a proposal, arrangement or contract in which the director is materially interested, but the Corporation Law of Japan provides that such director is required to refrain from voting on such matters at the board of director's meetings.

The Corporation Law of Japan provides that compensation for directors is determined at a general meeting of shareholders of a company. Within the upper limit approved by the shareholders' meeting, the board of directors will determine the amount of compensation for each director. The board of directors may, by its resolution, leave such decision to the president's discretion.

The Corporation Law of Japan provides that a significant loan from third party by a company should be approved by the board of directors. Our regulations of the board of directors have adopted this policy.

There is no mandatory retirement age for directors under the Corporation Law of Japan or our Articles of Incorporation.

There is no requirement concerning the number of shares one individual must hold in order to qualify him or her as a director under the Corporation Law of Japan or our Articles of Incorporation.

### **Rights of Shareholders of our Common Stock**

We have issued only one class of shares, our common stock. Rights of holders of shares of our common stock have under the Corporation Law of Japan and our Articles of Incorporation include:

- the right to receive dividends when the payment of dividends has been approved at a shareholders' meeting, with this right lapsing three full years after the due date for payment according to a provision in the Articles,
- the right to receive interim dividends as provided for in the Articles, with this right lapsing three full years after the due date for payment according to a provision in the Articles,
- the right to vote at a shareholders' meeting (cumulative voting is not allowed under the Articles),
- the right to receive surplus in the event of liquidation, and
- the right to require us to purchase shares when a shareholder opposes resolutions including (i) the transfer of all or material part of the business, (ii) an amendment of the Articles to establish a restriction on share transfer, (iii) a share exchange or share transfer to establish a holding

company, (iv) split of the company or (v) merger, all of which must be consummated by a two-thirds affirmative vote of the voting rights of the shareholders at a shareholders' meeting at which shareholders having not less than one-third of the total number of voting rights held by all shareholders who can exercise their voting rights are in attendance.

A shareholder is generally entitled to one vote per one unit of our shares at a shareholders' meeting. In general, under the Corporation Law of Japan and our Articles of Incorporation, a shareholders' meeting may adopt a resolution by a majority of the voting rights represented at the meeting. The Corporation Law of Japan and our Articles of Incorporation require a quorum for the election of directors and statutory auditors of not less than one-third of the total number of voting rights held by all shareholders who can exercise their voting rights. A corporate shareholder, having more than one-quarter of its voting rights directly or indirectly held by us, does not have voting rights. We have no voting rights with respect to our own common stock. Shareholders may exercise their voting rights through proxies, provided that a shareholder may appoint only one shareholder who has a voting right as its proxy. Our board of directors may entitle our shareholders to cast their votes in writing. Our board of directors may also entitle our shareholders to cast their votes by electrical devices.

While the Corporation Law of Japan, in general, requires a quorum of the majority of voting rights and approval of two-thirds of the voting rights presented at the meeting of any material corporate actions, it allows a company to reduce the quorum for such special resolutions by its Articles of Incorporation to not less than one-third of the total number of voting rights held by all shareholders who can exercise their voting rights. We adopted a quorum of not less than one-third of the total number of voting rights in our Articles of Incorporation for special resolutions for material corporate actions, such as:

- a reduction of the stated capital,
- amendment of our Articles of Incorporation (except amendments that the board of directors are authorized to make under the Corporation Law of Japan),
- establishment of a 100% parent-subsidiary relationship through a share exchange or share transfer requiring shareholders' approval,
- a dissolution, merger or consolidation requiring shareholders' approval,
- a company split requiring shareholders' approval,
- a transfer of the whole or an important part of our business,
- the taking over of the whole of the business of any other corporation requiring shareholders' approval, and
- issuance of new shares at a specially favorable price, or issuance of stock acquisition rights or bonds with stock acquisition rights with specially favorable conditions to persons other than shareholders.

The Corporation Law of Japan provides additional specific rights for shareholders owning a substantial number of voting rights.

Shareholders holding more than one sixth of the total number of the voting rights of all shareholders who can exercise their voting rights have the right to oppose:

- short-form share transfer (only in respect of the shareholders of the company to be a 100% parent company by the short-form share transfer),
- short-form company split into an existing company (only in respect of the shareholders of the exiting company that takes over the target business of the split company), and
- short-form absorption (only in respect of the shareholders of the exiting company that absorbs the target company by the short-form absorption).

Shareholders holding 10% or more of the total number of voting rights of all shareholders (or our total outstanding shares) have the right to apply to a court of competent jurisdiction, or competent court, for:

- dissolution, and
- commencement of reorganization proceedings as provided for in the Company Reorganization Law of Japan.

Shareholders who have held 3% or more of the total number of voting rights of all shareholders (or our total outstanding shares) for six months or more have the right to:

- demand the convening of a general meeting of shareholders,
- apply to a competent court for removal of a director or statutory auditor,
- apply to a competent court for removal of a liquidator, and
- apply to a competent court for an order to inspect our business and assets in a special liquidation proceeding.

Shareholders holding 3% or more of the total number of voting rights of all shareholders (or our total outstanding shares) have the right to:

- examine our accounting books and documents and make copies of them, and
- apply to a competent court for appointment of an inspector to inspect our operation or financial condition.

Shareholders who have held 1% or more of the total number of voting rights of all shareholders for six months or more have the right to apply to a competent court for appointment of an inspector to review the correctness of the convocation and voting procedures of a general meeting of shareholders.

Shareholders who have held 1% or more of the total number of voting rights of all shareholders or 300 voting rights for six months or more have the right to demand that certain matters be made objects and added to the agenda items at a general meeting of shareholders.

Shareholders who have held any number of shares for six months or more have the right to demand:

- us to institute an action to enforce the liability of one of our directors or statutory auditors,
- us to institute an action to recover from a recipient the benefit of a proprietary nature given in relation to exercising the right of a shareholder, and

- a director on our behalf for the cessation of an illegal or ultra vires action.

There is no provision under the Corporation Law of Japan or our Articles of Incorporation which forces shareholders to make additional contributions when requested by us.

Under the Corporation Law of Japan, in order to change the rights of shareholders which are stipulated and defined in our Articles of Incorporation, we must amend our Articles of Incorporation. Amendment must be approved by a special resolution of shareholders where two-thirds of shareholders vote at a shareholders' meeting at which shareholders having not less than one-third of the voting rights held by all shareholders are in attendance.

Annual general meetings and extraordinary general meetings of shareholders are convened by a representative director based on the determination to convene it by our board of directors. A shareholder having held 3% or more of our total outstanding shares for six months or more is entitled to demand the directors to convene a shareholders' meeting under the Corporation Law of Japan. Under our Articles of Incorporation, shareholders of record as of March 31 of each year have the right to attend the annual general meeting of our shareholders. In order to determine the shareholders entitled to attend extraordinary general meetings of our shareholders, we are required to make public notice of record date at least two weeks prior to the record date. A convocation notice will be sent to these shareholders at least two weeks prior to the date of the shareholders' meeting.

### **Restrictions on Holders of our Common Stock**

There is no restriction on non-resident or foreign shareholders on the holding of our shares or on the exercise of voting rights. However, pursuant to a provision of our share handling regulations, a shareholder who does not have an address or residence in Japan is required to file its temporary address in Japan or that of a standing proxy having any address or residence in Japan with our transfer agent.

There is no provision in our Articles of Incorporation that would have the effect of delaying, deferring or preventing a change in control that would operate only with respect to a merger, acquisition or corporate restructuring involving us.

There is no provision in our Articles of Incorporation or other subordinated rules regarding the ownership threshold, above which shareholder ownership must be disclosed. A shareholder holding more than 5% of the shares in a public company in Japan is required to disclose such shareholding pursuant to the Securities Exchange Law of Japan.

There is no provision in our Articles of Incorporation governing changes in the capital more stringent than is required by law.

For a description of rights of holders of ADSs, please see the "Description of American Depositary Receipts" section in our F-1 Registration Statement (File No. 333-10584), declared effective on August 3, 1999, as amended, hereby incorporated by reference.

### **C. Material Contracts.**

The following are summaries of our material contracts, other than those we entered into in the ordinary course of business.

*Subscription Agreement, dated September 16, 2003, between Internet Initiative Japan Inc. and Nippon Telegraph and Telephone Corporation.* On September 16, 2003, we entered into a Subscription Agreement with Nippon Telegraph and Telephone Corporation ("NTT") under which NTT agreed to purchase 10,883

shares of our common stock for ¥951,300 per share, or approximately ¥10.4 billion. After the consummation of this agreement, NTT and its affiliates owned a total of 12,315 shares of our common stock, or approximately 31.6%. Under the terms of this agreement, we and NTT agreed to undertake efforts to jointly engage in the development of broadband and Information Technology and other related businesses, to expand the business relationship between the two parties in connection with new business opportunities of us and to discuss secondment of employees between us and NTT. The agreement also provides NTT with the right to maintain its current percentage ownership in our company if we issue new shares and has the right to request that we file a registration statement to enable NTT to sell its shares in the United States or Japanese markets. In addition, the agreement gives NTT the right to nominate up to three persons to serve on either our board of directors or our board of statutory auditors subject to approval of any such nomination by our shareholders at the first meeting of shareholders after NTT's investment.

*Service Agreement dated, March 25, 2004, between Internet Initiative Japan Inc. and IJ America Inc.* On March 25, 2004, we entered into a Service Agreement with IJ America Inc. ("IJ-A"), under which IJ-A provides the operation and maintenance services for the U.S. portion of our Internet backbone and we and IJ-A agree to the method for calculating pricing for the operation and maintenance of the backbone.

*Limitation of Liability Agreement dated, June 29, 2005 and June 28, 2006, between Internet Initiative Japan Inc. and outside directors and outside statutory auditors.* We entered into a Limitation of Liability Agreement with our outside directors, Mr. Yoshifumi Nishikawa and Mr. Junnosuke Furukawa on June 29, 2005, and Mr. Yasuro Tanahashi and Mr. Takashi Hiroi as our outside directors and Mr. Masaki Okada and Mr. Masaaki Koizumi as our outside statutory auditors on June 28, 2006, respectively, under which we limit the liability of outside directors and outside statutory auditors in accordance to the rules defined in Article 427 of the Corporation Law of Japan.

*Joint Venture Agreement, dated, January 19, 2006, between Internet Initiative Japan Inc. and Konami Corporation.* We entered into a joint venture agreement regarding the establishment and management of Internet Revolution Inc. ("i-revo") with Konami Corporation. In the agreement, we committed an additional contribution for capital investment or working capital to i-revo of up to ¥90 million for the period from November 2006 to April 2007.

#### **D. Exchange Controls.**

There are no laws, decrees, regulations or other legislation in Japan that affect either our ability to import or export capital for our use or our ability to pay dividends to non-resident holders of our securities.

#### **E. Taxation.**

##### **Japanese Taxation**

The following is a discussion summarizing material Japanese tax consequences to an owner of shares or ADSs who is a non-resident of Japan or a non-Japanese corporation without a permanent establishment in Japan to which the relevant income is attributable. The statements regarding Japanese tax laws set forth below are based on the laws in force and as interpreted by the Japanese taxation authorities as at the date hereof. These statements are subject to changes in the applicable Japanese laws or double taxation conventions occurring after that date. This summary is not exhaustive of all possible tax considerations which may apply to a particular investor. Potential investors should satisfy themselves as to:

- the overall tax consequences of the ownership and disposition of shares or ADSs, including specifically the tax consequences under Japanese law,
- the laws of the jurisdiction of which they are resident, and

- any tax treaty between Japan and their country of residence, by consulting their own tax advisers.

Generally, a non-resident of Japan or a non-Japanese corporation is subject to Japanese withholding tax on dividends paid by Japanese corporations. Stock splits, except when treated as dividends in certain conditions, are not subject to Japanese income tax.

The Convention between the Government of Japan and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (the “Treaty”) was newly signed on November 7, 2003 and the Treaty entered into force on March 30, 2004. Upon the Treaty coming into force, the Convention between Japan and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on March 8, 1971 (the “Prior Treaty”) ceased to have effect. The Treaty reduces the maximum rate of Japanese withholding tax which may be imposed on dividends paid to a United States resident or corporation not having a “permanent establishment” in Japan. A “permanent establishment” in Japan is generally a fixed place of business for industrial or commercial activity in Japan. With respect to taxes withheld at source, the Treaty is applicable for amount taxable on or after July 1, 2004. The other provisions of the Treaty are applicable to the fiscal year beginning on or after January 1, 2005.

Under the Treaty, the maximum withholding rate for most shareholders is limited to 10% of the gross amount actually distributed. However, the maximum rate is 5% of the gross amount actually distributed, if the recipient is a corporation that owns directly or indirectly, on the date on which entitlement to the dividends is determined, at least 10% of the voting shares of the paying corporation. Moreover, withholding tax on dividends is not imposed, if the recipient is

- a corporation that has owned, directly or indirectly through one or more residents of either Japan or the U.S., more than 50% of the voting shares of the paying corporation for the period of twelve months ending on the date on which entitlement to the dividends is determined and which meets additional requirements, or
- a pension fund, provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such pension fund.

The following table summarizes changes of the maximum withholding rate imposed on dividends by the Treaty:

The Prior Treaty		The Treaty	
10% or more of the voting shares	10%	More than 50% of the voting shares	0%
		10% to 50% of the voting shares	5%
Others	15%	Others	10%

For purposes of the Treaty and Japanese tax law, U.S. holders of ADRs will be treated as the owners of the shares underlying the ADSs evidenced by the ADRs.

Unless an applicable tax treaty, convention or agreement reduces the maximum rate of withholding tax, the rate of Japanese withholding tax applicable to dividends paid by Japanese corporations to a non-resident or non-Japanese corporation is 20%. Japan has entered into income tax treaties, conventions or agreements, reducing the above-mentioned withholding tax rate for investors with a number of countries. These countries include, among others, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, New Zealand, Norway, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The withholding tax rate is further reduced if investors and IJJ have some capital relationship as provided for in an applicable tax treaty.

Non-resident holders who are entitled to a reduced rate of Japanese withholding tax on payment of dividends by IIJ must submit the required form in advance through IIJ to the relevant tax authority before payment of dividends. The required form is the Application Form for Income Tax Convention regarding Relief from Japanese Income Tax on Dividends. A standing proxy for non-resident holders may provide such application service. See “Description of Capital Stock — General”. With respect to ADSs, the reduced rate is applicable if The Bank of New York, as depositary, or its agent submits two Application Forms for Income Tax Convention — one form must be submitted before payment of dividends, and the other form must be submitted within eight months after our fiscal year end. To claim the reduced rate, a non-resident holder of ADSs will be required to file proof of taxpayer status, residence and beneficial ownership, as applicable. The non-resident holder will also be required to provide information or documents clarifying its entitlement to the tax reduction as may be required by the depositary.

A non-resident holder of shares or ADSs who does not submit an application in advance will be entitled to claim from the relevant Japanese tax authority a refund of withholding taxes withheld in excess of the rate of an applicable tax treaty.

Gains derived from the sale outside Japan of the shares or ADSs by a non-resident of Japan or a non-Japanese corporation are in general not subject to Japanese income or corporation taxes. In addition, gains derived from the sale of shares or ADSs within Japan by a non-resident of Japan or non-Japanese corporation not having a permanent establishment in Japan are in general not subject to Japanese income or corporation taxes. An individual who has acquired shares or ADSs as a distributee, legatee or donee may have to pay Japanese inheritance and gift taxes at progressive rates.

IIJ has paid or will pay any stamp, registration or similar tax imposed by Japan in connection with the issue of the shares, except that IIJ will not pay any tax payable in connection with the transfer or sale of the shares by a holder thereof.

### **United States Taxation**

The following discusses United States federal income tax consequences of the ownership of shares or ADSs. It only applies to U.S. holders of shares or ADSs, as defined below, who hold their shares or ADSs as capital assets. It does not address special classes of holders, some of whom may be subject to other rules including:

- tax-exempt entities,
- life insurance companies,
- dealers in securities,
- traders in securities that elect to mark-to-market,
- investors liable for alternative minimum tax,
- investors that actually or constructively own 10% or more of the voting stock of IIJ,
- investors that hold shares or ADSs as part of a straddle or a hedging or conversion transaction, or
- investors whose functional currency is not the U.S. dollar.

This discussion is based on the tax laws of the United States, including the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations and administrative and judicial interpretations, as currently in effect, as well as on the Treaty. These laws are subject to change, possibly on a retroactive basis. In addition, this discussion is based in part upon the representations of the depository and the assumption that each obligation in the deposit agreement relating to the ADRs and any related agreement will be performed in accordance with its terms.

For purposes of this discussion, a “U.S. holder” is a beneficial owner of shares or ADSs that is:

- a citizen or resident of the United States,
- a domestic corporation,
- an estate whose income is subject to United States federal income tax regardless of its source, or
- a trust if a United States court can exercise primary supervision over the trust’s administration and one or more United States persons are authorized to control all substantial decisions of the trust.

This discussion addresses only United States federal income taxation. You should consult your own tax advisor regarding the United States federal, state and local and other tax consequences of owning and disposing of shares and ADSs in your particular circumstances.

In general, and taking into account the earlier assumptions, for United States federal income tax purposes, if you hold ADRs evidencing ADSs, you will be treated as the owner of the shares represented by those ADSs. Exchanges of shares for ADRs, and ADRs for shares, generally will not be subject to United States federal income tax.

The discussion under the headings “Taxation of Dividends” and “Taxation of Capital Gains” assumes that we will not be treated as a passive foreign investment company (PFIC) for U.S. federal income tax purposes. For a discussion of the rules that apply if we are treated as a PFIC, see the discussion under the heading “PFIC Rules” below.

### ***Taxation of Dividends***

Under the United States federal income tax laws, if you are a U.S. holder, the gross amount of any dividend we pay out of our current or accumulated earnings and profits (as determined for United States federal income tax purposes) is subject to United States federal income taxation. If you are a noncorporate U.S. holder, dividends paid to you in taxable years beginning before January 1, 2011 that constitute qualified dividend income will be taxable to you at a maximum tax rate of 15% provided that you hold the shares or ADSs for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date and meet other holding period requirements.

You must include any Japanese tax withheld from the dividend payment in this gross amount even though you do not in fact receive it. The dividend is taxable to you when you, in the case of shares, or the Depository, in the case of ADSs, receive the dividend, actually or constructively. The dividend will not be eligible for the dividends-received deduction generally allowed to United States corporations in respect of dividends received from other United States corporations. The amount of the dividend distribution that you must include in your income as a U.S. holder will be the U.S. dollar value of the Japanese yen payments made, determined at the spot Japanese yen/U.S. dollar rate on the date the dividend distribution is includible in your income, regardless of whether the payment is in fact converted into U.S. dollars. Generally, any gain or loss resulting from currency exchange fluctuations during the period from the date you include the dividend

payment in income to the date you convert the payment into U.S. dollars will be treated as ordinary income or loss and will not be eligible for the special tax rate applicable to qualified dividend income. The gain or loss generally will be income or loss from sources within the United States for foreign tax credit limitation purposes.

Distributions in excess of current and accumulated earnings and profits, as determined for United States federal income tax purposes, will be treated as a return of capital to the extent of your basis in the shares or ADSs and thereafter as capital gain.

Subject to certain limitations, the Japanese tax withheld in accordance with the Treaty and paid over to Japan will be creditable against your United States federal income tax liability. Special rules apply in determining the foreign tax credit limitation with respect to dividends that are subject to the maximum 15% tax rate. To the extent a refund of the tax withheld is available to you under Japanese law or under the Treaty, the amount of tax withheld that is refundable will not be eligible for credit against your United States federal income tax liability.

Dividends constitute income from sources outside the United States, but dividends paid in taxable years beginning before January 1, 2007 generally will be “passive” or “financial services” income, and dividends paid in taxable years beginning after December 31, 2006 will, depending on your circumstances, be “passive” or “general” income which, in either case, is treated separately from other types of income for purposes of computing the foreign tax credit allowable to you.

### ***Taxation of Capital Gains***

If you sell or otherwise dispose of your shares or ADSs, you will recognize capital gain or loss for United States federal income tax purposes equal to the difference between the U.S. dollar value of the amount that you realize and your tax basis, determined in U.S. dollars, in your shares or ADSs. Capital gain of a noncorporate U.S. holder that is recognized in taxable years beginning before January 1, 2011 is generally taxed at a maximum rate of 15% where the holder has a holding period greater than one year. Additionally, gain or loss will generally be from sources within the United States for foreign tax credit limitation purposes.

### ***PFIC Rules***

We do not believe that we will be treated as a PFIC for United States federal income tax purposes for our most recent taxable year. However, this conclusion is a factual determination made annually and thus may be subject to change. Because of the nature of our income and assets, we could be determined to be a PFIC for our current and subsequent taxable years.

In general, we will be a PFIC with respect to you if for any of our taxable years in which you held our ADSs or shares:

- at least 75% of our gross income for the taxable year is passive income, or
- at least 50% of the value, determined on the basis of a quarterly average, of our assets is attributable to assets that produce or are held for the production of passive income.

Passive income generally includes dividends, interest, royalties, rents (other than certain rents and royalties derived in the active conduct of a trade or business), annuities and gains from assets that produce passive income. If a foreign corporation owns at least 25% by value of the stock of another corporation, the foreign corporation is treated for purposes of the PFIC tests as owning its proportionate share of the assets of the other corporation, and as receiving directly its proportionate share of the other corporation’s income.

If we are treated as a PFIC and you did not make a mark-to-market election, as described below, you will be subject to special rules with respect to:

- any gain you realize on the sale or other disposition of your shares or ADSs, and
- any “excess distribution” that we make to you (generally, any distributions to you during a single taxable year that are greater than 125% of the average annual distributions received by you in respect of the shares or ADSs during the three preceding taxable years or, if shorter, your holding period for the shares or ADSs).

Under these rules:

- the gain or excess distribution will be allocated ratably over your holding period for the shares or ADSs,
- the amount allocated to the taxable year in which you realized the gain or excess distribution will be taxed as ordinary income,
- the amount allocated to each prior year, with certain exceptions, will be taxed at the highest tax rate in effect for that year, and
- the interest charge generally applicable to underpayments of tax will be imposed in respect of the tax attributable to each such year.

Special rules apply for calculating the amount of the foreign tax credit with respect to excess distributions by a PFIC.

If your shares or ADSs are treated as stock of a PFIC, you may make a mark-to-market election. If you make this election, you will not be subject to the PFIC rules described above. Instead, in general, you will include as ordinary income each year the excess, if any, of the fair market value of your shares or ADSs at the end of the taxable year over your adjusted basis in your shares or ADSs. These amounts of ordinary income will not be eligible for the favorable tax rates applicable to qualified dividend income or long-term capital gains. You will also be allowed to take an ordinary loss in respect of the excess, if any, of the adjusted basis of your shares or ADSs over their fair market value at the end of the taxable year or over their final sale or disposition prices, but only to the extent of the net amount of previously included income as a result of the mark-to-market election. Your basis in the shares or ADSs will be adjusted to reflect any such income or loss amounts.

In addition, notwithstanding any election you make with regard to the shares or ADSs, dividends that you receive from us will not constitute qualified dividend income to you if we are a PFIC either in the taxable year of the distribution or the preceding taxable year. Dividends that you receive that do not constitute qualified dividend income are not eligible for taxation at the 15% maximum rate applicable to qualified dividend income. Instead, you must include the gross amount of any such dividend paid by us out of our accumulated earnings and profits (as determined for United States federal income tax purposes) in your gross income, and it will be subject to tax at rates applicable to ordinary income.

If you own shares or ADSs during any year that we are a PFIC, you must file Internal Revenue Service Form 8621.

**F. Dividends and Paying Agents.**

Not required.

**G. Statement by Experts.**

Not applicable.

**H. Documents on Display.**

We file periodic reports and other information with the Securities and Exchange Commission. The Securities and Exchange Commission maintains a web site at [www.sec.gov](http://www.sec.gov) that contains reports and other information regarding us and other registrants that file electronically with the Securities and Exchange Commission. You may read and copy any document we file with the Securities and Exchange Commission at the Securities and Exchange Commission's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the operation of its public reference room. In addition, you may also inspect reports filed with the Securities and Exchange Commission and other information at our Tokyo headquarters, located at Jinbocho Mitsui Bldg., 1-105 Kanda Jinbo-cho, Chiyoda-ku, Tokyo 101-0051, Japan. Some of this information may also be found on our website at <http://www.ij.ad.jp/>. This information is not incorporated by reference into this annual report on Form 20-F.

**I. Subsidiary Information.**

Not applicable.

**Item 11. Quantitative and Qualitative Disclosures about Market Risk.**

We are exposed to market risks from changes in interest rates, equity prices and foreign currency exchange rates.

**Interest Rate Risk**

The table below provides information about financial instruments held by us that are sensitive to changes in interest rates, including debt obligations and interest rate swaps. For debt obligations, the table presents whether the interest component is fixed or variable, the amount and timing of cash flows, the expected weighted-average interest rates over the next five years, as well as the fair value of each debt instrument. For interest rate swaps, the table presents the notional amounts and weighted average interest rates by expected maturity dates.

March 31, 2006	Expected maturity date					Total	Fair value or Gain (loss)
	2007	2008	2009	2010	2011		
	(millions of yen)						
<b>Long-term debt obligations:</b>							
Fixed rate long-term borrowings and installment payable	756	—	—	—	—	756	756
Average interest rate	1.883%	—%	—%	—%	—%	1.883%	
Variable rate long-term borrowings	1,234	290	—	—	—	1,524	1,524
Average interest rate	1.413%	1.440%	—%	—%	—%	1.418%	

March 31, 2006	Expected maturity date					Total	Fair value or Gain (loss)
	2007	2008	2009	2010	2011		
<b>Interest rate swap contracts —</b>							
Notional amount – variable to fixed:	900	250	—	—	—	1,150	(4)
Average pay rate	1.812%	1.670%	—%	—%	—%	1.781%	
Average receive rate	1.166%	1.150%	—%	—%	—%	1.162%	

March 31, 2005	Expected maturity date					Total	Fair value or Gain (loss)
	2006	2007	2008	2009	2010		
<b>Long-term debt obligations:</b>							
Fixed rate long-term borrowings and installment payable	1,652	1,006	—	—	—	2,658	2,655
Average interest rate	1.913%	1.819%	—%	—%	—%	1.877%	
Variable rate long-term borrowings	1,084	484	40	—	—	1,608	1,608
Average interest rate	1.284%	1.544%	3.255%	—%	—%	1.411%	
<b>Interest rate swap contracts —</b>							
Notional amount – variable to fixed:	1,000	400	—	—	—	1,400	(9)
Average pay rate	1.900%	1.990%	—%	—%	—%	1.926%	
Average receive rate	1.118%	1.185%	—%	—%	—%	1.137%	

Our policy on managing interest rate risk is to hedge our exposure to variability in future cash flow of floating rate interest payment on long-term bank borrowings. In order to reduce cash flow risk exposures on floating rate borrowings, we utilize interest rate swaps to convert floating rate borrowings into fixed rate borrowings. We do not hold derivative instruments for speculative purposes. Also, we do not hold or issue financial instruments for trading purposes. See note 15 to our consolidated financial statements included in this annual report on Form 20-F.

#### Equity Price Risk

The fair value of certain of our investments, primarily in marketable securities, exposes us to equity price risks. In general, we have invested in highly liquid and low-risk instruments, which are not held for trading purposes. We are exposed to changes in the market prices of the securities. As of March 31, 2005 and 2006, the fair value of such investments was ¥8,948 million and ¥6,775 million, respectively. The potential loss in fair value resulting from a 10% adverse change in equity prices would be approximately ¥895 million and ¥678 million as of March 31, 2005 and 2006, respectively. See Note 2 to our consolidated financial statements, included in this annual report on Form 20-F.

#### Foreign Currency Exchange Rate Risk

The only significant assets held by us which are exposed to foreign currency exchange risk are U.S. dollar denominated bank deposits. The carrying value, which also represents fair value, amounted to \$6,584 thousand (¥706 million) and \$3,764 thousand (¥442 million) at March 31, 2005 and 2006, respectively. The potential loss in fair value for such financial instruments from a 10% adverse change in quoted foreign currency exchange rates would have been approximately ¥71 million and ¥44 million at March 31, 2005 and 2006, respectively.

**Item 12. Description of Securities Other than Equity Securities.**

Not applicable.

**PART II**

**Item 13. Defaults, Dividend Arrearages and Delinquencies.**

None.

**Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds.**

None.

**Item 15. Controls and Procedures.**

**Disclosure Controls and Procedures**

As of the end of the fiscal year ended March 31, 2006, our management, with the participation of Koichi Suzuki, our president, chief executive officer and representative director, and Akihisa Watai, our director, chief financial officer and chief accounting officer, performed an evaluation of our disclosure controls and procedures.

Under Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, disclosure controls and procedures means our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of March 31, 2006.

**Changes in Internal Control Over Financial Reporting**

With the participation of our chief executive officer and chief financial officer, we also evaluated any change in our internal control over financial reporting that occurred during the fiscal year ended March 31, 2006.

Under Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934, internal control over financial reporting means a process designed by, or under the supervision of, our chief executive officer and chief financial officer and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets,

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of our financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors, and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Based on that evaluation, our chief executive officer and chief financial officer concluded that no changes were made in our internal control over financial reporting that occurred during the fiscal year ended March 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

#### **Item 16A. Audit Committee Financial Expert**

At our shareholders' meeting on June 24, 2004, two statutory auditors were newly nominated and our board of statutory auditors has determined that one of the nominated statutory auditors serving on the Board of Statutory Auditors, Masaaki Koizumi, is an "audit committee financial expert" as defined in Item 16A. of Form 20-F. Mr. Koizumi is independent from us.

An "audit committee financial expert" is defined in Item 16A. of Form 20-F to mean a person who has the following attributes:

- (1) An understanding of generally accepted accounting principles and financial statements,
- (2) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves,
- (3) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities,
- (4) An understanding of internal controls over financial reporting,
- (5) An understanding of audit committee functions.

Such person shall have acquired the attributes described above through:

- (1) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions,
- (2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions,
- (3) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements, or
- (4) Other relevant experience.

A person who is determined to be an audit committee financial expert will not be deemed an “expert” for any purpose, including without limitation for purposes of section 11 of the Securities Act of 1933 (15 U.S.C. 77k), as a result of being designated or identified as an audit committee financial expert pursuant to this Item 16A. The designation or identification of a person as an audit committee financial expert pursuant to this Item 16A does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification. The designation or identification of a person as an audit committee financial expert pursuant to this Item 16A does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

**Item 16B. Code of Ethics.**

At our Board of Directors Meeting on April 28, 2004, we adopted a Code of Ethics, the Internet Initiative Japan Code of Conduct, applicable to all employees and officers, including our chief executive officer, chief financial officer and chief accounting officer. The Code of Conduct is attached as Exhibit 11.1 to this annual report on Form 20-F.

On April 27, 2006, we amended the Code of Ethics to add a provision to the effect that officers and employees shall respect various stake holders.

**Item 16C. Principal Accountant Fees and Services.**

*Independent Auditor Fees and Services*

The Board of Directors engaged Deloitte Touche Tohmatsu to perform an annual audit of our financial statements for each of the fiscal years ended March 31, 2005 and 2006. The following table sets forth the aggregate fees billed for services rendered by Deloitte Touche Tohmatsu for each of the last two fiscal years.

	<b>Fiscal year ended March 31,</b>	
	<b>2005</b>	<b>2006</b>
	(millions of yen)	
Audit fees <sup>(1)</sup>	74	80
Audit-related fees <sup>(2)</sup>	—	—
Tax fees <sup>(3)</sup>	0	—
All other fees <sup>(4)</sup>	<u>35</u>	<u>4</u>
<i>Total fees</i>	<u>109</u>	<u>84</u>

- (1) These are the aggregate fees billed for the fiscal year for professional services rendered by Deloitte Touche Tohmatsu for the audit of our annual financial statements and services that are normally provided in connection with statutory and regulatory filings or engagements for those fiscal years.
- (2) These are the aggregate fees billed for the fiscal year for assurance and related services by Deloitte Touche Tohmatsu that are reasonably related to the performance of the audit or review of our financial statements other than those reported under “Audit Fees” above. These services include internal control reviews and consultation concerning financial accounting and reporting standards.
- (3) These are the aggregate fees billed for the fiscal year for professional services rendered by Deloitte Touche Tohmatsu for tax compliance, tax advice and tax planning.
- (4) These are the aggregate fees for the fiscal year for all other products and services provided by Deloitte Touche Tohmatsu including consultation services related to the Sarbanes Oxley Act of 2002 and the Privacy Mark System being instituted by The Japan Information Processing Development Center.

### ***Board of Statutory Auditors Pre-Approval Policies and Procedures***

The Board of Statutory Auditors has adopted policies and procedures for pre-approving all audit and permissible non-audit work performed by independent registered public accounting firm in accordance with Rule 2-01(c)(7)(i)(B) under Regulation S-X. Under those policies and procedures, the Board of Statutory Auditors must pre-approve individual audit and non-audit services to be provided to us by our independent registered public accounting firm and its affiliates. Those policies and procedures also describe prohibited non-audit services that may never be provided by independent registered public accounting firm.

All of the services provided by our independent registered public accounting firm from May 6, 2003, when our pre-approval policies went into effect, through the end of the fiscal year ended March 31, 2006 were pre-approved by the Board of Statutory Auditors pursuant to the pre-approval policies described above, and none of such services were approved pursuant to the procedures described in Rule 2-01(c)(7)(i)(C) of Regulation S-X, which waives the general requirement for pre-approval in certain circumstances.

### **Item 16D. Exemptions from the Listing Standards for Audit Committees.**

With respect to the requirements of Rule 10A-3 under the Securities Exchange Act of 1934 relating to listed company audit committees, which apply to us through Rules 4350(d)(3) and 4350(d)(2)(A)(ii) of the NASD Manual, we rely on an exemption provided by paragraph (c)(3) of that Rule available to foreign private issuers with boards of statutory auditors meeting certain requirements. For a Nasdaq-listed Japanese company with a board of statutory auditors, the requirements for relying on paragraph (c)(3) of Rule 10A-3 are as follows:

- The board of statutory auditors must be established, and its members must be selected, pursuant to Japanese law expressly requiring such a board for Japanese companies that elect to have a corporate governance system with statutory auditors,
- Japanese law must and does require the board of statutory auditors to be separate from the board of directors,
- None of the members of the board of statutory auditors may be elected by management, and none of the listed company's executive officers may be a member of the board of statutory auditors,
- Japanese law must and does set forth standards for the independence of the members of the board of statutory auditors from the listed company or its management, and
- The board of statutory auditors, in accordance with Japanese law or the registrant's governing documents, must be responsible, to the extent permitted by Japanese law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by Japanese law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed company, including its principal accountant which audits its consolidated financial statements included in its annual reports on Form 20-F.

To the extent permitted by Japanese law:

- The board of statutory auditors must establish procedures for (i) the receipt, retention and treatment of complaints received by us regarding accounting, internal accounting controls, or

auditing matters, and (ii) the confidential, anonymous submission by our employees of concerns regarding questionable accounting or auditing matters,

- The board of statutory auditors must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties, and
- The listed company must provide for appropriate funding, as determined by its board of statutory auditors, for payment of (i) compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for us, (ii) compensation to any advisers employed by the board of statutory auditors, and (iii) ordinary administrative expenses of the board of statutory auditors that are necessary or appropriate in carrying out its duties.

In our assessment, our Board of Statutory Auditors, which meets the requirements for reliance on the exemption in paragraph (c)(3) of Rule 10A-3 described above, is not materially less effective than an audit committee meeting all the requirements of paragraph (b) of Rule 10A-3 (without relying on any exemption provided by that Rule) at acting independently of management and performing the functions of an audit committee as contemplated therein.

**Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers.**

We did not purchase any of our shares for the fiscal year ended March 31, 2006.

**PART III**

**Item 17. Financial Statements.**

Not applicable.

**Item 18. Financial Statements.**

See Financial Statements for Internet Initiative Japan Inc. and Subsidiaries beginning on page F-1.

**Item 19. Exhibits.**

- 1.1 Articles of Incorporation, as amended (English translation)
- 1.2 Share Handling Regulations, as amended (English translation)
- 1.3 Regulations of the Board of Directors, as amended (English translation)\*
- 1.4 Regulations of the Board of Statutory Auditors, as amended (English translation)\*\*
- 2.1 Specimen Common Stock Certificate\*\*\*
- 2.2 Bylaws of the IIJ Employee Shareholders' Association (with English translation)\*\*\*
- 2.3 Form of Deposit Agreement among IIJ, The Bank of New York as depositary and all owners and holders from time to time of American Depositary Receipts, including the form of American Depositary Receipt\*\*\*\*
- 4.1 Basic Agreement to Delegate Services, dated April 1, 1997, between Internet Initiative Japan Inc. and IIJ Technology Inc. (with English translation)\*\*\*
- 4.2 Shareholders' Agreement Relating to the Establishment of INTERNET MULTIFEED CO., dated August 20, 1997, between Nippon Telegraph and Telephone Corporation and the Registrant (with English translation)\*\*\*
- 4.3 Basic Agreement to Delegate Services, dated April 1, 1998, between Internet Initiative Japan Inc. and Net Care, Inc. (with English translation)\*\*\*
- 4.4 Lease Agreement, dated March 14, 2003, between Internet Initiative Japan Inc. and Mitsui Fudosan

- Co., Ltd. (English translation)\*
- 4.5 Sublease Agreements, dated March 15, 2003, between Internet Initiative Japan Inc., IJ Technology Inc. and Net Care, Inc. (English translations)\*
- 4.6 Pledge Agreement, dated March 14, 2003, among Internet Initiative Japan Inc., IJ Leasing Co., Ltd. and Nissay Leasing Company, Limited (English translation)\*
- 4.7 Joint Venture Agreement, dated January 19, 2006, between Internet Initiative Japan Inc. and Konami Corporation (English translation)
- 4.20 Subscription Agreement, dated September 16, 2003, between Internet Initiative Japan Inc. and Nippon Telegraph and Telephone Corporation (English translation)\*
- 4.21 Service Agreement, dated March 25, 2004, between Internet Initiative Japan Inc. and IJ America Inc.\*\*\*\*\*
- 4.24 Agreement on Limited Liability, dated June 29, 2005 and June 28, 2006, between Internet Initiative Japan Inc. and outside directors and outside statutory auditors\*\*\*\*\*
- 8.1 List of Significant Subsidiaries (See “Our Group Companies” in Item 4.B. of this Form 20-F)
- 11.1 Internet Initiative Japan Code of Conduct
- 12.1 Certification of the principal executive officer required by 17 C.F.R. 240.13a-14(a)
- 12.2 Certification of the principal financial officer required by 17 C.F.R. 240.13a-14(a)
- 13.1 Certification of the chief executive officer required by 18 U.S.C. Section 1350
- 13.2 Certification of the chief financial officer required by 18 U.S.C. Section 1350
- 14.1 Selected unaudited financial statement data as of and for the year ended March 31, 2003 of Crosswave Communications Inc.\*

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(\*) Incorporated by reference to the corresponding exhibit to our annual report on Form 20-F (File No. 0-30204) filed on September 30, 2003.

(\*\*) Incorporated by reference to the corresponding exhibit to our annual report on Form 20-F (File No. 0-30204) filed on August 3, 2005.

(\*\*\*) Incorporated by reference to the corresponding exhibit to our Form F-1 Registration Statement (File No. 333-10584) declared effective on August 3, 1999.

(\*\*\*\*) Incorporated by reference to the Registration Statement on Form F-6 (File No. 333-110862) filed on December 2, 2003.

(\*\*\*\*\*) Incorporated by reference to the corresponding exhibit to our annual report on Form 20-F (File No. 0-30204) filed on July 23, 2004.

(\*\*\*\*\*) We and each of Mr. Yoshifumi Nishikawa and Mr. Junnosuke Furukawa as our outside directors entered into an Agreement on Limited Liability, dated June 29, 2005. We and each of Mr. Yasuro Tanahashi and Mr. Takashi Hiroi as our outside directors and each of Mr. Masaki Okada and Mr. Masaaki Koizumi as our outside statutory auditors entered into an Agreement on Limited Liability, dated June 28, 2006.

Except for Exhibit 2.3, we have not included as exhibits certain instruments with respect to our long-term debt. Except for Exhibit 2.3, the amount of debt authorized under each long-term debt instrument does not exceed 10% of our total assets. We agree to furnish a copy of any long-term debt instrument to the Commission upon request.

**SIGNATURE**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

Internet Initiative Japan Inc.

By: /s/ Koichi Suzuki

Name: Koichi Suzuki

Title: President, Chief Executive Officer  
and Representative Director

Date: July 11, 2006

**Internet Initiative Japan Inc. and Subsidiaries**

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## **Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of  
Internet Initiative Japan Inc.:

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

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Internet Initiative Japan Inc. and subsidiaries as of March 31, 2005 and 2006 and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

Our audits also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 1. Such U.S. dollar amounts are presented solely for the convenience of readers outside Japan.

/s/ DELOITTE TOUCHE TOHMATSU

Tokyo, Japan

May 26, 2006 (June 28, 2006 as to Note 17)

**Internet Initiative Japan Inc. and Subsidiaries**

**Consolidated Balance Sheets  
March 31, 2005 and 2006**

	Thousands of Yen		Thousands of U.S. Dollars (Note 1)
	2005	2006	2006
<b>ASSETS</b>			
<b>CURRENT ASSETS:</b>			
Cash (Note 15)	¥ 5,286,477	¥13,727,021	\$ 116,846
Accounts receivable, net of allowance for doubtful accounts of ¥41,400 thousand and ¥23,411 thousand (\$199 thousand) at March 31, 2005 and 2006, respectively (Notes 3, 4 and 11)	7,407,439	11,962,304	101,824
Inventories	140,096	851,857	7,251
Prepaid expenses	604,935	1,031,325	8,778
Other current assets, net of allowance for doubtful accounts of ¥33,250 thousand (\$283 thousand) at March 31, 2006 (Notes 3 and 9)	108,228	214,121	1,823
Total current assets	13,547,175	27,786,628	236,522
INVESTMENTS IN AND ADVANCES TO EQUITY METHOD INVESTEES, net of loan loss valuation allowance of ¥31,378 thousand and ¥16,701 thousand (\$142 thousand) at March 31, 2005 and 2006, respectively (Notes 3 and 4)	713,607	1,162,971	9,899
OTHER INVESTMENTS (Notes 2, 8 and 15)	9,930,781	8,020,705	68,273
PROPERTY AND EQUIPMENT—Net (Notes 5 and 7)	9,722,366	10,299,496	87,670
INTANGIBLE ASSETS—Net (Note 6)	561,211	632,594	5,385
GUARANTEE DEPOSITS (Notes 7 and 8)	2,050,665	1,549,653	13,191
OTHER ASSETS, net of allowance for doubtful accounts of ¥376,092 thousand and ¥40,980 thousand (\$349 thousand) at March 31, 2005 and 2006 respectively (Notes 3, 9, 10 and 15)	590,666	1,252,942	10,665
<b>TOTAL</b>	<b>¥37,116,471</b>	<b>¥50,704,989</b>	<b>\$ 431,605</b>

(Continued)

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Balance Sheets  
March 31, 2005 and 2006

	Thousands of Yen		Thousands of U.S. Dollars (Note 1)
	2005	2006	2006
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>CURRENT LIABILITIES:</b>			
Short-term borrowings (Note 8)	¥ 4,724,633	¥ 4,555,000	\$ 38,772
Long-term borrowings—current portion (Notes 8 and 15)	2,736,056	1,989,963	16,939
Payable under securities loan agreement (Note 8)	1,729,520	999,600	8,509
Capital lease obligations—current portion (Note 7)	2,774,974	3,003,914	25,569
Accounts payable (Notes 4 and 11)	4,860,733	10,107,942	86,040
Accrued expenses	541,118	540,027	4,597
Other current liabilities	817,517	1,702,208	14,489
Total current liabilities	18,184,551	22,898,654	194,915
LONG-TERM BORROWINGS (Notes 8 and 15)	1,529,963	290,000	2,469
CAPITAL LEASE OBLIGATIONS—Noncurrent (Note 7)	4,339,028	4,980,659	42,396
ACCRUED RETIREMENT AND PENSION COSTS (Note 10)	143,346	223,332	1,901
OTHER NONCURRENT LIABILITIES (Note 9)	275,533	827,086	7,040
Total liabilities	24,472,421	29,219,731	248,721
MINORITY INTEREST	1,028,977	1,263,320	10,753
<b>COMMITMENTS AND CONTINGENCIES (Note 14)</b>			
<b>SHAREHOLDERS' EQUITY (Notes 11 and 12):</b>			
Common stock—authorized, 377,600 shares; issued and outstanding, 191,800 shares at March 31, 2005, authorized, 377,600 shares; issued and outstanding, 204,300 shares at March 31, 2006	13,765,372	16,833,847	143,291
Additional paid-in capital	23,637,628	26,599,217	226,415
Accumulated deficit	(34,434,052)	(29,680,482)	(252,643)
Accumulated other comprehensive income	8,690,125	6,553,594	55,785
Treasury stock—602 shares and 777 shares held by an equity method investee at March 31, 2005 and 2006, respectively	(44,000)	(84,238)	(717)
Total shareholders' equity	11,615,073	20,221,938	172,131
<b>TOTAL</b>	<b>¥ 37,116,471</b>	<b>¥ 50,704,989</b>	<b>\$ 431,605</b>

See notes to consolidated financial statements.

(Concluded)

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Statements of Operations  
Three Years in the Period Ended March 31, 2006

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2004	2005	2006	2006
<b>REVENUES (Notes 4 and 11):</b>				
Connectivity and value-added services:				
Dedicated access	¥12,862,132	¥11,372,701	¥10,625,268	\$ 90,443
Dial-up access	3,088,498	2,936,973	2,673,808	22,760
Value-added services	4,296,228	5,004,730	6,249,891	53,200
Other	2,117,794	3,169,413	3,673,872	31,272
Total	22,364,652	22,483,817	23,222,839	197,675
Systems integration	11,847,687	15,853,824	23,504,537	200,072
Equipment sales	4,567,123	3,364,926	3,085,208	26,262
 Total revenues	 38,779,462	 41,702,567	 49,812,584	 424,009
<b>COST AND EXPENSES (Notes 4, 7 and 11):</b>				
Cost of connectivity and value-added services	20,047,438	19,483,890	20,077,990	170,906
Cost of systems integration	9,851,726	12,200,137	18,120,418	154,243
Cost of equipment sales	4,346,243	3,111,369	2,818,036	23,987
Total cost	34,245,407	34,795,396	41,016,444	349,136
Sales and marketing (Note 16)	3,527,490	2,794,561	3,079,526	26,213
General and administrative (Note 6)	2,098,481	2,665,980	3,147,315	26,790
Research and development	357,968	198,979	158,155	1,346
 Total cost and expenses	 40,229,346	 40,454,916	 47,401,440	 403,485
<b>OPERATING INCOME (LOSS)</b>	<b>(1,449,884)</b>	<b>1,247,651</b>	<b>2,411,144</b>	<b>20,524</b>
<b>OTHER INCOME (EXPENSES):</b>				
Interest income	37,516	12,877	13,099	111
Interest expense	(702,036)	(685,857)	(437,364)	(3,723)
Foreign exchange gains (losses)	(6,493)	5,958	3,470	30
Net gain on other investments (Note 2)	1,412,858	2,439,330	3,197,690	27,219
Gain arising from issuance of equity method investee's share	16,088	25,933	—	—
Other—net	224,287	102,616	190,520	1,622
 Other income—net	 982,220	 1,900,857	 2,967,415	 25,259
<b>INCOME (LOSS) FROM OPERATIONS BEFORE INCOME TAX EXPENSE, MINORITY INTERESTS AND EQUITY IN NET LOSS OF EQUITY METHOD INVESTEEES</b>	<b>(467,664)</b>	<b>3,148,508</b>	<b>5,378,559</b>	<b>45,783</b>
<b>INCOME TAX EXPENSE (Note 9)</b>	<b>32,536</b>	<b>99,870</b>	<b>257,360</b>	<b>2,191</b>
<b>MINORITY INTERESTS IN (EARNINGS) LOSSES OF SUBSIDIARIES</b>	<b>235,812</b>	<b>(109,161)</b>	<b>(353,883)</b>	<b>(3,012)</b>
<b>FORWARD</b>	<b>¥ (264,388)</b>	<b>¥ 2,939,477</b>	<b>¥ 4,767,316</b>	<b>\$ 40,580</b>

(Continued)

**Internet Initiative Japan Inc. and Subsidiaries**  
**Consolidated Statements of Operations**  
**Three Years in the Period Ended March 31, 2006**

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2004	2005	2006	2006
<b>FORWARD</b>	<u>¥ (264,388)</u>	<u>¥2,939,477</u>	<u>¥4,767,316</u>	<u>\$ 40,580</u>
<b>EQUITY IN NET LOSS OF EQUITY METHOD INVESTEES (Note 4):</b>				
Equity method net loss	(286,317)	(33,208)	(13,746)	(117)
Impairment loss on advance to Crosswave	<u>(1,719,981)</u>	<u>—</u>	<u>—</u>	<u>—</u>
<b>Total equity in net loss of equity method investees</b>	<u>(2,006,298)</u>	<u>(33,208)</u>	<u>(13,746)</u>	<u>(117)</u>
<b>NET INCOME (LOSS)</b>	<u>¥(2,270,686)</u>	<u>¥2,906,269</u>	<u>¥4,753,570</u>	<u>\$ 40,463</u>
<b>NET INCOME PER SHARE (Note 13):</b>				
<b>BASIC WEIGHTED-AVERAGE NUMBER OF COMMON SHARES OUTSTANDING</b>	158,554	191,559	195,613	
<b>DILUTED WEIGHTED-AVERAGE NUMBER OF COMMON SHARES OUTSTANDING</b>	158,554	191,559	195,955	
		Yen		U.S. Dollars
<b>BASIC NET INCOME (LOSS) PER COMMON SHARE</b>	<u>¥(14,321)</u>	<u>¥15,172</u>	<u>¥24,301</u>	<u>\$ 207</u>
<b>DILUTED NET INCOME (LOSS) PER COMMON SHARE</b>	<u>¥(14,321)</u>	<u>¥15,172</u>	<u>¥24,258</u>	<u>\$ 206</u>

See notes to consolidated financial statements.

(Concluded)

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Statements of Shareholders' Equity  
Three Years in the Period Ended March 31, 2006

	Thousands of Yen						
	Shares of Common Stock Outstanding (Including Treasury Stock)	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Note 12)	Treasury Stock	Total
BALANCE, APRIL 1, 2003	112,400	¥ 7,082,336	¥17,068,353	¥(35,069,635)	¥ 914,610		¥(10,004,336)
Net loss				(2,270,686)			(2,270,686)
Other comprehensive income, net of tax					5,280,839		5,280,839
Total comprehensive income							3,010,153
Issuance of common stock, net of issuance cost	79,400	6,683,036	6,569,275				13,252,311
Purchase of common stock by an equity method investee						¥(44,000)	(44,000)
BALANCE, MARCH 31, 2004	191,800	13,765,372	23,637,628	(37,340,321)	6,195,449	(44,000)	6,214,128
Net income				2,906,269			2,906,269
Other comprehensive income, net of tax					2,494,676		2,494,676
Total comprehensive income							5,400,945
BALANCE, MARCH 31, 2005	191,800	13,765,372	23,637,628	(34,434,052)	8,690,125	(44,000)	11,615,073
Net income				4,753,570			4,753,570
Other comprehensive loss, net of tax					(2,136,531)		(2,136,531)
Total comprehensive income							2,617,039
Issuance of common stock, net of issuance cost	12,500	3,068,475	2,961,589				6,030,064
Purchase of common stock by an equity method investee						(40,238)	(40,238)
BALANCE, MARCH 31, 2006	<u>204,300</u>	<u>¥16,833,847</u>	<u>¥26,599,217</u>	<u>¥(29,680,482)</u>	<u>¥ 6,553,594</u>	<u>¥(84,238)</u>	<u>¥ 20,221,938</u>

	Thousands of U.S. Dollars (Note 1)						
	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Note 12)	Treasury Stock	Total	
BALANCE, MARCH 31, 2005	\$117,172	\$201,206	\$ (293,106)	\$ 73,971	\$ (375)	\$ 98,868	
Net income			40,463			40,463	
Other comprehensive loss, net of tax				(18,186)		(18,186)	
Total comprehensive income						22,277	
Issuance of common stock, net of issuance cost	26,119	25,209				51,328	
Purchase of common stock by an equity method investee					(342)	(342)	
BALANCE, MARCH 31, 2006	<u>\$143,291</u>	<u>\$226,415</u>	<u>\$ (252,643)</u>	<u>\$ 55,785</u>	<u>\$ (717)</u>	<u>\$172,131</u>	

See notes to consolidated financial statements.

**Internet Initiative Japan Inc. and Subsidiaries**

**Consolidated Statements of Cash Flows  
Three Years in the Period Ended March 31, 2006**

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2004	2005	2006	2006
<b>OPERATING ACTIVITIES:</b>				
Net income (loss)	¥(2,270,686)	¥ 2,906,269	¥ 4,753,570	\$ 40,463
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	4,008,324	4,193,093	4,209,037	35,828
Provision for retirement and pension costs, less payments	(16,960)	70,659	76,095	648
Provision for (reversal of) allowance for doubtful accounts and advances	449,164	24,781	(12,009)	(102)
Loss on disposal of property and equipment	109,588	143,887	118,855	1,012
Loss on disposal and impairment of telephone rights	48,201	99,075	2,040	17
Net gain on other investments	(1,412,858)	(2,439,330)	(3,197,690)	(27,219)
Foreign exchange losses (gains)	5,124	(15,466)	(7,825)	(67)
Gain arising from issuance of equity method investee's share	(16,088)	(25,933)	—	—
Loss (gains) on retirement of convertible notes	(88,975)	5,195	—	—
Equity method net loss	286,317	33,208	13,746	117
Impairment loss on advance to Crosswave	1,719,981	—	—	—
Minority interests in earnings (losses) of subsidiaries	(235,812)	109,161	353,883	3,012
Deferred income tax expense (benefit)	1,976	(11,023)	(230,841)	(1,965)
Others	38,539	79,247	18,490	157
Changes in operating assets and liabilities:				
Decrease (increase) in accounts receivable	784,728	1,607,692	(4,460,173)	(37,965)
Decrease (increase) in inventories, prepaid expenses and other current and noncurrent assets	(275,103)	228,358	(1,390,398)	(11,835)
Increase (decrease) in accounts payable	(1,132,209)	(2,307,729)	4,975,623	42,353
Increase in income taxes payable	2,041	97,913	334,854	2,850
Increase (decrease) in accrued expenses and other current and noncurrent liabilities	(81,926)	439,440	1,001,567	8,526
Net cash provided by operating activities—(Forward)	<u>¥ 1,923,366</u>	<u>¥ 5,238,497</u>	<u>¥ 6,558,824</u>	<u>\$ 55,830</u>

(Continued)

**Internet Initiative Japan Inc. and Subsidiaries**

**Consolidated Statements of Cash Flows  
Three Years in the Period Ended March 31, 2006**

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2004	2005	2006	2006
Net cash provided by operating activities—(Forward)	¥ 1,923,366	¥ 5,238,497	¥ 6,558,824	\$ 55,830
<b>INVESTING ACTIVITIES:</b>				
Purchases of property and equipment	(1,657,302)	(577,133)	(919,366)	(7,826)
Purchase of short-term and other investments	(325,665)	(12,566)	(674,569)	(5,742)
Investment in an equity method investee	—	—	(750,000)	(6,384)
Purchase of subsidiary stock from minority shareholders	—	(61,680)	(192,142)	(1,635)
Proceeds from sales and redemption of short-term and other investments	2,170,584	2,976,017	3,613,239	30,756
Advance to Crosswave	(1,719,981)	—	—	—
Payments of guarantee deposits	(9,114)	(48,683)	(62,074)	(528)
Refund of guarantee deposits	683,132	71,850	568,869	4,842
Payment for refundable insurance policies	(21,007)	(25,231)	(25,917)	(221)
Refund from insurance policies	7,432	18,348	6,301	54
Acquisition of a newly controlled company, net of cash acquired	—	—	229,457	1,953
Acquisition of business	—	(375,123)	—	—
Other	19,458	8,204	11,052	94
Net cash provided by (used in) investing activities	(852,463)	1,974,003	1,804,850	15,363
<b>FINANCING ACTIVITIES:</b>				
Proceeds from issuance of long-term borrowings	400,000	2,250,000	1,000,000	8,512
Repayments of long-term borrowings	(1,943,735)	(1,840,246)	(2,986,056)	(25,418)
Proceeds from securities loan agreement	—	2,546,320	4,897,040	41,684
Repayments of securities loan agreement	—	(816,800)	(5,626,960)	(47,897)
Principal payments under capital leases	(2,733,012)	(2,867,625)	(3,105,519)	(26,434)
Net increase (decrease) in short-term borrowings	1,740,495	(1,839,460)	(169,633)	(1,444)
Repurchase of convertible notes	(3,047,460)	(745,488)	—	—
Redemption of convertible notes	—	(11,088,000)	—	—
Proceeds from issuance of common stock, net of issuance cost	13,252,311	—	6,030,064	51,328
Proceeds from issuance of subsidiary stock to minority shareholders	—	188,632	—	—
Net cash provided by (used in) financing activities	7,668,599	(14,212,667)	38,936	331
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(43,615)	2,405	37,934	323
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	8,695,887	(6,997,762)	8,440,544	71,847
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	3,588,352	12,284,239	5,286,477	44,999
CASH AND CASH EQUIVALENTS, END OF YEAR	¥12,284,239	¥ 5,286,477	¥13,727,021	\$ 116,846

(Continued)

**Internet Initiative Japan Inc. and Subsidiaries**

**Consolidated Statements of Cash Flows  
Three Years in the Period Ended March 31, 2006**

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2004	2005	2006	2006
<b>ADDITIONAL CASH FLOW INFORMATION:</b>				
Interest paid	¥ 625,248	¥ 613,817	¥ 426,692	\$ 3,632
Income taxes paid	48,413	29,227	148,101	1,261
<b>NONCASH INVESTING AND FINANCING ACTIVITIES:</b>				
Acquisition of assets by entering into capital leases	1,865,309	4,433,906	3,842,952	32,712
Exchange of common stock investment due to merger:				
Market value of common shares acquired	—	37,950	7,390	63
Cost of investment	—	2,500	2,584	22
Acquisition of business and a company:				
Assets acquired	—	1,202,007	843,485	7,180
Cash paid	—	(375,123)	(733,589)	(6,244)
Liabilities assumed	—	826,884	109,896	936

See notes to consolidated financial statements.

(Concluded)

## **Internet Initiative Japan Inc. and Subsidiaries**

### **Notes to Consolidated Financial Statements**

#### **1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Internet Initiative Japan Inc. (“IIJ,” a Japanese corporation) was founded in December 1992 to develop and operate Internet access services and other Internet-related services in Japan and is 29.7 percent jointly owned by Nippon Telegraph and Telephone Corporation (“NTT”) and its subsidiary as of March 31, 2006. IIJ and subsidiaries (collectively, the “Company”) provide Internet access services throughout Japan and into the United States of America and the rest of Asia. The Company also provides Internet systems design and integration representing principally sales of Internet network systems and equipment and miscellaneous Internet access-related services.

The Company manages its business and measures results based on a single Internet-related services industry segment. Substantially all revenues are from customers operating in Japan.

The accompanying consolidated financial statements have been prepared on a going-concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Although the Company has incurred operating losses and net losses in each of the past six fiscal years ended March 31, 2004 (with the exception of operating income for the year ended March 31, 2002), the Company has recorded operating income and net income for the years ended March 31, 2005 and 2006. At March 31, 2006, the Company had indebtedness of ¥15,819,136 thousand. As a result of increasing net income, liquidation of certain available-for-sale securities and completion of a public offering of ¥6,030,064 thousand (after deducting stock issuance cost) on the Mothers market of the Tokyo Stock Exchange, the negative working capital of ¥4,637,376 thousand at March 31, 2005 turned positive in the amount of ¥4,887,974 thousand at March 31, 2006.

#### **Certain Significant Risks and Uncertainties—**

The Company has available-for-sale securities of ¥6,775,388 thousand at March 31, 2006 and believes that the fluctuations in stock price of available-for-sale securities could have a material adverse effect on the Company’s future financial position, results of operations or cash flows.

The Company relies on telecommunications carriers for significant portion of network backbone, and regional NTT subsidiaries, electric power companies and their affiliates for local connections to customers. Currently, NTT Communications is the largest provider of network infrastructure. The Company believes that its use of multiple carriers and suppliers significantly mitigates concentrations of credit risk. However, any disruption of telecommunication services could have an adverse effect on operating results.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments, accounts receivable and guarantee deposits. The Company’s management believes that the risks associated with accounts receivable is mitigated by the large number of customers comprising its customer base.

## Summary of Significant Accounting Policies

**Basis of Presentation**—IIJ maintains its record in accordance with generally accepted accounting principles in Japan. Certain adjustment and reclassifications have been incorporated in the accompanying consolidated financial statements to conform to generally accepted accounting principles in the United States of America (“U.S. GAAP”). These adjustments were not recorded in the statutory accounts.

Certain reclassifications have been made to prior periods to conform to the current year presentation.

**Translation into U.S. Dollars**—IIJ maintains its accounts in Japanese yen, the currency of the country in which it is incorporated and principally operates. The U.S. dollar amounts included herein represent a translation using the noon buying rate in New York City for cable transfers in yen as certified for customs purposes by the Federal Reserve Bank of New York at March 31, 2006 of ¥ 117.48 = \$1 solely for the convenience of the reader. The translation should not be construed as a representation that the yen amounts have been, could have been, or could in the future be converted into U.S. dollars.

**Consolidation**—The consolidated financial statements include the accounts of IIJ and all of its subsidiaries, Net Care, Inc. (“Net Care”), IIJ Technology Inc. (“IIJ Technology”), IIJ Media Communications Inc. (“MC”), which was merged with IIJ on October 1, 2005, IIJ America, Inc. (“IIJ America”) and IIJ Financial Systems Inc. (“IIJ FS”), which have fiscal years ending March 31, except for IIJ America. IIJ America’s fiscal year end is December 31 and such date was used for purposes of preparing the consolidated financial statements as it is not practicable for the subsidiary to report its financial results as of March 31.

There were no significant events that occurred during the intervening period that would require adjustment to or disclosure in the accompanying consolidated financial statements. Significant intercompany transactions and balances have been eliminated in consolidation. Investments in companies over which IIJ has significant influence but not control are accounted for by the equity method. For other than a temporary decline in the value of investments in equity method investees below the carrying amount, the investment is reduced to fair value and an impairment loss is recognized.

A subsidiary or equity method investee may issue its shares to third parties at amounts per share in excess of or less than the Company’s average per share carrying value. With respect to such transactions, the resulting gains or losses arising from the change in ownership are recorded in income for the year in which such shares are issued.

**Use of Estimates**—The preparation of financial statements in conformity with generally accepted accounting principles 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 reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions used are primarily in the areas of impairment loss on advances to equity method investees, valuation allowances for deferred tax assets, allowance for doubtful accounts, and estimated useful lives of fixed assets. Actual results could differ from those estimates.

**Revenue Recognition**—Revenues from customer connectivity services consist principally of dedicated Internet access services and dial-up Internet access services. Dedicated Internet access services represent full-line IP services and standard-level IP services (T1 Standard and IIJ FiberAccess/F Service). Dial-up Internet access services are provided to both enterprises and individuals (IIJ4U). The term of these contracts is one year for dedicated Internet access services and generally one month for dial-up Internet access services. All these services are billed and recognized monthly on a straight-line basis.

Value-added service revenues consist principally of sales of various Internet access-related services such as firewalls services. Value-added services also include monthly fees from data center services such as housing, monitoring and security services. Other revenues under connectivity and value-added services consist principally of Wide-area Ethernet services and call-center customer support. The terms of these services are generally for one year and revenues are recognized on a straight-line basis during the service period.

Initial set up fees received in connection with connectivity services and value-added services are deferred and recognized over the contract period.

Systems integration revenues consist principally of the development of Internet network systems or design and related maintenance, monitoring and other operating services. The period for the development of the systems or designs is less than one year and revenues are recognized when network systems and equipment are delivered and accepted by the customer. The development of the Internet network systems or design includes multiple element arrangements such as planning, systems design, and construction services, and equipment and software purchased from third parties. When the equipment or system is delivered prior to other elements of the arrangement, revenue is deferred until other service elements are completed and accepted by the customer. Maintenance, monitoring and operating service revenues are recognized ratably over the separate contract period, which is generally for one year.

Systems integration service is subject to the Emerging Issues Task Force (“EITF”) Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables” which was adopted as of April 1, 2004. The adoption of EITF No. 00-21 did not have any effect on the consolidated financial statements.

Equipment sales are reported on a gross or net basis in accordance with EITF Issue No. 99-19 “Reporting Revenue Gross as a Principal versus Net as an Agent”. Revenues are recognized when equipments are delivered and accepted by the customer.

**Cash and cash equivalents**—Cash and cash equivalents include time deposits and readily marketable securities with original maturities of three months or less.

**Allowance for Doubtful Accounts**—An allowance for doubtful accounts is established in amounts considered to be appropriate based primarily upon the Company’s past credit loss experience and an evaluation of potential losses in the receivables outstanding.

**Other Investments**—In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” all marketable equity securities are classified as available-for-sale securities, which are accounted for at fair value with unrealized gains and losses excluded from earnings and reported in accumulated other comprehensive income (loss). The cost of securities sold is determined based on average cost.

The Company reviews the fair value of available-for-sale investments on a regular basis to determine if the fair value of any individual investment has declined below its cost and if such decline is other than temporary. If the decline in value is judged to be other than temporary, the cost basis of the investment is written down to fair value. Other than temporary declines in value are determined taking into consideration the extent of decline in fair value, the length of time that the decline in fair value below cost has existed and events that might accelerate the recognition of impairment. The resulting realized loss is included in the consolidated statements of operations in the period in which the decline was deemed to be other than temporary.

Non-marketable equity securities are carried at cost as fair value is not readily determinable. If the value of a security is estimated to have declined and such decline is judged to be other than temporary, the security is written down to the fair value. Determination of impairment is based on the consideration of such factors as operating results, business plans and change in the regulatory, economic or technological environment of the investees. Fair value is determined as the Company’s interest in the net assets of investees.

**Inventories**—Inventories consist mainly of network equipment purchased for resale and work-in-process for development of Internet network systems. Network equipment purchased for resale is stated at the lower of cost, which is determined by the average-cost method, or market. Work-in-process for development of network systems is stated at the lower of actual production costs, including overhead cost, or market. Inventories are reviewed periodically and items considered to be slow-moving or obsolete are written down to their estimated net realizable value.

**Leases**—Capital leases, which meet specific criteria noted in SFAS No.13, “Accounting for Leases”, are capitalized at the inception of the lease at the present value of the minimum lease payments. All other leases are accounted for as operating leases. Lease payments for capital leases are apportioned to interest expense and a reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Operating lease payments are recognized as an expense on a straight-line basis over the lease term.

**Property and Equipment**—Property and equipment are recorded at cost. Depreciation and amortization of property and equipment, including purchased software and capitalized leases, are computed principally using the straight-line method based on either the estimated useful lives of assets or the lease period, whichever is shorter.

The useful lives for depreciation and amortization by major asset classes are as follows:

	Range of Useful Lives
Data communications, office and other equipment	2 to 15 years
Leasehold improvements	3 to 15 years
Purchased software	5 years
Capitalized leases	4 to 7 years

**Impairment of Long-lived Assets**—Long-lived assets consist principally of property and equipment, including those items leased under capital leases. The Company evaluates the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”. There were no impairment losses for long-lived assets for the three years in the period ended March 31, 2006.

**Goodwill and Intangible Assets**—In accordance with SFAS No. 142, “Goodwill and Other Intangible Assets”, goodwill (including equity-method goodwill) and intangible assets that are deemed to have indefinite useful lives are not amortized, but are subject to impairment testing. Impairment testing is performed annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company performs annual impairment tests on March 31.

**Pension and severance indemnities plans**—The Company has pension plans and /or severance indemnities plans. The cost of the pension plans and severance indemnities plans are accrued based on amounts determined using actuarial methods, in accordance with SFAS No. 87, “Employers’ Accounting for Pensions”.

**Income Taxes**—The provision for income taxes is based on earnings before income taxes and includes the effects of temporary differences between assets and liabilities recognized for financial reporting purposes and income tax purposes and operating loss carryforwards. Valuation allowances are provided against assets that are not likely to be realized.

**Foreign Currency Transactions**—Foreign currency assets and liabilities, which consist substantially of cash and accounts payable for connectivity leases to international carriers denominated in U.S. dollars, are stated at the amount as computed by using year-end exchange rates and the resulting transaction gain or loss is recognized in earnings.

**Derivative Financial Instruments**—All derivatives are recorded at fair value as either asset or liabilities in the balance sheet in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended by SFAS No. 138 and No. 149 (collectively, “SFAS No. 133”). In accordance with SFAS No. 133, the Company designated interest swap contracts as a hedge of the variability of cash flows to be paid related to interest on floating rate borrowings (cash flow hedge) and the effective portion of the derivative’s gain or loss is initially reported as a component of other comprehensive income and subsequently reclassified into earnings when the underlying transaction affects earnings. The ineffective portion of the gain or loss is reported in earning immediately. The Company enters into contracts to hedge interest rate risks and does not enter into contracts or utilize derivatives for trading purposes. For transactions which occurred after July 1, 2003, the Company adopted SFAS No. 149. The adoption of SFAS No.149 had no effect on the Company’s consolidated financial position or result of operation.

**Stock Splits**—On August 4, 2005, IIJ’s board of directors approved a five-for-one split of IIJ’s common stock. Shareholders of record on August 31, 2005 received an additional common share. The stock split was effective on October 11, 2005. In order to reflect this split, information pertaining to shares, earnings per share and issue price per share during the year ended March 31, 2004, has been restated in the accompanying financial statements and related notes.

**Stock-based Compensation**—The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion (“APB”) No. 25 (“APB No. 25”), “Accounting for Stock Issued to Employees” and related interpretations. Accordingly, the Company recognizes compensation expense in an amount equal to the excess of the quoted market price over the exercise price of the option at the grant date. For options with a vesting period, the compensation expense is charged to operations ratably over the vesting period. The Company has not recognized any stock-based compensation expense for the years ended March 31, 2004, 2005 and 2006.

In accordance with SFAS No. 123, “Accounting for Stock-Based Compensation,” (“SFAS No. 123”) as amended by SFAS No. 148, “Accounting for Stock-Based Compensation—Transition and Disclosure,” the following pro forma net income (loss) and income (loss) per share information for the years ended March 31, 2004, 2005 and 2006, including the effects of fair values associated with the warrants of IIJ Technology is presented as if the Company accounted for its stock options using the fair value method. Under the fair value method, the estimated fair value of the stock options is charged against income on a straight-line basis over the options’ vesting period:

	Thousands of Yen			Thousands of U.S. Dollars
	2004	2005	2006	2006
<b>Net income (loss):</b>				
As reported	¥(2,270,686)	¥2,906,269	¥4,753,570	\$ 40,463
Addition: Total stock-based employee compensation determined under fair value based method for all awards, net of tax	(32,020)	—	—	—
<b>Pro forma</b>	<b>¥(2,302,706)</b>	<b>¥2,906,269</b>	<b>¥4,753,570</b>	<b>\$ 40,463</b>
	2004	Yen 2005	2006	U.S. Dollars 2006
<b>Basic net income (loss) per common shares:</b>				
As reported	¥(14,321)	¥15,172	¥24,301	\$ 207
Pro forma	(14,523)	15,172	24,301	207
	2004	Yen 2005	2006	U.S. Dollars 2006
<b>Diluted net income (loss) per common shares:</b>				
As reported	¥(14,321)	¥15,172	¥24,258	\$ 206
Pro forma	(14,523)	15,172	24,258	206

**Research and developments**—Research and development costs are expensed as incurred.

**Advertising**—Advertising costs are expensed as incurred.

**Basic and Diluted Net Income (Loss) per Share**—Basic net income (loss) per share is computed by dividing net income (loss) by the weighted-average number of shares of common stock outstanding during the year. Diluted net income (loss) per share reflects the potential dilutive effect of stock options and convertible bonds.

**Other Comprehensive Income (Loss)**—Other comprehensive income (loss) consists of translation

adjustments resulting from the translation of financial statements of a foreign subsidiary, unrealized gains or losses on available-for-sale securities and gains or losses on cash flow hedging derivative instruments.

**Segment Reporting** —SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information,” establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise that engages in business activities from which it may earn revenues and incur expense and for which separate financial information is available that is evaluated regularly by the chief operation decision maker in deciding how to allocate resources and in assessing performance.

The Company provides a comprehensive range of network solutions to meet its customers’ needs by cross-selling a variety of services, including Internet connectivity services, value-added services, systems integration and sales of network-related equipment. The Company’s chief operating decision maker, who is the Company’s Chief Executive Officer, regularly reviews the revenue and cost of sales on a consolidated basis and makes decisions regarding how to allocate resources and assess performance based on a single operating unit.

**New Accounting Standards—**

In December 2004, the FASB issued revised SFAS No. 123 (Revised 2004), “Share-Based Payment” (“SFAS No. 123R”) which replaces the existing SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires compensation expense for stock options and other share-based payment to be measured and recorded based on the instruments’ fair value. SFAS No. 123R is effective for the fiscal period beginning after June 15, 2005. The Company will adopt SFAS No. 123R and the related FASB Staff Positions (“FSP”) on April 1, 2006 by using modified prospective application, which requires recognizing expenses for options granted prior to the adoption date equal to the fair value of unvested amounts over the remaining vesting period. The portion of these options’ fair value attributable to vested awards prior to the adoption of SFAS No. 123R is never recognized. As all existing granted stock-based awards of the Company have vested, the adoption of SFAS No. 123R will not have any impact on the Company’s consolidated financial position or results of operations.

In November 2005, the FASB issued FSP No. 115-1 and No. 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” on the basis of the EITF’s consensus on Issue 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”. FSP No. 115-1 and No. 124-1 addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. FSP No. 115-1 and No. 124-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP No. 115-1 and No. 124-1 is effective for reporting periods beginning after December 15, 2005. The adoption of FSP No. 115-1 and No. 124-1 did not have a material effect on the Company’s financial position or results of operations.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs—an amendment of ARB No. 43, Chapter 4” (“SFAS No. 151”) which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and also requires that the allocation of fixed production overhead be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 will not have a material impact on the Company’s consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Nonmonetary Assets—amendment of APB Opinion No. 29” (“SFAS No. 153”). The statement addresses the measurement of exchanges of nonmonetary assets and eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material impact on the Company’s consolidated financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections—a replacement of APB opinion No. 20 and SFAS No. 3” (“SFAS No. 154”). SFAS No. 154 requires that changes in accounting principle are retrospectively applied by applying the new accounting principle as of the beginning of the first period presented as if that principle had always been used, although APB opinion No. 20 required that changes in accounting principle are applied cumulatively in the period of change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In July 2005, the FASB issued FSP APB No.18-1, “Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence” (“FSP APB No. 18-1”). FSP APB No. 18-1 requires that an investor’s proportionate share of an investee’s equity adjustments for other comprehensive income is offset against the carrying value of the investment at the time significant influence is lost. FSP APB No. 18-1 is effective for reporting periods beginning after July 12, 2005. The adoption of FSP APB No. 18-1 did not have a material impact on the Company’s consolidated financial position or results of operations.

## 2. OTHER INVESTMENTS

Pursuant to SFAS No. 115, all of the Company's marketable equity securities were classified as available-for-sale securities. Information regarding the securities classified as available-for-sale at March 31, 2005 and 2006 is as follows:

	Thousands of Yen			
	Cost	Unrealized Gains	Unrealized Losses	Fair Value
March 31, 2005				
Available-for-sale—Equity securities	<u>¥215,258</u>	<u>¥8,738,792</u>	<u>¥ 5,882</u>	<u>¥8,948,168</u>
March 31, 2006				
Available-for-sale—Equity securities	<u>¥222,807</u>	<u>¥6,552,623</u>	<u>¥ 42</u>	<u>¥6,775,388</u>
	Thousands of U.S. Dollars			
	Cost	Unrealized Gains	Unrealized Losses	Fair Value
March 31, 2006				
Available-for-sale—Equity securities	<u>\$ 1,897</u>	<u>\$ 55,776</u>	<u>\$ 0</u>	<u>\$ 57,673</u>

The following table provides the fair value and gross unrealized losses of the Company's investments, which have been deemed to be temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of March 31, 2005 and 2006:

	Thousands of Yen					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2005						
Marketable equity securities	¥ 68,742	¥ 5,882	¥ —	¥ —	¥ 68,742	¥ 5,882
March 31, 2006						
Marketable equity securities	¥ 1,338	¥ 42	¥ —	¥ —	¥ 1,338	¥ 42
	Thousands of U.S. Dollars					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2006						
Marketable equity securities	\$ 11	\$ 0	\$ —	\$ —	\$ 11	\$ 0

The Company regularly reviews all of the Company's investments to determine if any are other-than-temporarily impaired. The analysis includes reviewing industry analyst reports, sector credit ratings and volatility of the security's market price.

The company's unrealized loss on an investment in marketable equity security relates to a U.S. telecommunication equipment supplier. The fair value of the investment is approximately 3% less than its cost. The duration of the unrealized loss position was less than 6 months. Based on the Company's ability and intent to hold the investment for a reasonable period of time sufficient for a recovery of fair value, the Company does not consider the investment to be other-than-temporarily impaired at March 31, 2006.

Proceeds from the sale of available-for-sale securities were ¥122,650 thousand, ¥2,614,768 thousand and

¥3,240,805 thousand (\$27,586 thousand) for the years ended March 31, 2004, 2005 and 2006, respectively. Gross realized gains of ¥55,965 thousand, ¥2,477,607 thousand and ¥3,222,397 thousand (\$27,429 thousand) were included in other income (expenses) for the year ended March 31, 2004, 2005 and 2006, respectively, and gross realized losses of ¥8,925 thousand were included in other income (expenses) for the year ended March 31, 2004.

The aggregate cost of the Company's cost method investments totaled ¥982,613 thousand and ¥1,245,317 thousand (\$10,600 thousand) at March 31, 2005 and 2006, respectively.

Losses on the write-down of investments in certain nonmarketable equity and debt securities, included in other income (expenses) were recognized to reflect the decline in value considered to be other than temporary, totaled ¥229,944 thousand for the year ended March 31, 2004. Losses on write-down of investments in certain marketable and nonmarketable equity securities, included in other income (expenses), were ¥34,151 thousand and ¥118,076 thousand, respectively, for the year ended March 31, 2005. Such losses in certain nonmarketable equity securities, included in other income (expenses) were ¥29,513 thousand (\$251 thousand) for the year ended March 31, 2006.

Gains on exchange of securities of ¥35,450 thousand and ¥ 4,806 thousand (\$41 thousand), included in other income (expenses), for the year ended March 31, 2005 and 2006, respectively, represented non-monetary gains from the exchange of marketable common shares in a merger transaction.

For the year ended March 31, 2004, IJ sold all of its shares of DLJdirectSFG Securities Inc., which had been held as other investments, and proceeds and gross realized gain from the sale were ¥1,946,875 thousand and ¥1,571,875 thousand, respectively.

In Japan, there is a market in which participants lend and borrow debt and equity securities without collateral from financial institutions under agreements known as lending and borrowing debt and equity securities contracts. Under the agreement, the Company loans equity securities without collateral. The Company has loaned ¥324,000 thousand (\$ 2,758 thousand) of available-for-sale securities to the financial institution as of March 31, 2006.

### 3. ALLOWANCE FOR DOUBTFUL ACCOUNTS AND ADVANCES

An analysis of the allowance for doubtful accounts and advances for the years ended March 31, 2004, 2005 and 2006 is as follows:

	Thousands of Yen				
	Balance at Beginning of Year	Credits Charged Off	Provision for (Reversal of) Doubtful Accounts and Advances	Reclassification	Balance at End of Year
Year ended March 31, 2004	<u>¥ 125,354</u>	<u>¥ (81,913)</u>	<u>¥ 449,164</u>	<u>—</u>	<u>¥492,605</u>
Year ended March 31, 2005	<u>¥ 492,605</u>	<u>¥ (68,516)</u>	<u>¥ 24,781</u>	<u>—</u>	<u>¥448,870</u>
Year ended March 31, 2006	<u>¥ 448,870</u>	<u>¥(357,519)</u>	<u>¥ (12,009)</u>	<u>¥ 35,000</u>	<u>¥ 114,342</u>

  

	Thousands of U.S. Dollars				
	Balance at Beginning of Year	Credits Charged Off	Reversal of Doubtful Accounts and Advances	Reclassification	Balance at End of Year
Year ended March 31, 2006	<u>\$ 3,821</u>	<u>\$ (3,043)</u>	<u>\$ (102)</u>	<u>\$ 297</u>	<u>\$ 973</u>

The provision for doubtful accounts and advances for the year ended March 31, 2004 included accounts receivable from Crosswave of ¥395,780 thousand and certain other customers.

The credits charged off for the year ended March 31, 2006 included the reversal of allowance for doubtful

accounts of Crosswave amounted to ¥345,994 thousand (\$2,945 thousand) due to the final distribution of remaining assets of Crosswave under the corporate reorganization proceedings.

#### 4. INVESTMENTS IN AND ADVANCES TO EQUITY METHOD INVESTEES

IJJ utilizes various companies in Japan and neighboring countries to form and operate its Internet business. Businesses operated by its equity method investees include dedicated high-speed data communication services, data center services (Crosswave) through December 15, 2003, connectivity services in Asian countries (Asia Internet Holding Co., Ltd., "AIH") through September 2005, multifeed technology services and location facilities for connecting high-speed Internet backbones (Internet Multifeed Co., "Multifeed"), Web page design services (atom Co., Ltd.), and data center services in Asian countries (i-Heart Inc., "i-Heart" and Ayalaport Makati Inc., "Ayalaport" through June, 2004).

Since July 2004, Ayalaport is no longer accounted for under equity method due to dilution of the Company's ownership and loss of ability to exercise significant influence.

AIH was no longer an equity method investee after October 1, 2005 since AIH was merged with IJJ.

On February 1, 2006, IJJ and Konami corporation established a joint venture company (Internet Revolution Inc., "i-revo") to operate comprehensive portal sites. IJJ invested ¥750,000 thousand (\$6,384 thousand) to i-revo and owned 30 percent ownership as of March 31, 2006. IJJ accounted i-revo as an equity method investee.

The aggregate amounts of balances and transactions of the Company with these equity method investees other than Crosswave as of March 31, 2005 and 2006, and for each of the three years in the period ended March 31, 2006 are summarized as follows:

	Thousands of Yen			Thousands of U.S. Dollars
	2004	2005	2006	2006
Accounts receivable	¥ —	¥ 118,130	¥ 253,208	\$ 2,155
Accounts payable	—	96,727	17,084	145
Revenues	1,329,482	1,245,361	1,286,275	10,949
Costs and expenses	1,245,607	1,145,834	656,184	5,585

During each of the three years in the period ended March 31, 2006, the Company did not receive any dividends from its equity method investees.

The Company's investments in and advances to these equity method investees and respective ownership percentage at March 31, 2005 and 2006 consisted of the following:

		Thousands of Yen			Thousands of U.S. Dollars
		2005	2006	2006	
AIH	26.69%	¥275,386	—%	¥ —	\$ —
Multifeed	28.58	242,719	29.44	317,144	2,700
Atom	40.00	155,837	40.00	116,974	995
i-revo		—	30.00	676,795	5,761
Other		39,665	—	52,058	443
Total		¥713,607		¥1,162,971	\$ 9,899

Advances of ¥19,868 thousand and ¥34,545 thousand (\$294 thousand) to i-Heart, net of loan loss valuation allowance were included in the balances as of March 31, 2005 and 2006 respectively.

Crosswave, was formed in October 1998 with ownership interests held by IJJ (40 percent), Toyota Motor Corporation ("Toyota") (30 percent) and Sony Corporation ("Sony") (30 percent). On August 9, 2000, Crosswave completed an initial public offering in the NASDAQ National Market in the United States of America. Concurrently, IJJ purchased 15,000 newly issued Crosswave common shares and on December 27,

2000, IJ also purchased 3,000,000 ADSs, representing 15,000 shares of Crosswave from the market. As a result of these transactions, the ownership of IJ, Sony and Toyota at March 31, 2003 was 37.85 percent, 23.9 percent and 23.9 percent, respectively.

On May 21, 2002, in connection with the Crosswave Financing Facilities Agreement (the "Agreement"), the Company entered into a Cash Deficiency Support Agreement ("CDS Agreement") with Crosswave and four Japanese commercial banks. In accordance with the provisions of the CDS Agreement, the Company deposited ¥5,000,000 thousand into a restricted account with a participating bank in May 2002.

In May and June 2003, the Company made unsecured loans of ¥1,719,981 thousand in total to Crosswave in order for Crosswave to meet its scheduled debt service obligation.

On August 20, 2003, Crosswave filed a voluntary petition for the commencement of corporate reorganization proceedings in Japan. On August 28, 2003, Crosswave received an order from the Tokyo District Court for the commencement of corporate reorganization proceedings. As a result of the commencement of corporate reorganization proceedings, the Company no longer has had the ability to exercise significant influence over operating and financial policies of Crosswave.

The Company recorded an equity method loss of Crosswave of ¥5,514,383 thousand for the year ended March 31, 2003, based on unaudited net loss information publicly disclosed by Crosswave prior to the commencement of corporate reorganization proceedings by Crosswave and not reflecting any adjustments which may have been required in respect thereof. In addition, the Company assessed the impairment of its investment in and deposits for Crosswave considering an evaluation of the recoverability of the equity investee's underlying net assets through sale or future operations upon emergence from bankruptcy and recognized an impairment loss on investment in and deposits for Crosswave of ¥7,153,087 thousand for the year ended March 31, 2003. This impairment loss consisted of the carrying amount of the investment of ¥2,098,762 thousand, the realized gain of related foreign currency translation adjustments of ¥1,925 thousand, stock purchase rights of ¥56,250 thousand and deposits of ¥5,000,000 thousand under the CDS Agreement.

The loans of ¥1,719,981 thousand made by the Company in May and June 2003 to Crosswave and accounts receivable from Crosswave of ¥395,780 thousand as of August 19, 2003 were written off in the year ended March 31, 2004.

Revenues from Crosswave consisted principally of dedicated Internet access services, monitoring services and sales of network systems which amounted to ¥1,196,080 thousand for the year ended March 31, 2004.

Cost and expenses incurred from transactions with Crosswave mainly consist of the cost of dedicated high-speed data communication services, which amounted to ¥4,816,146 thousand for the year ended March 31, 2004. The revenues and costs and expenses include those recognized after Crosswave's filing voluntary petition of corporate reorganization, which amounted to ¥425,597 thousand and ¥1,820,518 thousand, respectively.

## 5. PROPERTY AND EQUIPMENT

Property and equipment as of March 31, 2005 and 2006 consisted of the following:

	Thousands of Yen		Thousands of U.S. Dollars
	2005	2006	2006
Data communications equipment	¥ 543,365	¥ 781,605	\$ 6,653
Office and other equipment	904,532	718,362	6,115
Leasehold improvements	823,313	780,143	6,641
Purchased software	4,917,483	5,425,819	46,185
Capitalized leases, primarily data communications equipment	13,251,657	14,458,667	123,073
Total	20,440,350	22,164,596	188,667
Less accumulated depreciation and amortization	(10,717,984)	(11,865,100)	(100,997)
Property and equipment—net	¥ 9,722,366	¥ 10,299,496	\$ 87,670

## 6. GOODWILL AND INTANGIBLE ASSETS

The components of intangible assets as of March 31, 2005 and 2006 are as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2005	2006	2006
<b>Non-amortized intangible assets:</b>			
Telephone rights	¥ 14,616	¥ 12,555	\$ 107
Customer relationship	113,360	113,360	965
Goodwill	<u>433,235</u>	<u>506,679</u>	<u>4,313</u>
<b>Total intangible assets</b>	<u>¥ 561,211</u>	<u>¥ 632,594</u>	<u>\$ 5,385</u>

The Company recorded disposal losses of ¥48,201 thousand, ¥73,271 thousand and ¥2,040 thousand (\$17 thousand) on telephone rights, which were not used by the Company upon cancellation of the contracts for the usage of telephone circuits for dial-up access services and the disposal loss was included in general and administrative expenses for the years ended March 31, 2004, 2005 and 2006, respectively.

NTT reduced the price of telephone rights by 50 percent after March 1, 2005 and the Company recorded an impairment loss of ¥25,804 thousand on telephone rights based on the new purchase price. The impairment loss was included in general and administrative expenses for the year ended March 31, 2005.

Goodwill of ¥405,349 thousand and ¥73,444 thousand (\$625 thousand) was recorded for the years ended March 31, 2005 and 2006, respectively.

On October 1, 2004, IIJ Financial Systems, a 100 percent owned subsidiary of IIJ Technology, which was a 69 percent owned subsidiary of IIJ at October 1, 2004, purchased the securities systems development and operation business from Yamatane Co.,Ltd (“Yamatane”) in order to initiate a business relationship with Yamatane’s customer base. The primary factor that contributed to the recognition of goodwill was an assembled workforce. The results of operations of this business are included in the statement of operations of the Company from October 1, 2004. The cash paid for this business was ¥375,123 thousand including incremental costs directly related to the transaction. The Company acquired an order backlog of ¥6,254 thousand, customer relationships valued at ¥113,360 thousand and recorded goodwill of ¥251,127 thousand in the transaction. The backlog became fully amortized during the year ended March 31, 2005. The pro forma impact of the acquisition of the business operations of Yamatane on consolidated revenues and net income (loss) of the Company, assuming the acquisition had been completed at the beginning of fiscal 2004 and 2005, would have been an increase to consolidated revenues of ¥2.3 billion and ¥1.2 billion, respectively, and a decrease to net loss of ¥109 million in fiscal 2004 and an increase to net income of ¥56 million in fiscal 2005.

No impairment on goodwill was recognized during the years ended March 31, 2004, 2005 and 2006.

## 7. LEASES

The Company enters into, in the normal course of business, various leases for domestic and international backbone services, office premises, network operation centers and data communications and other equipment. Certain leases that meet one or more of the criteria set forth in the provision of SFAS No. 13, “Accounting for leases” have been classified as capital leases and the others have been classified as operating leases.

**Operating Leases**—The Company has operating lease agreements with telecommunications carriers and others for the use of connectivity lines, including local access lines that customers use to connect to IIJ’s network. The leases for domestic backbone connectivity are generally either non-cancelable for a minimum one-year lease period or cancelable during a lease period of three years, with a significant penalty for cancellation (35 percent). The leases for international backbone connectivity during one-year lease period are substantially non-cancelable. The Company also leases its office premises, for which refundable lease deposits are capitalized as guarantee deposits, and certain office equipment under non-cancelable operating leases which expire on various dates through the year 2008 and also leases its network operation centers

under non-cancelable operating leases.

Refundable guarantee deposits as of March 31, 2005 and 2006 consist of as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2005	2006	2006
Head office	¥1,705,036	¥1,185,307	\$ 10,090
Sales and subsidiaries offices	296,971	308,494	2,626
Others	48,658	55,852	475
Total refundable guarantee deposits	<u>¥2,050,665</u>	<u>¥1,549,653</u>	<u>\$ 13,191</u>

Lease expenses related to backbone lines for the years ended March 31, 2004, 2005 and 2006 amounted to ¥4,719,638 thousand, ¥3,550,885 thousand and ¥ 3,516,322 thousand (\$ 29,931 thousand), respectively. Lease expenses for local access lines for the years ended March 31, 2004, 2005 and 2006, which are only attributable to dedicated access revenues, amounted to ¥3,500,468 thousand, ¥4,040,192 thousand and ¥ 4,558,382 thousand (\$ 38,801 thousand), respectively. Other lease expenses for the years ended March 31, 2004, 2005 and 2006 amounted to ¥3,786,739 thousand, ¥3,303,717 thousand and ¥ 3,653,766 thousand (\$ 31,101 thousand), respectively.

The Company has subleased a part of its office premises. Lease expenses mentioned above have been reduced by sublease revenues totaling ¥88,895 thousand, ¥406,451 thousand and ¥435,224 thousand (\$3,705 thousand) for the years ended March 31, 2004, 2005 and 2006, respectively.

**Capital Leases**—The Company conducts its connectivity and other services by using data communications and other equipment leased under capital lease arrangements. The fair values of the assets upon execution of the capital lease agreements and accumulated depreciation amounted to ¥13,251,657 thousand and ¥6,336,386 thousand at March 31, 2005 and ¥14,458,667 thousand (\$123,073 thousand) and ¥6,819,503 thousand (\$ 58,048 thousand) at March 31, 2006, respectively.

As of March 31, 2006, future lease payments under non-cancelable operating leases, including the aforementioned non-cancelable connectivity lease agreements (but excluding dedicated access lines which the Company charges outright to customers), and capital leases were as follows:

	Thousands of Yen			Thousands of U.S. Dollars		
	Connectivity Lines Operating Leases	Other Operating Leases	Capital Leases	Connectivity Lines Operating Leases	Other Operating Leases	Capital Leases
Year ending March 31:						
2007	¥ 27,302	¥ 1,376,986	¥ 3,262,311	\$ 232	\$ 11,721	\$ 27,769
2008	—	1,174,192	2,535,823	—	9,995	21,585
2009	—	142,566	1,778,729	—	1,214	15,141
2010	—	70,354	697,143	—	599	5,934
2011	—	19,623	179,496	—	167	1,528
2012 and thereafter	—	55,154	35,729	—	469	304
Total minimum lease payments	<u>¥ 27,302</u>	<u>¥ 2,838,875</u>	¥ 8,489,231	<u>\$ 232</u>	<u>\$ 24,165</u>	\$ 72,261
Less amounts representing interest			<u>504,658</u>			<u>4,296</u>
Present value of net minimum capital lease payments			7,984,573			67,965
Less current portion			<u>3,003,914</u>			<u>25,569</u>
Noncurrent portion			<u>¥ 4,980,659</u>			<u>\$ 42,396</u>

## 8. BORROWINGS AND CONVERTIBLE NOTES

Short-term borrowings at March 31, 2005 and 2006 consist of bank overdrafts. Short-term borrowings bear fixed-rate interest and their weighted average rates at March 31, 2005 and 2006 were 1.375 percent.

Long-term borrowings as of March 31, 2005 and 2006 consisted of the following:

	Thousands of Yen		Thousands of
	2005	2006	U.S. Dollars
			2006
Unsecured long-term loans payable to banks, maturing at various dates through calendar 2007 (see Note 15). Interest is payable at a variable rate. Weighted average interest rates were 3.255 percent, and 2.206 percent at March 31, 2005 and 2006, respectively.	¥ 208,000	¥ 374,000	\$ 3,184
Unsecured long-term loans payable to banks (secured in 2005), maturing in calendar 2006 (see Note 15). Weighted average interest rates were 1.789 percent and 1.710 percent at March 31, 2005 and 2006, respectively.	2,350,000	600,000	5,107
Unsecured long-term loans payable to banks (secured in 2005), maturing at various dates through calendar 2007 (see Note 15). Interest is payable at a variable rate based on TIBOR which was 0.1 percent and 0.133 percent as of March 31, 2005 and 2006, respectively. Weighted average interest rates were 1.137 percent and 1.130 percent at March 31, 2005 and 2006, respectively.	1,400,000	1,150,000	9,789
Long-term installment loans payable at various dates through calendar 2007 (see Note 15). Interest rates were 2.55 percent at March 31, 2005 and 2006.	308,019	155,963	1,328
<b>Total</b>	<b>4,266,019</b>	<b>2,279,963</b>	<b>19,408</b>
Less current portion	(2,736,056)	(1,989,963)	(16,939)
<b>Long-term borrowings, less current portion</b>	<b>¥ 1,529,963</b>	<b>¥ 290,000</b>	<b>\$ 2,469</b>

The Company entered into interest rate swap contracts to manage its interest rate exposure resulting in a fixed interest rate for a portion of its long-term debt. The effective weighted average interest rates for ¥1,400,000 thousand and ¥1,150,000 thousand (\$9,789 thousand) of the long-term loan outstanding at March 31, 2005 and 2006 after giving effect to such swap agreements were 1.926 percent and 1.781 percent per annum, respectively (see Note 15).

On March 14, 2003, the Company entered into a long-term installment loan agreement with a leasing company to finance the payment for rental deposits given to other lessor for its new head office. The principal of the loan is ¥155,963 thousand (\$1,328 thousand) and the loan is secured by a first priority pledge against a claim for the guarantee deposits of ¥1,146,039 thousand (\$9,755 thousand) at March 31, 2006.

Substantially all short-term and long-term bank borrowings are made under agreements which, as is customary in Japan, provide that under certain conditions the bank may require the borrower to provide collateral (or additional collateral) or guarantor with respect to the borrowings and that the bank may treat any collateral, whether furnished as security for short-term or long-term loans or otherwise, as collateral for all indebtedness to such bank. Also, provisions of certain loan agreements grant certain rights of possession to the lenders in the event of default. The Company did not provide banks with any collateral for outstanding loans as of March 31, 2006.

Annual maturities of long-term borrowings outstanding as of March 31, 2006 are as follows:

Year Ending March 31	Thousands of Yen	Thousands of U.S. Dollars
2007	¥ 1,989,963	\$ 16,939
2008	290,000	2,469
<b>Total</b>	<b>¥ 2,279,963</b>	<b>\$ 19,408</b>

The Company entered into bank overdraft agreements with certain Japanese banks for which the unused balance outstanding as of March 31, 2006 was ¥3,210,000 thousand (\$27,324 thousand).

The 1.750 percent unsecured yen convertible notes due March 2005 in the aggregate principal amount of ¥15,000,000 thousand were issued in April 11, 2000. The notes were convertible at the option of the holders at ¥19,875 thousand per share at any time on or before March 15, 2005. The notes were redeemable at the Company's option at any time before March 15, 2005, in whole or in part, at par with unpaid and accrued interest; provided that the closing trading price for the Company's shares for a certain period prior to giving notice of redemption is of at least 140 percent of the conversion price.

In October and November 2003, IIJ repurchased a portion of its 1.750 percent unsecured yen convertible notes, with an aggregate face value of ¥3,168,000 thousand, for ¥3,047,460 thousand in the open market, resulting in a realized gain of ¥120,540 thousand. A portion of deferred issuance cost, amounting to ¥31,565 thousand, corresponding to the repurchased convertible notes was charged to income and was offset against the gain. The net gain realized on retirement of these convertible notes was presented as other income.

In June 2004, IIJ repurchased a portion of its 1.750 percent unsecured yen convertible notes, with an aggregate face value of ¥744,000 thousand, for ¥745,488 thousand in the open market, resulting in a realized loss of ¥1,488 thousand. A portion of deferred issuance cost, amounting to ¥3,707 thousand, corresponding to the repurchased convertible notes was charged to loss upon redemption. The net loss realized on retirement of these convertible notes was presented as other expense.

In March 2005, IIJ redeemed the remainder of its unsecured yen convertible notes amounting to ¥11,088,000 thousand at their carrying value.

Since August 2004, the Company has been a party to a securities loan agreement with a certain Japanese financial institution. The available-for-sale securities loaned to the financial institution were ¥2,189,600 thousand and ¥1,230,000 thousand (\$10,470 thousand), and the cash received in return was ¥1,729,520 thousand and ¥999,600 thousand (\$8,509 thousand) at March 31, 2005 and 2006, respectively. These transactions were accounted for as secured borrowings and the cash received was recorded as payable under the securities loan agreement and securities lent were recorded as other investments. The agreement requires the Company to provide certain marketable securities as collateral at the commencement of the transaction. The Company is required to make a partial repayment or receive additional borrowings depending on the market value of securities pledged. The Company paid the interest on the payables at a variable rate, which was 0.6349 percent and 0.37 percent as of March 31, 2005 and 2006, respectively.

## 9. INCOME TAXES

Amendments to Japanese tax regulations were enacted into law on March 31, 2003 and became effective from the fiscal year beginning April 1, 2004. Income taxes imposed by the national, prefectural and municipal governments of Japan resulted in a normal statutory rate of approximately 42 percent for the year ended March 31, 2004 and 41 percent for the years ended March 31, 2005 and 2006.

The reserve for tax contingencies related to the denial of the usage of tax operating loss carryforwards by IIJ America, a U.S. subsidiary, was ¥197,753 thousand (\$1,683 thousand) as of March 31, 2006. This is management's best estimate of the potential liability for tax contingencies.

Income (loss) from operations before income tax expense, minority interests and equity in net loss of equity method investees and income tax expense for the years ended March 31, 2004, 2005, and 2006 consists of the following components:

	Thousands of Yen			Thousands of U.S. Dollars
	2004	2005	2006	2006
Income (loss) from operations before income tax expense, minority interests and equity in net loss of equity method investees:				
Domestic	¥(535,648)	¥3,168,974	¥5,316,535	\$ 45,255
Foreign	67,984	(20,466)	62,024	528
Total	<u>¥(467,664)</u>	<u>¥3,148,508</u>	<u>¥5,378,559</u>	<u>\$ 45,783</u>
Income taxes—current:				
Domestic	¥ 30,560	¥ 118,893	¥ 289,376	\$ 2,463
Foreign	—	0	198,825	1,693
Total	<u>¥ 30,560</u>	<u>¥ 110,893</u>	<u>¥ 488,201</u>	<u>\$ 4,156</u>
Income taxes—deferred:				
Domestic	¥ 1,976	¥ (11,023)	¥ (230,841)	\$ (1,965)
Foreign	—	—	—	—
Total	<u>¥ 1,976</u>	<u>¥ (11,023)</u>	<u>¥ (230,841)</u>	<u>\$ (1,965)</u>

Net deferred income tax assets and liabilities are reflected on the consolidated balance sheets as of March 31, 2005 and 2006 as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2005	2006	2006
Current Assets—Other current assets	¥ 26,399	¥ 138,938	\$ 1,183
Noncurrent Assets—Other assets	—	193,681	1,649
Noncurrent liabilities—Other noncurrent liabilities	(7,748)	(83,127)	(708)
Total	<u>¥ 18,651</u>	<u>¥ 249,492</u>	<u>\$ 2,124</u>

The approximate effect of temporary differences and carryforwards giving rise to deferred tax balances at March 31, 2005 and 2006 was as follows:

	Thousands of Yen				Thousands of U.S. Dollars	
	2005		2006		2006	
	Deferred Tax Assets	Deferred Tax Liabilities	Deferred Tax Assets	Deferred Tax Liabilities	Deferred Tax Assets	Deferred Tax Liabilities
Unrealized gains on available-for-sale securities	¥ —	¥ 3,580,494	¥ —	¥ 2,686,560	\$ —	\$ 22,868
Valuation of limited partnership investments for tax purpose	—	35,014	—	81,020	—	690
Capitalized leases	74,621	—	84,345	—	718	—
Accrued expenses	185,732	—	161,902	—	1,378	—
Retirement and pension cost	58,885	—	89,705	—	764	—
Stock issuance cost	15,548	—	29,212	—	249	—
Allowance for doubtful accounts	1,461,058	—	16,333	—	139	—
Depreciation	25,699	—	25,070	—	213	—
Net loss on other investment	92,080	—	127,115	—	1,082	—
Operating loss carryforward	9,902,013	—	9,602,271	—	81,735	—
Other	261,843	27,563	121,659	69,109	1,036	588
Total	<u>12,077,479</u>	<u>3,643,071</u>	<u>10,257,612</u>	<u>2,836,689</u>	<u>87,314</u>	<u>24,146</u>
Valuation allowance	(8,415,757)	—	(7,171,431)	—	(61,044)	—
Total	<u>¥ 3,661,722</u>	<u>¥ 3,643,071</u>	<u>¥ 3,086,181</u>	<u>¥ 2,836,689</u>	<u>\$ 26,270</u>	<u>\$ 24,146</u>

As of March 31, 2005 and 2006, the valuation allowance for deferred tax assets has been provided at amounts which are not considered more likely than not to be realized. The net changes in the valuation allowance for deferred tax assets were a decrease of ¥1,864,583 thousand, a decrease of ¥2,224,170 thousand and a decrease of ¥1,244,326 thousand (\$10,592 thousand) for the years ended March 31, 2004, 2005 and 2006, respectively.

As of March 31, 2006, IJ and IJ America had tax operating loss carryforwards of ¥22,359,559 thousand (\$190,327 thousand) and \$8,550 thousand, respectively. These loss carryforwards are available to offset future taxable income, and will expire in the period ending March 31, 2013 in Japan and December 31, 2025 in the United States of America as follows:

	Year Ending March 31	Thousands of	
		Yen	U.S. Dollars
2007		¥ —	\$ —
2008		—	—
2009		915,435	7,792
2010		13,675,603	116,408
2011 and thereafter		8,772,948	74,677
Total		¥ 23,363,986	\$ 198,877

A reconciliation between the amount of reported income taxes and the amount of income taxes computed using the normal statutory rate for each of the three years in the period ended March 31, 2006 is as follows:

	Thousands of Yen			Thousands of
	2004	2005	2006	U.S. Dollars
Amount computed by using normal Japanese statutory tax rate	¥(196,419)	¥ 1,290,888	¥ 2,205,209	\$ 18,771
Increase (decrease) in taxes resulting from:				
Expenses not deductible for tax purpose	11,080	34,820	38,653	329
Reserve for tax contingencies	—	—	197,753	1,683
Inhabitant tax-per capital	30,560	23,410	25,085	213
Realization of tax benefit of operating loss carryforwards	(51,994)	(1,426,755)	(439,256)	(3,739)
Other change in valuation allowance	454,009	261,380	(1,933,379)	(16,457)
Tax benefit on losses of equity method investee	(80,355)	—	—	—
Expiration of operating loss carryforwards	611,498	—	149,750	1,275
Effect of change in tax rate	(42,034)	—	—	—
Tax benefit on losses of Crosswave	(722,098)	—	—	—
Other—net	18,289	(83,873)	13,545	116
Income tax expense as reported	¥ 32,536	¥ 99,870	¥ 257,360	\$ 2,191

## 10. RETIREMENT AND PENSION PLANS

IIJ and certain subsidiaries have unfunded retirement benefit and noncontributory defined benefit pension plans which together cover substantially all of their employees who are not directors and also participate in a contributory multi-employer pension plan, the Japan Computer Information Service Employee's Pension Fund (the "Multi-Employer Plan"), covering substantially all of their employees.

Approximately 70 percent of the employees' benefits from IIJ's severance indemnity plan was transferred in May 1997 to its newly established noncontributory defined benefits pension plan. The following information regarding net periodic pension cost and accrued pension cost also includes the 30 percent of severance benefits not transferred to the noncontributory plan. Under the severance and pension plans, all of IIJ's employees are entitled, upon voluntary retirement with 15 years or more service, or upon mandatory retirement at age 60, to a 10-year period of annuity payments (or lump-sum severance indemnities) based on the rate of pay at the time of retirement, length of service and certain other factors. IIJ's employees who do not meet these conditions are entitled to lump-sum severance indemnities.

As stipulated by the Japanese Welfare Pension Insurance Law, the Multi-Employer Plan is composed of a substitutional portion of Japanese Pension Insurance and a multi-employers' portion of a contributory defined benefit pension plan. The benefits for the substitutional portion are based on a standard remuneration schedule under the Welfare Pension Insurance Law and the length of participation. The multi-employers' portion of the benefits is based on the employees' length of service. However, assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer, including IIJ. The net pension cost under the Multi-Employer Plan is recognized when contributions become due.

Net periodic pension cost for the years ended March 31, 2004, 2005 and 2006 included the following components:

	Thousands of Yen			Thousands of
	2004	2005	2006	U.S. Dollars
Service cost	¥ 150,149	¥ 221,132	¥ 240,765	\$ 2,049
Interest cost	8,809	14,944	20,524	175
Expected return on plan assets	(11,722)	(13,129)	(16,736)	(142)
Amortization of transition obligation	402	402	402	3
Recognized net actuarial loss	575	8,262	1,904	16
Net periodic pension cost	<u>¥ 148,213</u>	<u>¥ 231,611</u>	<u>¥ 246,859</u>	<u>\$ 2,101</u>

The funded status as of March 31, 2005 and 2006 is as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2005	2006	2006
<b>Change in benefit obligation:</b>			
Benefit obligation at beginning of year	¥ 933,969	¥1,140,240	\$ 9,706
Service cost	221,132	240,765	2,049
Interest cost	14,944	20,524	175
Actuarial loss (gain)	(558)	(31,171)	(266)
Benefit paid	(29,247)	(40,906)	(348)
<b>Benefit obligation at end of year</b>	<b>¥1,140,240</b>	<b>¥1,329,452</b>	<b>\$ 11,316</b>
<b>Change in plan assets:</b>			
Fair value of plan assets at beginning of year	¥ 656,443	¥ 796,946	\$ 6,784
Actual return on plan assets	17,844	68,185	580
Employer contribution	143,471	155,191	1,321
Benefits paid	(20,812)	(22,466)	(191)
<b>Fair value of plan assets at end of year</b>	<b>¥ 796,946</b>	<b>¥ 997,856</b>	<b>\$ 8,494</b>
Funded status	(343,294)	(331,596)	(2,822)
Unrecognized actuarial loss	195,530	111,009	945
Unrecognized transition obligation	4,418	4,016	34
<b>Net amount recognized</b>	<b>¥ (143,346)</b>	<b>¥ (216,571)</b>	<b>\$ (1,843)</b>
<b>Accumulated benefit obligation</b>	<b>¥ 635,122</b>	<b>¥ 750,900</b>	<b>\$ 6,392</b>

Amounts recognized in the consolidated balance sheets consist of accrued retirement and pension costs of ¥143,346 thousand as of March 31, 2005, and prepaid pension costs of ¥3,891 (\$33 thousand) thousand and accrued retirement and pension costs of ¥220,462 thousand (\$1,877 thousand) as of March 31, 2006.

The Company uses a March 31 measurement date for all its plans.

Actuarial assumptions as of March 31:

	Benefit Obligations		Net Periodic Costs		
	2005	2006	2004	2005	2006
Discount rate	1.8%	2.0%	1.5%	1.6%	1.8%
Expected long-term rate of return on plan assets			2.5	2.0	2.1
Rate of increase in compensation	3.4	3.4	2.0	3.25	3.4

The Company sets the discount rate assumption annually at March 31 to reflect the market yield of Japanese Government Bonds matched against the average remaining service period of employees.

The basis for determining the long-term rate of returns is a combination of historical returns and prospective return assumptions derived from pension trust funds' managing company.

III's funding policies with respect to the noncontributory plan are generally to contribute amounts considered tax deductible under applicable income tax regulations. Plan assets including life insurance pooled investment portfolios consist of Japanese Government bonds, other debt securities and marketable equity securities.

Life insurance pooled investment portfolios are managed by an insurance company and guarantee a minimum rate of return.

The Company's investment strategy for the plan assets is to manage the assets in order to pay retirement benefits to plan participants while minimizing cash contributions from the Company over the life of the plans. This is accomplished by preserving capital through diversification in equity and debt securities based on portfolio determined by the insurance company forecasting macroeconomics in order to maximize long-term rate of return, while considering the liquidity need of the plans.

The projected allocation of the plan assets managed by the insurance company is developed in consideration of the expected long-term investment returns for each category of the plan assets. Approximately 63.0%, 35.0%, and 2.0% of the plan assets excluding pooled investment portfolios will be allocated to debt securities, equity securities and other financial instruments, respectively, to moderate the level of volatility in pension plan asset returns and reduce risks. 50% of the employer's contribution to the plan during the year ending March 31, 2007 will be allocated to life insurance pooled investment portfolios and other 50% will be allocated to the forementioned investments.

The Company's pension plan asset allocations as of March 31, 2005 and 2006 by asset category are as follows:

Asset category:	2005		2006	
Equity securities	21.3%	(34.8)%	22.4%	(35.9)%
Debt securities	38.8	(63.2)	38.8	(62.1)
Life insurance pooled investment portfolios	38.7	(—)	37.6	(—)
Other	1.2	(2.0)	1.2	(2.0)
Total	<u>100.0%</u>	<u>(100.0)%*</u>	<u>100.0%</u>	<u>(100.0)%*</u>

\*The percentages in parentheses represent the Company's position plan asset allocation excluding life insurance pooled investment portfolios.

The unrecognized net loss and the unrecognized net obligation at the date of initial application are being amortized over 14 years and 21 years, respectively.

Contributions due and paid during the years ended March 31, 2004, 2005 and 2006 under the Multi-Employer Plan, including its substitutional portion, amounted to ¥344,900 thousand, ¥466,543 thousand and ¥451,312 thousand (\$3,842 thousand), respectively.

IJJ expects to contribute ¥155,191 thousand (\$1,321 thousand) to its pension plan in the year ending March 31, 2007.

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

Year Ending March 31	Thousands of	
	Thousands of yen	U.S. Dollars
2007	¥ 30,823	\$ 262
2008	45,551	388
2009	41,747	355
2010	45,766	390
2011	50,970	434
2012 —2016	<u>294,075</u>	<u>2,503</u>
Total	<u>¥ 508,932</u>	<u>\$ 4,332</u>

Under the Japanese Commercial Code (the "Code"), the amount of retirement benefits for retiring directors and statutory auditors to be approved by the shareholders. In March, 2006, IJJ newly established a retirement plan for statutory auditors. The Company recorded a liability for the retirement benefits for statutory auditors of ¥2,870 thousand (\$24 thousand), which would be required if they retire at March 31, 2006. There were no other benefits approved or paid to retired directors or statutory auditors for each of three years in the period ended March 31, 2006.

## 11. SHAREHOLDERS' EQUITY

Through May 1, 2006, IJJ is subject to the Code.

The Code requires that at least 50% of the issue price of new shares be recorded as common stock and that the rest of the issue price be recorded as additional paid-in capital, which is a component of capital surplus. The Code permits Japanese companies, in accordance with an approval of the Board of Directors, to issue shares to existing shareholders without consideration as a stock split. Such issuance of shares generally does not give rise to changes within the shareholders' accounts.

The Code also provides that an amount equal to at least 10% of the aggregate amount available for dividends and certain other appropriations of retained earnings associated with cash outlays applicable to each period shall be appropriated as legal reserve (a component of retained earnings) until such reserve and additional paid-in capital equals 25% of common stock. The amount of total legal reserve and additional paid-in capital that exceeds 25% of common stock may be made available for payment of dividends in accordance with an approval of a shareholders' meeting. In addition, the Code permits the transfer of a portion of additional paid-in capital and legal reserve to the common stock in accordance with an approval of the Board of Directors.

The Code allows IJJ to purchase treasury stock and dispose of such treasury stock in accordance with an approval of the Board of Directors. The amount of treasury stock purchased cannot exceed the amount available for dividends to shareholders.

In addition to the provision that requires an appropriation for legal reserve in connection with the cash outlays, the Code also imposes certain limitations on the amount of capital surplus and retained earnings available for dividends. No amount was available for dividends under the Code as of March 31, 2006, based on the amount recorded in IJJ's general books of account.

Dividends are paid in accordance with an approval of a shareholders' meeting held subsequent to the end of the fiscal year to which the dividends are applicable. Semiannual interim dividends may also be paid in accordance with an approval of the Board of Directors, subject to certain limitations imposed by the Code.

On May 1, 2006, a new corporation law (the "Corporation Law") became effective. The Corporation Law reformed and replaced the Code with various revisions that, for the most part, are applicable to events or transactions occurring on or after May 1, 2006 and for the fiscal years ending on or after May 1, 2006. The significant changes brought about by the Corporation Law that affect financial matters are summarized below:

### (a) Dividends

Under the Corporation Law, companies can pay dividends at any time during the fiscal year in addition to the year-end dividend in accordance with an approval of a shareholders' meeting. For companies that meet certain criteria such as: (1) having a Board of Directors, (2) having independent auditors, (3) having a Board of Statutory Auditors, and (4) having a term of service for directors prescribed as one year rather than two years as the normal term by its articles of incorporation, the Board of Directors may declare dividends (except for dividends in kind) if the company has prescribed so in its articles of incorporation. Semiannual interim dividends may also be paid once a year in accordance with an approval of the Board of Directors. Under the Code, certain limitations were imposed on the amount of capital surplus and retained earnings available for dividends. The Corporation Law also provides certain limitations on the amounts available for dividends or the purchase of treasury stock. The limitation is defined as the amount available for dividends to the shareholders, but the amount of net assets after dividends must be maintained as at least ¥3 million.

### (b) Increases / decreases and transfer of common stock, reserve and surplus

The Corporation Law requires that an amount equal to 10% of dividends must be appropriated as legal reserve (a component of retained earnings) or as additional paid-in capital (a component of capital surplus) depending on the capital account charged at the payment of such dividends up to the aggregate amount of legal reserve and additional paid-in capital equal to 25% of common stock. Under the Code, the aggregate amount of additional paid-in capital and legal reserve that exceeds 25% of the common stock may be made available for dividends in accordance with an approval of a shareholders' meeting. Under the Corporation Law, the total amount of additional paid-in capital and legal reserve may be reversed without limitation of such threshold. The Corporation Law also provides that common stock, legal reserve, additional paid-in capital, and other capital surplus and retained earnings can be transferred among these accounts under certain

conditions in accordance with an approval of a shareholders' meeting.

(c) Treasury stock and treasury stock acquisition rights

The Corporation Law also allows companies to purchase treasury stock and dispose of such treasury stock in accordance with an approval of the Board of Directors if the company has prescribed so in its articles of incorporation. The amount of treasury stock purchased cannot exceed the amount available for dividends to the shareholders which is determined by specific formula.

The Corporation Law also provides that companies can purchase both treasury stock acquisition rights and treasury stock.

On June 27, 2003, IJ issued 16,325 new shares of common stock at ¥83,640 per share for ¥1,365,423 thousand by a private placement to third parties in Japan. The proceeds from the private placement were used as working capital of the Company.

On September 17, 2003, primarily to provide for the redemption of the convertible notes due March 2005, IJ issued 63,075 new shares of common stock at ¥190,260 per share for ¥12,000,650 thousand in a private placement in Japan to NTT for ¥9,603,374 thousand, NTT Communications for ¥749,624 thousand, a wholly owned subsidiary of NTT, ITOCHU Corporation and Sumitomo Corporation for ¥499,432 thousand each and three other companies for ¥648,787 thousand. As a result of the transaction, the total number of IJ's outstanding common shares increased to 191,800 shares, and NTT and its subsidiary owned 31.6 percent of IJ's outstanding common shares. Concurrently, IJ entered into a Subscription Agreement with NTT under which IJ allows NTT to nominate up to three persons as directors or statutory auditors, subject to approval by IJ's shareholders. The agreement also provides NTT with preemptive rights to subscribe to any additional future issuances by IJ in order to maintain its shareholding. In addition, IJ and NTT agreed to undertake efforts to jointly engage in the development of broadband and information technology and other related business, to expand the business relationship between the two parties in connection with new business opportunities of IJ and discuss secondment of employees to each other.

Upon completion of this transaction, NTT and its subsidiaries are related parties of the Company. The Company entered into a number of different types of transactions with NTT and its subsidiaries including purchases of wireline telecommunication services for Company's offices. For the Company's connectivity and value added services, the Company purchases international and domestic backbone services, local access lines and rental rack space in data centers from NTT and its subsidiaries. The Company sells to NTT and its subsidiaries its services including OEM services, system integration services and monitoring services for their data centers.

The amounts of balances as of March 31, 2005 and 2006 and transactions of the Company with NTT and its subsidiaries for the each of the three years in the period ended March 31, 2006, are summarized as follows.

	Thousands of Yen			Thousands of U.S. Dollars
	2004	2005	2006	2006
Accounts receivable	¥ —	¥ 286,389	¥ 366,648	\$ 3,121
Accounts payable	—	687,757	710,322	6,046
Revenues	954,341	1,413,379	1,394,791	11,873
Costs and expenses	4,531,189	7,672,480	8,075,542	68,740

In December, 2005, IJ completed a public offering 12,500 new shares (equivalent to 5,000,000 ADSs) of common stock by a firm-commitment basis underwriting at an offering price of ¥534,022 (an issue value of ¥490,955) per share on the Mothers market of the Tokyo Stock Exchange. The net proceeds to IJ from the public offering, after deducting stock issuance costs, were ¥6,030,064 thousand. Stock issuance costs of ¥106,873 thousand were deducted from additional paid-in capital.

**Stock Option Plans**—In May 2000, IJ granted 295 options to 34 directors and employees. The options vested fully on April 8, 2002 and are exercisable for eight years from that date. In August 2001, IJ granted 395 options to 44 directors and employees. The options became fully vested on June 28, 2003 and are exercisable for eight years from that date. No options are available for additional grant as of March 31, 2006. No compensation expense has been recognized in the consolidated statements of operations pursuant to APB No. 25, because the exercise price was greater than the market price on the dates of grant. In March 2000, IJ Technology issued bonds with 2,000 detachable warrants in the amount of ¥600,000 thousand. The bonds were repurchased in April 2000 and warrants to purchase the subsidiary's 775 common shares at an exercise

price of ¥300,000 per share based on fair market value were immediately purchased by certain officers and employees of IIJ and the subsidiary. One thousand warrants were purchased by IIJ. Warrants were exercisable upon issuance. On March 29, 2006, 1,000 of the warrants of IIJ Technology were expired. The remaining warrants are exercisable through March 29, 2007. The exercise price was revised to ¥250,326 (\$2,131 thousand) per share as of March 31, 2006, due to the effects of issuances of new shares during the year ended March 31, 2006.

The following table summarizes the transactions of IIJ's stock option plans for the three years in the period ended March 31, 2006:

	Number of Options	Number of Shares	Thousands of Yen Weighted Average Exercise Price per Common Shares
Unexercised options outstanding—April 1, 2003	675	3,375	¥ 1,336
Options granted	—	—	—
Options exercised	—	—	—
Options forfeited	60	300	1,873
Unexercised options outstanding—March 31, 2004	615	3,075	¥ 1,063
Options granted	—	—	—
Options exercised	—	—	—
Options forfeited	70	350	1,510
Unexercised options outstanding—March 31, 2005	545	2,725	¥ 1,006
Options granted	—	—	—
Options exercised	—	—	—
Options forfeited	15	75	944
Unexercised options outstanding—March 31, 2006	530	2,650	¥ 1,007

Due to the effect of the stock split in October 2005, grantees of options can purchase five shares by exercising one option.

Summarized information about stock options outstanding as of March 31, 2006 is as follows:

Exercise Price (Thousands of Yen)	Outstanding		Exercisable
	Number of Shares Underlying Options	Remaining Life (in Years)	Number of Shares Underlying Options
¥ 2,163	975	4.0	975
334	1,675	5.3	1,675

## 12. OTHER COMPREHENSIVE INCOME

The change in each component of other comprehensive income (loss) for the years ended March 31, 2004, 2005 and 2006 is as follows:

	Thousands of Yen		
	Before Tax Amount	Tax (Expense) or Benefit	Net of Tax Amount
<b>Year ended March 31, 2004:</b>			
Foreign currency translation adjustments	¥ (45,582)	¥ —	¥ (45,582)
Unrealized holding gain (loss) on securities:			
Amount arising during the period	5,354,719	(2,184,739)	3,169,980
Less: Reclassification adjustments for losses included in net loss	(47,040)	19,192	(27,848)
Release in deferred tax asset valuation allowance*	—	2,165,547	2,165,547
Net unrealized holding gain (loss) during the period	5,307,679	—	5,307,679
Gain on cash flow hedging derivative instruments:			
Amount arising during the period	(7,561)	—	(7,561)
Less: Reclassification adjustments for losses included in net loss	26,303	—	26,303
Net gain on cash flow hedging derivative instruments	18,742	—	18,742
Other comprehensive income (loss)	¥ 5,280,839	¥ —	¥ 5,280,839
<b>Year ended March 31, 2005:</b>			
Foreign currency translation adjustments	¥ (25,858)	¥ —	¥ (25,858)
Unrealized holding gain (loss) on securities:			
Amount arising during the period	4,989,951	(2,045,880)	2,944,071
Less: Reclassification adjustments for gains included in net income	(2,478,906)	1,016,351	(1,462,555)
Release in deferred tax asset valuation allowance*	—	1,029,529	1,029,529
Net unrealized holding gain (loss) during the period	2,511,045	—	2,511,045
Gain on cash flow hedging derivative instruments:			
Amount arising during the period	(3,521)	—	(3,521)
Less: Reclassification adjustments for losses included in net income	13,010	—	13,010
Net gain on cash flow hedging derivative instruments	9,489	—	9,489
Other comprehensive income (loss)	¥ 2,494,676	¥ —	¥ 2,494,676

	Thousands of Yen		
	Before Tax Amount	Tax (Expense) or Benefit	Net of Tax Amount
<b>Year ended March 31, 2006:</b>			
Foreign currency translation adjustments	¥ 38,331	¥ —	¥ 38,331
<b>Unrealized holding gain (loss) on securities:</b>			
Amount arising during the period	1,046,874	(429,218)	617,656
Less: Reclassification adjustments for gains included in net income	(3,227,203)	1,323,153	(1,904,050)
Increase in deferred tax asset valuation allowance*	—	(893,935)	(893,935)
Net unrealized holding gain (loss) during the period	<u>(2,180,329)</u>	<u>—</u>	<u>(2,180,329)</u>
<b>Gain on cash flow hedging derivative instruments:</b>			
Amount arising during the period	(4,541)	—	(4,541)
Less: Reclassification adjustments for losses included in net income	10,008	—	10,008
Net gain on cash flow hedging derivative instruments	<u>5,467</u>	<u>—</u>	<u>5,467</u>
Other comprehensive income (loss)	<u>¥(2,136,531)</u>	<u>¥ —</u>	<u>¥(2,136,531)</u>

	Thousands of U.S. Dollars		
	Before Tax Amount	Tax (Expense) or Benefit	Net of Tax Amount
<b>Year ended March 31, 2006:</b>			
Foreign currency translation adjustments	\$ 326	\$ —	\$ 326
<b>Unrealized holding gain (loss) on securities:</b>			
Amount arising during the period	8,911	(3,654)	5,257
Less: Reclassification adjustments for gains included in net income	(27,470)	11,263	(16,207)
Increase in deferred tax asset valuation allowance*	—	(7,609)	(7,609)
Net unrealized holding gain (loss) during the period	<u>(18,559)</u>	<u>—</u>	<u>(18,559)</u>
<b>Gain on cash flow hedging derivative instruments:</b>			
Amount arising during the period	(38)	—	(38)
Less: Reclassification adjustments for losses included in net income	85	—	85
Net gain on cash flow hedging derivative instruments	<u>47</u>	<u>—</u>	<u>47</u>
Other comprehensive income (loss)	<u>\$(18,186)</u>	<u>\$ —</u>	<u>\$(18,186)</u>

\* The release (increase) in the deferred tax asset valuation allowance has resulted from unrealized gains and (losses) on available-for-sale securities, respectively.

The components of accumulated other comprehensive income (loss) at March 31, 2005 and 2006 are as follows:

	Thousands of Yen		Thousands of
	2005	2006	U.S. Dollars
Foreign currency translation adjustments	¥ (33,295)	¥ 5,036	\$ 43
Unrealized holding gain on securities	8,732,910	6,552,581	55,776
Loss on cash flow hedging derivative instruments	(9,490)	(4,023)	(34)
	<u>¥8,690,125</u>	<u>¥6,553,594</u>	<u>\$ 55,785</u>

### 13. BASIC AND DILUTED NET INCOME (LOSS) PER SHARE

Basic and diluted net income (loss) per share computation for three years ended March 31, 2004, 2005 and 2006 is as follows.

	Thousands of Yen			Thousands of
	2004	2005	2006	U.S. Dollars
<b>Numerator:</b>				
Net income (loss)	¥(2,270,686)	¥2,906,269	¥4,753,570	\$ 40,463
Effect of dilution	—	—	—	—
Net income (loss)-diluted	<u>¥(2,270,686)</u>	<u>¥2,906,269</u>	<u>¥4,753,570</u>	<u>\$ 40,463</u>
<b>Denominator:</b>				
	Number of shares			
	2004	2005	2006	
Weighted-average common shares outstanding	158,554	191,559	195,613	
Effect of Stock options	—	—	342	
Diluted common shares outstanding	<u>158,554</u>	<u>191,559</u>	<u>195,955</u>	
	Yen			U.S. Dollars
	2004	2005	2006	2006
Basic net income (loss) per common share	<u>¥ (14,321)</u>	<u>¥ 15,172</u>	<u>¥ 24,301</u>	<u>\$ 207</u>
Diluted net income (loss) per common share	<u>¥ (14,321)</u>	<u>¥ 15,172</u>	<u>¥ 24,258</u>	<u>\$ 206</u>

For the year ended March 31, 2004, all potential common shares, shares issuable upon exercise of stock options or conversion of convertible notes, have been excluded from the computation of diluted net loss per share because the effect would be antidilutive.

For the year ended March 31, 2005, potentially dilutive shares have been excluded from the computation of diluted net income because the exercise prices of the options were greater than the average market price of the common shares and the effect of conversion of the convertible notes would be antidilutive.

For the year ended March 31, 2006, the following potentially dilutive shares have been excluded from the computation of diluted net income because the exercise prices of the options were greater than the average market price of the common shares.

Diluted net income (loss) per share does not include the effects of the following potential common shares:

	Year ended March 31		
	2004	2005	2006
Shares issuable under stock options	3,075	2,725	975
Shares issuable related to convertible notes on an “as-if-converted” basis	2,975	—	—

#### 14. COMMITMENTS AND CONTINGENT LIABILITIES

In December 2001, a class action complaint alleging violations of the federal securities laws was filed against the Company, naming IIJ, certain of its officers and directors as defendants, and underwriters of IIJ’s initial public offering. Similar complaints have been filed against over 300 other issuers that have had initial public offerings since 1998 and such actions have been included in a single coordinate proceeding in the Southern District of New York. An amended complaint was filed on April 24, 2002 alleging, among other things, that the underwriters of IIJ’s initial public offering violated the securities laws (i) by failing to disclose in the offering’s registration statement certain alleged compensation arrangements entered into with the underwriters’ clients, such as undisclosed commissions or tie-in agreements to purchase stock in the after-market, and (ii) by engaging in manipulative practices to artificially inflate the price of IIJ’s stock in the after-market subsequent to the initial public offering. On July 15, 2002, the Company joined in an ‘omnibus’ motion to dismiss the amended complaint filed by the issuers and individuals named in the various coordinated cases. In June 2003, the Company approved a settlement with the plaintiffs in this matter. IIJ, along with the settling issuer defendants, filed a motion seeking the court’s preliminary approval of the settlement. The court granted preliminary approval of the settlement on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005. The settlement fairness hearing has been set for April 24, 2006. Following the hearing, if the court determines that the settlement is fair to the class members, the settlement will be approved. The settlement releases IIJ and the individual defendants for liability for the conduct alleged in the action. Under the settlement, the Company agreed to assign away, not assert, or release certain potential claims the Company may have against IIJ’s underwriters. Approximately 260 defendant issuers participated in this settlement. As to financial impact on the Company, the settlement provides that the class members will be guaranteed \$1 billion in recoveries by the insurers of the issuers. In addition to IIJ’s portion of the proposed settlement, some of the continuing legal expenses incurred in connection with the partial settlement would be borne by IIJ’s insurer based on the settlement agreement and an individual agreement between IIJ and IIJ’s insurer. Consequently, the Company believes that there will be no significant financial impact on the Company as a result of this matter.

In addition to the foregoing, the Company is a party to other suits and claims that arise in the normal course of business. The negative adverse outcome of such suits and claims would not have a significant impact on the financial statements.

In January 19, 2006, IIJ entered into a joint venture agreement regarding the establishment and management of i-revo with Konami corporation. In the agreement, IIJ committed an additional contribution for capital investment or working capital to i-revo of up to ¥90,000 thousand (\$766 thousand) for the period from November 2006 to April 2007.

#### 15. DERIVATIVE AND OTHER FINANCIAL INSTRUMENTS

**Interest Rate Swap Agreement**—The Company is exposed to changes in interest rates that are associated with long-term bank borrowings. The Company’s policy on managing the interest rate risk is to hedge the exposure to variability in future cash flows of floating rate interest payments on the long-term bank borrowings. In order to reduce cash flow risk exposures on floating rate borrowings, the Company utilizes interest rate swap agreements to convert a floating rate borrowing to a fixed rate borrowing.

The Company is also exposed to credit-related losses in the event of non-performance by counterparties to interest rate swaps, but it is not expected that any counterparties will fail to meet their obligations, because counterparties are internationally recognized financial institutions.

Changes in fair value of interest rate swaps designated as hedging instrument are reported in accumulated other comprehensive income during the years ended March 31, 2004, 2005 and 2006. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the hedged bank borrowings affect earnings. The term, notional amount and repricing date of interest rate swaps exactly match those of the long-term borrowings. The swap terms are "at the market," so they have zero value at inception. Thus, there was no ineffectiveness recognized in earnings for the years ended March 31, 2004, 2005 and 2006. For the years ended March 31, 2004, 2005 and 2006, net derivative loss of ¥26,303 thousand, ¥13,010 thousand and ¥10,008 thousand (\$85 thousand) were reclassified to interest expense, respectively.

Approximately ¥7,116 thousand (\$61 thousand) of accumulated other comprehensive loss related to the interest rate swaps are expected to be reclassified as an adjustment to interest expense as a yield adjustment of the hedged bank borrowings within the next 12 months.

**Fair Value**—In the normal course of business, the Company invests in financial assets and incurs financial liabilities. To estimate the fair value of those financial assets, liabilities and derivatives, the Company used quoted market prices to the extent that they were available. Where a quoted market price is not available, the Company estimates fair value using primarily the discounted cash flow method. For certain financial assets and liabilities, such as trade receivables and trade payables, which are expected to be collected and settled within one year, the Company assumed that the carrying amount approximates fair value due to their short maturities. Investment for which it is not practicable to estimate fair value are investments in a number of unaffiliated and unlisted smaller sized companies and the estimate of their fair values cannot be made without incurring excessive costs. Refundable insurance policies are carried at cash surrender value. The carrying amounts or notional amounts and fair value of financial instruments are summarized below:

	Thousands of Yen				Thousands of U.S. Dollars	
	2005		2006		2006	
	Carrying Amount or Notional Amount	Fair Value or Gain (Loss)	Carrying Amount or Notional Amount	Fair Value or Gain (Loss)	Carrying Amount or Notional Amount	Fair Value or Gain (Loss)
Other investments for which it is:						
Practicable to estimate fair value	¥8,948,168	¥8,948,168	¥6,775,388	¥6,775,388	\$57,673	\$57,673
Not practicable	982,613	—	1,245,317	—	10,600	—
Noncurrent refundable insurance policies (other assets)	62,636	62,636	82,252	82,252	700	700
Long-term borrowings and installment payable, including current portion	4,266,019	4,262,908	2,279,963	2,279,963	19,407	19,407
Interest rate swap contracts	1,400,000	(9,490)	1,150,000	(4,023)	9,789	(34)

Cash at March 31, 2005 and 2006 includes U.S. dollar denominated current bank deposits of ¥705,940 thousand and ¥442,169 thousand (\$3,764 thousand), respectively.

**16. ADVERTISING EXPENSES**

Advertising expenses incurred during the years ended March 31, 2004, 2005 and 2006 related primarily to advertisements in magazines, journals and newspapers and amounted to ¥106,525 thousand, ¥151,226 thousand and ¥223,696 thousand (\$1,904 thousand), respectively.

**17. SUBSEQUENT EVENTS**

At the 14<sup>th</sup> Ordinary General Shareholders' Meeting held on June 28, 2006, IJ's shareholders approved the reductions of additional paid-in capital of ¥21,980,395 thousand (\$187,099 thousand) and common stock of ¥2,539,222 thousand (\$21,624 thousand) to eliminate accumulated deficit for purposes of reporting under the Corporation Law in its non-consolidated financial statements. The reductions are pursuant to Article 447.1 and 448.1 of the Corporation Law. The effective date is August 4, 2006.

\* \* \* \* \*

(English Translation)

ARTICLES OF INCORPORATION

Executed on December 3, 1992

Amended on June 28, 2006

CHAPTER I. GENERAL PROVISIONS

(Corporate Name)

Article 1.

The Company shall be called Kabushiki Kaisha Internet Initiative, which shall be expressed in English as Internet Initiative Japan Inc.

(Objects)

Article 2.

The objects of the Company shall be to engage in the following categories of business:

- (1) Telecommunications business under the Telecommunications Business Law;
- (2) Processing, mediation and provision of information and contents by using telecommunications networks;
- (3) Agency for the management business such as the management of networks and the management of information and telecommunications systems;
- (4) Planning, consulting service, development, operation and maintenance of or for information and telecommunications systems;
- (5) Development, sales, lease and maintenance of computer software;
- (6) Development, sales, lease and maintenance of telecommunications' machinery and equipment;
- (7) Telecommunications construction business;
- (8) Agency for non-life insurance business;
- (9) Research, study, education and training related to the foregoing; and
- (10) Any and all businesses incidental or related to the foregoing.

(Location of Head Office)

Article 3.

The Company shall have its head office in Chiyoda-ku, Tokyo.

(Establishment of Organs)

Article 4.

The Company shall have shareholders meeting, directors and the following organization:

- (1) Board of directors
- (2) Statutory auditors
- (3) Board of statutory auditors
- (4) Accounting auditors.

(Method of Public Notice)

Article 5.

Public notices of the Company shall be given by electronic public notice; provided that in case it is impossible to place electronic public notice due to accident or any other unavoidable events, they shall be given in the Nihon Keizai Shinbun.

## CHAPTER II. SHARES

(Total Number of Shares Authorized to be Issued)

Article 6.

The total number of shares authorized to be issued by the Company shall be three hundred seventy seven thousand and six hundred (377,600) shares.

(Issuance of Share Certificates)

Article 7.

The Company shall issue share certificates representing its shares.

(Share Handling Regulations)

Article 8.

The procedures concerning shares and handling charges thereof shall be governed by the Share Handling Regulations to be prescribed by the Board of Directors.

(Shareholder Register Agent)

Article 9.

The Company shall appoint a shareholder register agent.

2. The shareholder register agent and its place of business shall be designated by a resolution of the Board of Directors.

3. The register of shareholders (hereinafter including the register of beneficial shareholders), the original register of stock acquisition rights and the register of lost share certificates shall be kept by the shareholder register agent at its place of business, and the listing or recording of entries into the register of shareholders, the original register of stock acquisition rights and the register of lost share certificates and other matters concerning shares and stock acquisition rights shall be handled by the shareholder register agent, and the Company shall not handle any such matters.

(Record Date)

Article 10.

The record date for the voting rights to be exercised at the ordinary general meeting of shareholders of the Company shall be March 31 of each year.

CHAPTER III. GENERAL MEETING OF SHAREHOLDERS

(Convocation)

Article 11.

An ordinary general meeting of shareholders of the Company shall be held within three (3) months from the last day of each business year and an extraordinary general meeting of shareholders may be held from time to time whenever necessary.

(Disclosure Internet and Deemed Provision of Reference Materials for a Shareholders Meeting)

Article 12.

For the purpose of convocation of a general meeting of shareholders, the Company may deem that it has duly provided its shareholders with the information to be listed or indicated in the reference materials for a general meeting of shareholders, the business report, financial statements and consolidated financial statements by disclosing the information via the Internet as provided for by the Ministry of Justice Ordinance.

(Chairman)

Article 13.

The President and Director shall chair a general meeting of shareholders. Should the President and Director be unable to so act, another director shall act in his/her place in the order predetermined by the Board of Directors.

(Voting by Proxy)

Article 14.

A shareholder may exercise his/her voting right through another one(1) shareholder having voting rights acting as a proxy in a general meeting of shareholders.

2. In the case of the preceding paragraph, the shareholder or his/her proxy shall submit to the Company an instrument evidencing his/her power as proxy for each general meeting of shareholders.

(Method of Resolution)

Article 15.

Unless otherwise provided for by law or these Articles of Incorporation, resolutions of a general meeting of shareholders shall be adopted by a majority vote of shareholders who are present and entitled to exercise voting rights at the meeting.

2. Special resolutions under Article 309 Paragraph 2 of the Corporation Law of Japan shall be passed by two-thirds or more of the voting rights of the shareholders present having one-third or more of the voting rights of all shareholders who are entitled to exercise voting rights.

CHAPTER IV. DIRECTORS AND THE BOARD OF DIRECTORS

(Number of Directors)

Article 16.

The number of directors of the Company shall be thirteen (13) at maximum.

(Election)

Article 17.

A resolution for election of directors shall be made by a majority of voting rights of the shareholders present at the meeting where the shareholders representing one third (1/3) or more of the total number of the voting rights of all shareholders entitled to vote thereat are present; provided that cumulative voting shall not be adopted for such election.

(Term of Office of Directors)

Article 18.

The term of office of directors shall expire at the close of the ordinary general meeting of shareholders held in relation to the last business year ending within two (2) years following their election to office.

(Convocation of Meetings of the Board of Directors)

Article 19.

Unless otherwise provided for by law, a meeting of the Board of Directors shall be convened and chaired by the President and Director.

2. The notice of convocation of a meeting of the Board of Directors shall be given to each director and statutory auditor at least three (3) days prior to the day set for such meeting; provided, however, that this period may be further shortened under pressing circumstances.

3. Matters concerning operation of meetings of the Board of Directors, etc. shall be governed by laws and regulations, the Articles of Incorporation and the Regulations of Board of Directors to be prescribed by the Board of Directors.

(Representative Director and Directors with Specific Titles)

Article 20.

Representative Directors shall be elected among directors by the resolution of the Board of Directors. Each Representative Director shall severally represent the Company.

2. The Board of Directors may, by its resolution, select from among its members one Chairman and Director, one President and Director, several Vice Presidents and Directors, several Senior Managing Directors and several Managing Directors.

(Method of Resolution of the Meeting of the Board of Directors)

Article 21.

A resolution of the Board of Directors shall be adopted by a majority vote of the directors present at the meeting

at which a majority of the directors authorized to vote thereat are present.

(Omission of Resolutions of a Board of Directors Meeting)

Article 22.

The Company shall deem that a proposal for a resolution at a meeting of the Board of Directors has been approved if all directors consent to the proposal in writing or by electronic means; provided, however that this shall not apply to the case where any of the statutory auditors raises an objection.

(Remuneration and other compensation)

Article 23.

The remuneration, bonus and other profit be paid to directors as consideration for the execution of duties (hereinafter referred to as 'Remuneration and other compensation') shall be determined by a general meeting of shareholders.

(Exemption of Liability for Directors)

Article 24.

The Company may, pursuant to the provision of Article 426 Paragraph 1 of the Corporation Law of Japan, with a resolution of the Board of Directors, exempt a director (either incumbent or past) from liabilities for damages under Article 423 Paragraph 1 of the Corporation Law of Japan with the limit of the amount for which the director would have been liable to compensate, less the minimum amount of liability as prescribed by laws or regulations, if the requirements prescribed by laws or regulations are satisfied.

2. The Company may, pursuant to Article 427 Paragraph 1 of the Corporation Law of Japan, enter into an agreement with an outside director under which liability of such director against the Company for the damages under Article 423 Paragraph 1 of the Corporation Law of Japan shall be limited if the requirements prescribed by laws or regulations are satisfied; provided, however, that the limited amount of such damages pursuant to the agreement shall be the larger of the amount not less than 10 million yen which has been determined in advance or the minimum amount of liability provided by laws or regulations.

#### CHAPTER V. STATUTORY AUDITORS AND THE BOARD OF STATUTORY AUDITORS

(Number of Statutory Auditors)

Article 25.

The Company shall have three (3) or more statutory auditors.

(Election)

Article 26.

A resolution for election of statutory auditors shall be made by a majority of voting rights of the shareholders present at the general meeting of shareholders where the shareholders representing one third (1/3) or more of the total number of the voting rights of all shareholders entitled to vote thereat are present.

(Term of Office of Statutory Auditors)

Article 27.

The term of office of statutory auditors shall expire at the close of the ordinary general meeting of shareholders in relation to the last business year ending within four (4) years following their election to office.

2. The term of office of a statutory auditor elected to fill a vacancy of his/her predecessor who retired or resigned prior to the expiration of term shall expire at such time as the term of office of his/her predecessor would otherwise expire.

(Full-time Statutory Auditors)

Article 28.

The Board of Statutory Auditors shall appoint a full-time statutory auditor(s) by a resolution thereof. A standing statutory auditor(s) shall be appointed from among full-time statutory auditors through mutual consultation among statutory auditors.

(Procedures for Convocation of the Meeting of the Board of Statutory Auditors)

Article 29.

A notice of the convocation of a meeting of the Board of Statutory Auditors shall be given to each statutory auditor at least three (3) days prior to the date set for such meeting; provided, however, that such period may be shortened under pressing circumstances.

2. Matters concerning operation of meetings of the Board of Statutory Auditors, etc. shall be governed by laws and regulations, the Articles of Incorporation and the Regulations of Board of Statutory Auditors to be prescribed by the Board of Statutory Auditors.

(Remuneration)

Article 30.

The Remuneration and other compensation for statutory auditors shall be determined by a general meeting of shareholders.

(Exemption of Liability for Statutory Auditors)

Article 31

.The Company may, pursuant to the provision of Article 426 Paragraph 1 of the Corporation Law of Japan, with a resolution of the Board of Directors, exempt a statutory auditor (either incumbent or past) from liabilities for damages under Article 423 Paragraph 1 of the Corporation Law of Japan with the limit of the amount for which the statutory auditor would have been liable to compensate, less the minimum amount of liability as prescribed by laws or regulations, if the requirements prescribed by laws or regulations are satisfied.

2. The Company may, pursuant to Article 427 Paragraph 1 of the Corporation Law of Japan, enter into an agreement with an outside statutory auditor under which liability of such statutory auditor against the Company for the damages under Article 423 Paragraph 1 of the Corporation Law of Japan shall be limited if the requirements prescribed by laws or regulations are satisfied; provided, however, that the limited amount of such damages pursuant to the agreement shall be the larger of the amount not less than 10 million yen which has been determined in advance or the minimum amount of liability provided by laws or regulations.

## CHAPTER VI. ACCOUNTING

(Business Year)

Article 32.

The business year of the Company shall commence on April 1 of each year and end on March 31 of the following year.

(Record Date for Surplus Distribution)

Article 33.

The record date for year-end dividend distribution shall be March 31 of each year.

2. The Company may, by resolution of the Board of Directors, pay interim dividends by fixing September 30 of each year as the record date.

(Prescription Period of Dividends)

Article 34.

In case any monetary dividends remain unclaimed for three (3) full years after the first date of payment, the Company shall be relieved from the obligation to make payment thereof.

2. No interest shall accrue on the outstanding dividends provided for in the preceding paragraph.

(English Translation)

SHARE HANDLING REGULATIONS  
CHAPTER I. GENERAL PROVISIONS

Article 1. (Purpose)

Matters concerning kinds of share certificates and the handling of shares and fractional shares of the Company shall be governed by these Regulations pursuant to the provisions of Article 8 of the Articles of Incorporation. Provided, however, that the handling of beneficial shareholders shall be conducted under the Regulations as well as under the rules set forth by the Central Securities Custody and Book-Entry Transfer System.

Article 2. (Shareholder Register Agent)

The Shareholder Register Agent of the Company, its place of business and forwarding offices shall be as listed below:

Shareholder Register Agent:

The Sumitomo Trust and Banking Company, Limited  
5-33, Kitahama 4-chome, Chuo-ku, Osaka

Place of business:

Securities Handling Department  
The Sumitomo Trust and Banking Company, Limited  
4-4, Marunouchi 1-chome, Chiyoda-ku, Tokyo

Forwarding offices:

Head office and all branches throughout the country of The Sumitomo Trust and Banking Company, Limited

Article 3. (Kinds of share certificates)

The share certificates to be issued by the Company shall be in denominations of one hundred (100), fifty (50), ten (10), five (5) and one (1) share.

Article 4. (Requests)

In the event a shareholder makes a request or notification in accordance with the legal, such request or notification shall be made by submitting prescribed forms, on which the registered seal impression ("seal impression") as stipulated in Article 18 shall be stamped.

2. Unless in case of the preceding paragraph, all requests, reports, applications or filings pursuant to these Regulations shall be made to the Shareholder Register Agent, in the form prescribed by the Company and shall bear seal impressions.

3. In the event that the procedures set forth in the paragraph 1 and paragraph 2 are made through a proxy, documents evidencing such proxy's authority shall be submitted.

4. In the event that consent by the curator or assistant is required when the request, notice, report, application or filing set forth in the paragraph 1 and paragraph 2 are made, documents evidencing such parties' consent shall be submitted.

Article 5. (Documentary evidence or guarantor)

The Company may require the submission of documentary evidence or require a guarantor to make a guarantee in the case of requests, reports, applications, filings or receipt in respect of the share certificates, or in the event the Company deems it necessary.

CHAPTER II. Enrollment and Record on Register of Shareholder

Article 6. (Enrollment and Record on Register of Shareholder)

1. In the event any enrollment or record onto the register of shareholder ("Transfer of Shares") is requested to the Company, a prescribed request form shall be submitted with the share certificates.

2. In the event that a person who acquired shares by any reason other than assignment makes an application for the transfer of shares, he shall, in addition to the procedure set forth in the preceding paragraph, submit documents evidencing the causes for such acquisition.

Article 7. (Transfer of shares pursuant to other procedures prescribed by laws)

In the event that the transfer of shares requires any procedures as statutorily prescribed, the application therefore shall be accompanied by the relevant share certificates and the documents evidencing completion of such procedures.

CHAPTER III. Notice with Respect to Beneficial Shareholders

Article 8. (Certificate of Beneficial Shareholder)

A beneficial shareholder shall submit a certificate of beneficial shareholder through a participant with a description of his/her name, address and other necessary matters required to be recorded thereon.

Article 9. (Notice with Respect to Beneficial Shareholders)

The number of shares held by beneficial shareholders and other necessary matters shall be reported by the Center by the method set forth preceding paragraph and rules prescribed by the Center.

Article 10. (Entry in Register of Beneficial Shareholders and Name Identification of Shareholders)

1. Entry in register of beneficial shareholders shall be made the preceding Article 8 and Article 9.
2. In the event a shareholder entered into the register of shareholders and a beneficial shareholder entered into the register of beneficial shareholders are recognized to be identical based upon registered address and name, the number of shares with respect to the same class of share shall be totaled in giving effect to the right of such shareholder,

CHAPTER IV. REGISTRATION OF PLEDGE AND TRUST ASSET

Article 11. (Registration or deregistration of pledge)

To request registration or deregistration of pledge with respect to shares, an application jointly signed by the pledgor and and pledgee shall be submitted together with the relevant share certificates.

Article 12. (Registration or deregistration of trust assets)

To request registration of trust assets with respect to shares, the trustor or trustee shall submit an application therefore together with the relevant share certificates. To request deregistration of trust

assets with respect to shares, the trustee or beneficiary shall submit an application therefore together with the relevant share certificates.

#### CHAPTER V. NON-POSSESSION OF SHARE CERTIFICATES

Article 13. (Application for non-possession of share certificates)

1. An application for non-possession of share certificates shall be submitted together with the relevant share certificates.

2. In the event that the above applications is accepted, non-issuance of share certificates shall be noted or recorded in the register of shareholders.

Article 14. (Application for delivery of no-possessed share certificates)

In the event that a shareholder who submitted an application for non-possession of share certificates requests the issuance of return thereof, an application therefore shall be submitted.

#### CHAPTER VI. NOTIFICATIONS

Article 15. (Notification of name and address, etc.)

A shareholder shall notify the Company of the following information. Provided, however, a beneficial shareholder shall notify it by the submission of a certificate of beneficial shareholder set forth in Article 8.

- (1) name and address;
- (2) in the event such a shareholder is a corporation; the titles and names of its representatives;
- (3) in the event a legal representative is elected for a shareholder; the position, name and address of such legal representative; and
- (4) in the event a shareholder is owned jointly, the name and address of the representative of such joint owners.

Article 16. (Expatriate share holders)

In the event the address of a shareholder in the preceding Article is in a foreign country, such a shareholder shall notify a temporal address to receive notices in Japan or appoint a standing agent in Japan and notify the Company of such matter. Provided, however, a beneficial shareholder shall notify it at the same time the submission of a certificate of beneficial shareholder set forth in Article 8.

Article 17. (Changes to registered information)

1. In the event matters regarding the registered information, pursuant to Article 12 and Article 13 are changed, such shareholder shall notify the Company of such changes.

2. In the event the name of a shareholder changes, and application therefore, share certificates and evidencing documents therefore shall be submitted, provided however, in the event that the share certificates are not issued or changes of matters indicated in the register of beneficial shareholders are made, the submission of share certificates is not required.

3. In the event the name, title or position of the legal representative, representative or agent of shareholder changes, an application therefore and evidencing documents therefore shall be submitted.

Article 18. (Submission of an imprint of seal)

1. A shareholder, its legal representative, representative or agent shall submit an imprint of its seal (or in the event of a foreign person or corporation whose country has signatory customs, an imprint of its signature) to the Company. Provided, however, a beneficial shareholder shall notify it by the submission of a certificate of beneficial shareholder set forth in Article 8.

2. In the event of a change of seal, such shareholder shall submit an imprint of the new seal.

Article 19. (Registered pledge and Lost Share Certificates, etc.)

The provisions of this Chapter shall be applied mutatis mutandis to registered pledgees and registered persons of lost share certificates.

#### CHAPTER VII. INSCRIPTION ON SHARE CERTIFICATES

Article 20. (Date of issue of Share Certificate and Names of shareholders)

1. The names of shareholders shall be inscribed on the share certificates.

2. In the event that shares are transferred. The date registered in the register shall be inscribed in the back of such a share certificates, the name of the transferee shall be inscribed thereon and certification by the Shareholder Register Agent shall be imprinted.

3. The provision in the preceding paragraph shall be applied mutatis mutandis in the event that an application pursuant to paragraph 2 of Article 17 is made.

Article 21. (Registration or deregistration of a pledge and trust assets)

1. In the event that registration or deregistration of a pledge pursuant to the provisions of Article 11 is made, such information and the date registered or recorded in the register shall be inscribed on the share certificate and certification by the Shareholder Register Agent shall be imprinted.

2. In the event that registration or deregistration of trust assets pursuant to the provisions of Article 12 is made, such information and the date registered or recorded in the register shall be inscribed on the share certificate and certification by the Shareholder Register Agent shall be imprinted.

#### CHAPTER VIII. REGISTRATION OF LOST SHARE CERTIFICATES

Article 22. (Registration or deregistration of lost share certificates)

1. To request registration or deregistration of lost share certificates, an application form or a request form shall be submitted together with the documents the Company requires.

2. To request registration set forth in the preceding Paragraph, fee for registration of lost share certificates set forth in Article 23 shall be paid.

3. In the event the holder of the share certificates which became subject to the registration of lost share certificates applies for the cancellation of the registration of lost share certificates set forth in Paragraph 1, the share certificates which have been registered as lost shall be submitted.

Article 23. (Fee for registration of lost share certificates)

The fee in respect of the request for registration of lost share certificates shall be the amount separately prescribed.

CHAPTER IX. REISSUANCE OF SHARE CERTIFICATES

Article 24. (Issuance of new share certificates due to division or consolidation)

To request issuance of new share certificates due to division or consolidation of share certificates, an application therefore shall be submitted together with the relevant share certificates.

Article 25. (Reissuance due to defacement or mutilation)

To request issuance of new shares due to defacement or mutilation of share certificates, new share certificates shall be issued in the exchange for such certificates; provided, however, that if it is difficult to discern the genuineness of the share certificates, the provisions of the preceding Chapter shall apply.

CHAPTER X. MISCELLANEOUS

Article 26. (Amendments)

Any amendments to or abolishment of this regulation shall be rendered by resolution of the Board of Directors of the Company.

Established on September 1, 1995

Amended on May 31, 2004

(English Translation)

Joint Venture Agreement

Konami Corporation (hereinafter referred to as "Konami") and Internet Initiative Japan Inc. (hereinafter referred to as "IIJ") wish to establish jointly a company who operates the Internet portal sites and to achieve results of cooperation between the parties in the field of consumer services and designing and production of contents by Konami and in the field of technical assistance regarding system integration and operation of network system by IIJ, by taking a role respectively. NOW, THEREFORE, both parties hereby agree, in respect with Konami and IIJ being shareholders of the new company, as follows:

<Incorporation of New Company>

Article 1. (Incorporation Procedures)

1. Konami and IIJ shall incorporate Kabushiki Kaisha Internet Revolution as a Japanese stock corporation (hereinafter referred to as the "New Company") on February 1, 2006. Konami shall take all responsibilities for prior procedures, acquisition of approval and license, etc., necessary for incorporation.
2. The New Company shall bear and pay all the cost and expense which were necessarily incurred for incorporation (including fees of attorney and judicial scrivener, registration license tax); provided, however, that Konami shall advance such fee until the New Company commences its business.
3. Konami and IIJ shall make the New Company to submit a consent letter to this Agreement to the parties after the New Company is incorporated.

Article 2. (Articles of Incorporation)

The Articles of Incorporation of the New Company shall be set forth as in Exhibit 1.

Article 3. (Amount of the Capital at the Time of Incorporation)

The amount of the capital shall be 1,250 million yen and the amount of the capital reserve shall be 1,250 million yen at the time of incorporation.

Article 4. (Shares)

The total number of shares to be issued by the New Company at the time of incorporation shall be 25,000 shares and Konami subscribes for 17,500 shares and IIJ subscribes for 7,500 shares.

Article 5. (Accounting)

1. The fiscal year of the New Company shall commence on April 1 of each year and end on March 31 of the following year.
2. The accounting auditor of the New Company shall be KPMG AZSA & Co. and, in the case of changing the accounting auditor, Konami and IIJ shall consult with each other and determine.

Article 6. (Directors)

1. The number of directors of the New Company shall be five.
2. Konami will nominate three directors of the New Company and IIJ will nominate two directors of the New Company.
3. Konami and IIJ may request dismissal of the directors nominated by itself at its own discretion and the other party will not object to such request.

4. Konami and IIJ may nominate substitution for any of the directors of the New Company nominated by itself who is no more a director for the reason of resign, retirement, death, dismissal or any other reason.

5. Konami and IIJ shall cooperate and vote each shares at the shareholders' meetings of the New Company in order to appoint or dismiss directors in accordance with the clause 2, 3 and 4.

6. In case that the shareholding ratio of each party is changed, the party who holds the majority shares may nominate three Directors.

7. The New Company shall pay remuneration to each director within the reasonable limits of amount as determined through the resolutions of the Board of Directors' Meetings and shall not pay retirement allowances.

#### Article 7. (Statutory Auditors)

1. The number of statutory auditors of the New Company shall be three.

2. Konami shall nominate one full-time statutory auditor and one part-time statutory auditor of the New Company and IIJ shall appoint one part-time statutory auditor of the New Company.

3. Konami and IIJ may submit dismissal of the statutory auditors nominated by itself at its own discretion and the other party will not object to such dismissal.

4. Konami and IIJ may nominate substitution for any of the statutory auditors of the New Company nominated by itself who is no more a statutory auditor for the reason of resign, retirement, death, dismissal or any other reason.

5. Konami and IIJ shall cooperate and vote each shares at the shareholders' meetings of the New Company in order to appoint or dismiss statutory auditors in accordance with the sub-clause 2, 3 and 4.

6. In case that the shareholding ratio of each party is changed, the party who holds the majority shares may nominate two Directors.

7. The New Company shall pay remuneration to each statutory auditor within the reasonable limits of amount as determined through the resolutions of the Board of Directors' Meetings and shall not pay retirement allowances.

#### Article 8. (Personnel Matters)

1. Konami shall transfer employment of its eighteen employees (excluding directors and statutory auditors) to the New Company as employees of the New Company and IIJ shall have its ten employees (excluding directors and statutory auditors) on loan to the New Company as employees of the New Company at the time of incorporation; provided, however, that Konami and IIJ acknowledge that the number of employees set forth in this clause may be increased or decreased within the reasonable limit until the incorporation of the New Company after this Agreement is entered.

2. The conditions of employment of Konami shall apply mutatis mutandis to the conditions of employment of the New Company.

#### <Management of the New Company>

#### Article 9. (Matters to be Resolved by the Unanimous Votes at the Board of Directors)

The following matters shall be resolved by the unanimous votes at the Board of Directors of the New Company;

- i. Amendment to the standards for matters requiring resolution at a meeting of the Board of Directors and the number of voting rights relating to such standards in the Regulations of the Board of Directors (the

Regulations of the Board of Directors originally provided for shall be set forth in Exhibit 2 attached hereto); and

- ii. Withdraw from the business as a whole or principal business of the New Company, assignment of the business of the New Company as a whole or an important part thereof and dissolution of the New Company.

Article 10. (Obligations of the New Company)

The New Company shall perform the following matters for Konami and IIJ;

- i. to submit the financial statement reporting of each quarter in accordance with U.S.GAAP within each period which Konami and IIJ designate respectively; and
- ii. to respond to the request such as reporting, auditing etc., in case that Konami or IIJ requests to the New Company without a delay in accordance with any applicable laws to Konami or IIJ, including the Commercial Code of Japan, Securities Exchange Law of Japan, Securities Exchange Act, the Public Company Accounting Reform and Investor Protection Act of 2002.

Article 11. (Operation Plans and Financing)

1. Konami and IIJ acknowledges in advance that both parties shall provide funding not more than 300 million yen to the New Company from November 1, 2006 until April 30, 2007 for capital investment and operating capital required in accordance with the operation plan of the New Company agreed by both parties at the time of conclusion of this Agreement (hereinafter referred to as "the Operation Plan of the New Company"). The ratio of the amount to be borne by each party shall be in accordance with the respective shareholding ratios of such party and the method of funding, such as issuance of new shares, loan or any other appropriate ones, shall be agreed separately between Konami and IIJ.

2. Konami and IIJ shall cooperate and vote each shares at the Meetings of Directors and the shareholders' meetings (if applicable) of the New Company in order that such method of funding agreed between both parties in accordance with the preceding clause should be approved.

3. In case that the Operation Plan of the New Company is changed in accordance with the agreement between Konami and IIJ, Konami and IIJ shall not be prevented from changing the time and amount of the funding set forth in the preceding clause.

<Matters Agreed on the New Company>

Article 12. (Public Announcement)

In case that Konami, IIJ or the New Company will make transmission of information, press release etc., upon the commencement of the operation of the New Company, such three parties shall agree the content and the time in advance. In such cases, the directors of the respective Konami, IIJ and the New Company shall cooperate and make such an announcement.

Article 13. (The Items to be Accepted in Advance by Konami and IIJ)

1. The New Company shall obtain prior written acceptance by Konami and IIJ in case that the New Company shall determine the items which brings amendment to the current and future capital structure of the New Company, such as issuance of new shares, issuance of share acquisition rights.

2. In case that the New Company will issue shares, share acquisition rights, bonds with share acquisition rights etc. (hereinafter referred to as the "Shares") in accordance with the acceptance by Konami and IIJ as set forth in the preceding clause, Konami and IIJ shall subscribe for the Shares in proportion to the respective

shareholding ratios of each party before such issuance of the Shares unless otherwise agreed in written. Notwithstanding the acceptance in accordance with the preceding clause, in case that Konami or IIJ will not subscribe for the Shares in proportion to the respective shareholding or complete the payment by the share payment date which the New Company designates, the New Company may assume that such party waived the right to subscribe the Shares and the New Company may request the other party to subscribe for the Shares.

#### Article 14. (Consultation)

If the New Company fails in respect to one of the following conditions, Konami and IIJ shall consult with each other on continuance of the operation, amendment to the ratios of shareholding, additional investment of the New Company:

- i. in case that it is revealed that the amount more than the amount of funds planned to be necessary at the beginning (2,800 million yen) is necessary as the funds; or
- ii. it is revealed that substantial change is necessary to the operating plan of the New Company;

#### Article 15. (Transfer of Shares)

1. Konami and IIJ shall continue to hold the shares of the New Company while this Agreement remains in effect and shall not assign, gift, pledge, mortgage such shares unless otherwise agreed between both parties.

2. In case that the other party fails in respect to one of the conditions set forth in Article 17. iv, v, or vi, Konami or IIJ may obtain first rights to purchase all the shares of the New Company which the other party obtains upon prior written notice to the other party within thirty days from the time of such failure. The purchase price of the shares in this case shall be calculated in accordance with the measures which both parties assume as reasonable.

#### Article 16. (Liquidation)

In case that the New Company enters into liquidation, IIJ and Konami shall receive a liquidation distribution in proportion to the respective shareholding ratios of each party at the time of liquidation.

#### Article 17. (Termination of this Agreement)

This Agreement shall remain in full force until one of the following cases occurs;

- i. in case that Konami and IIJ agree on termination of this Agreement with each other in written;
- ii. in case that the number of respective voting right to the New Company which Konami or IIJ owns becomes less than twenty percent;
- iii. in case that the New Company has made a resolution on new listing on securities markets;
- iv. in case that Konami or IIJ has made a resolution on dissolution;
- v. in case that Konami or IIJ fails into payment suspension or insolvency, or files by itself or by a third party of a commencement of the proceedings of bankruptcy, civil rehabilitation, company liquidation, special liquidation or corporate reorganization; or
- vi. in case that, if Konami or IIJ violates this Agreement, the non-violating party declares an intention to terminate this Agreement in written notice for the reason that such failure remains uncorrect more than sixty days from such receipt, notwithstanding the receipt of written notice from the non-violating party informing such failure and correction.

Article 18. (Confidentiality)

1. Konami and IIJ shall keep secret and confidential technology, information, data, know-how, etc. disclosed by the other party by clearly expressing as confidential (hereinafter referred to as "Confidential Information") and shall not disclose Confidential Information to any third party, unless otherwise required by law or order of court proceedings during three years from the time of such disclosure (provided, however, that the preceding limit of confidentiality period shall not be applicable for Confidential Information in relation to the customer of the disclosing party and personal information). Konami and IIJ acknowledge in advance that the other party may disclose the fact and the contents of this Agreement in public in accordance with the provisions of the relative securities exchange laws of Japan and U.S.

2. The term "Confidential Information" shall not include any such information obtained from the other party or the New Company which was already or becomes publicly known through no wrongful act, was in the possession of the other party at the time of the disclosure or is rightfully received from a third party.

3. The obligation set forth in this article shall survive the termination of this Agreement for any reason.

Article 19. (Governing Law)

This Agreement shall be governed by and construed in accordance with the laws of Japan.

Article 20. (Jurisdiction)

The original and non-exclusive jurisdiction shall be the Tokyo District Court.

Article 21. (No Assignment)

Neither Konami nor IIJ may assign its rights or obligation under this Agreement or transfer or pledge this Agreement without prior written consent of the other party.

IN WITNESS WHEREOF, this Agreement has been executed in duplicate, one each of which shall be retained by each party after the printing of its name and the impression of its seal.

January 19, 2006

Konami: Konami Corporation  
2-4-1, Marunouchi, Chiyoda-ku, Tokyo, Japan  
Kagemasa Kozuki  
Representative Director

IIJ: Internet Initiative Japan Inc.  
105, Kanda Jinbo-cho 1-chome  
Chiyoda-ku, Tokyo  
Koichi Suzuki  
Representative Director

ARTICLES OF INCORPORATION

Executed on January 19, 2006

Notarized on

Incorporated on

CHAPTER I. GENERAL PROVISIONS

Article 1. (Corporate Name)

The Company shall be called Kabushiki Kaisha Internet Revolution, which shall be expressed in English as Internet Revolution Inc.

Article 2. (Objects)

The objects of the Company shall be to engage in the following categories of business:

- (1) Planning, development, designing, manufacturing, sales, lease, export and import of or for computers, peripherals, relative devices and computer software;
- (2) Sales, lease of and agency for mobile telephones and mobile telecommunication equipment;
- (3) Management business of computer networks;
- (4) Planning, design, production, editing of Internet content and website;
- (5) Agency for obtaining Internet domain names;
- (6) Internet connectivity services business;
- (7) Operation of Internet online shopping mall;
- (8) Agency for operation and introduction of Internet online settlement system;
- (9) Planning, production, sales, export and import of master copies of CDs, DVDs, music tapes, videos, game devices, software;
- (10) Collection, distribution, processing and sales of information, graphical content, music and sales of the relative device and equipment on telecommunication system;
- (11) Information processing service and information provision service business;
- (12) Planning, production, operation of advertising, promotion, event and advertising agency;
- (13) Sales of information media for advertising;
- (14) Planning, editing, production and sales of printed materials such as books and magazines and electronic publication;

- (15) Online shopping business;
- (16) Various marketing business;
- (17) Agency for collection;
- (18) Agency for consulting of sales promotion, application acceptance, customer management;
- (19) Issuance and sales of prepaid voucher specified in the relative law;
- (20) Management of entertainers, models, artists, athletes and the portrait rights;
- (21) Planning and development of character goods, management, licensing, assignment of the copyrights, the design patent rights, the trademark rights of such character goods and agency and representation related to the foregoing;
- (22) Obtaining and management of intellectual property rights and industrial property rights such as copyrights, neighbouring rights, design patent rights, trademark rights, etc;
- (23) Purchase and sales of secondhand goods;
- (24) Sales, processing, export and import of petroleum products and foods;
- (25) Manufacturing, processing, export and import of cosmetics, medical products, quasi-drugs, alcoholic liquors, oils and fats, health appliances and medical appliances;
- (26) Development, manufacturing, processing, export and import of textile products for clothing, garments, interior products, daily goods, home electrical appliance, cameras, game machines, sports equipment, toys;
- (27) Production of seed and ornamental plant, breeding of pet animals, export and import of such plant and pet animals and manufacturing, processing, sales, export and import of gardening goods and pet goods; and
- (28) Any and all businesses incidental or related to the foregoing.

Article 3. (Location of Head Office)

The Company shall have its head office in Minato-ku, Tokyo.

Article 4. (Method of Public Notice)

Public notices of the Company shall be given by official gazette.

CHAPTER II. SHARES

Article 5. (Total Number of Shares Authorized to be Issued)

The total number of shares authorized to be issued by the Company shall be one hundred thousand (100,000) shares.

Article 6. (Restriction on Transfer of Shares)

The transfer of shares of the Company shall be approved by a resolution of the Board of Directors.

Article 7. (Record Date)

The shareholders entitled to exercise voting rights at the ordinary general meeting of shareholders of the

Company relevant to each fiscal year shall be those shareholders with voting rights who are listed or recorded in the last register of shareholders as of March 31 of the fiscal year.

2. In addition to the preceding paragraph, whenever necessary, the Company may fix a record date after giving a public notice according to a resolution of the Board of Directors.

Article 8. (Nonissuance of Share Certificates)

The Company may suspend to issue share certificates.

CHAPTER III. GENERAL MEETING OF SHAREHOLDERS

Article 9. (Convocation)

An ordinary general meeting of shareholders of the Company shall be held within three (3) months from the day immediately following the settlement of accounts of each fiscal year and an extraordinary general meeting of shareholders may be held from time to time whenever necessary.

2. The shareholders entitled to exercise voting rights shall be those shareholders with voting rights who are listed or recorded in the last register of shareholders as of March 31 of the fiscal year at the ordinary general meeting of shareholders of the Company and who are recorded in the last register of shareholders as of the date fixed according to the resolution of the Board of Directors at the extraordinary general meeting of shareholders.

3. A general meeting of shareholders may be at the location of the head office of the Company.

Article 10. (Convocator and Chairman)

Unless otherwise provided for by law, a general meeting of shareholders shall be convened and chaired by the Chairman or the President. Should the Chairman and the President be unable to so act, another director shall act in his/her place in the order predetermined by the Board of Directors.

Article 11. (Method of Resolution)

Unless otherwise provided for by law or these Articles of Incorporation, resolutions of a general meeting of shareholders shall be adopted by a majority vote of shareholders present at the meeting.

Article 12. (Voting by Proxy)

A shareholder may exercise his/her voting right through another shareholder having voting rights acting as a proxy in a general meeting of shareholders; provided that the number of his/her proxy shall be one (1) and an instrument evidencing his/her power as proxy shall be submitted to the Company.

CHAPTER IV. DIRECTORS AND THE BOARD OF DIRECTORS

Article 13. (Number of Directors)

The number of directors of the Company shall be five (5).

Article 14. (Election of Directors)

Directors of the Company shall be elected at a general meeting of shareholders.

2. A resolution for election of directors of the Company shall be made by a majority of voting rights of the shareholders present at the meeting where the shareholders representing one third (1/3) or more of the total number of the voting rights of all shareholders are present.

3. Cumulative voting shall not be adopted for such election.

Article 15. (Term of Office of Directors)

The term of office of directors shall expire at the close of the ordinary general meeting of shareholders held in relation to the last settlement of accounts within one (1) year following their assumption of office.

2. The term of office of a director elected to increase the number of directors shall expire at the time when the term of office of the other incumbent directors shall expire.

3. The term of office of a director elected to fill a vacancy shall expire at such time as the term of office of his/her predecessor would otherwise expire.

Article 16. (Representative Director and Directors with Specific Titles)

Representative Directors shall be elected by the resolution of the Board of Directors.

2. The Board of Directors may, by its resolution, select from among its members one Chairman, one President, several Vice Presidents, several Senior Managing Directors, several Managing Directors.

Article 17. (Convocation and Chairman of Meetings of the Board of Directors)

Unless otherwise provided for by law, a meeting of the Board of Directors shall be convened and chaired by the Chairman or the President. Should the Chairman and the President be unable to so act, another director shall act in his/her place in the order predetermined by the Board of Directors.

2. The notice of convocation of a meeting of the Board of Directors shall be given to each director and statutory auditor at least three (3) days prior to the day set for such meeting; provided, however, that this period may be further shortened under pressing circumstances.

Article 18. (Regulations of Board of Directors)

Unless otherwise provided for by law or or these Articles of Incorporation, matters concerning meetings of the Board of Directors shall be governed by the Regulations of Board of Directors to be prescribed by the Board of Directors.

Article 19. (Remuneration)

The total amount of remuneration for directors shall be determined in a general meeting of shareholders.

CHAPTER V. STATUTORY AUDITORS AND THE BOARD OF STATUTORY AUDITORS

Article 20. (Number of Statutory Auditors)

The Company shall have three (3) statutory auditors.

Article 21. (Election of Statutory Auditors)

Statutory auditors of the Company shall be elected at a general meeting of shareholders.

2. A resolution for election of statutory auditors shall be made by a majority of voting rights of the shareholders present at the meeting where the shareholders representing one third (1/3) or more of the total number of the voting rights of all shareholders are present.

Article 22. (Term of Office of Statutory Auditors)

The term of office of statutory auditors shall expire at the close of the ordinary general meeting of shareholders in relation to the last settlement of accounts within four (4) years following their assumption of office.

2. The term of office of a statutory auditor elected to fill a vacancy shall expire at such time as the term of office of his/her predecessor would otherwise expire.

Article 23. (Standing Statutory Auditors)

The Statutory Auditors of the Company shall elect Standing Statutory Auditors from among themselves.

Article 24. (for Convocation of the Meeting of the Board of Statutory Auditors)

A notice of the convocation of a meeting of the Board of Statutory Auditors shall be given to each statutory auditor at least three (3) days prior to the date set for such meeting; provided, however, that such period may be shortened under pressing circumstances.

Article 25 (Regulations of the Board of Statutory Auditors)

Unless otherwise provided for by law or these Articles of Incorporation, matters concerning meetings of the Board of Statutory Auditors shall be governed by the Regulations of Board of Statutory Auditors to be prescribed by the Board of Statutory Auditors.

Article 26. (Remuneration)

The total amount of remuneration for statutory auditors shall be determined in a general meeting of shareholders.

#### CHAPTER VI. ACCOUNTING

Article 27. (Fiscal Year)

The fiscal year of the Company shall commence on April 1 of each year and end on March 31 of the following year and the last day of the fiscal year shall be the closing date of its accounts.

Article 28. (Dividends and Interim Dividends)

Dividends shall be paid to the shareholders or pledgees who are listed or recorded in the last register of shareholders as of the closing date of each account of the Company.

2. The Company may, by resolution of the Board of Directors, pay interim dividends to shareholders or pledgees listed or recorded in the last register of shareholders as of September 30 in each year.

Article 29. (Prescription Period)

In case dividends or interim dividends remain unreceived for three (3) full years after the first date of payment, the Company shall be relieved from the obligation to make payment thereof.

#### CHAPTER VII. SUPPLEMENTARY PROVISIONS

Article 30. (Number of Shares to be issued at the time of Incorporation)

The number of shares to be issued at the time of incorporation shall be twenty-five thousand (25,000) common shares and the par value of a share shall be one hundred thousand (100,000) Yen; provided, however, that the amount not to be incorporated into capital out of the total paid value of new shares shall be fifty thousand

(50,000) Yen per share.

Article 31. (First Fiscal Year)

The first fiscal year of the Company shall commence on the date of incorporation and end on March 31, 2006.

Article 32. (Term of Office of the First Directors and the First Statutory Auditors)

The term of office of the first directors and the first statutory auditors of the Company shall expire at the close of the ordinary general meeting of shareholders held in relation to the last settlement of accounts within one (1) year following their assumption of office.

Article 33. (First Directors and First Statutory Auditors)

The first directors and the first statutory auditors of the Company shall be as follows;

Directors: Kazuya Takahashi, Hiroshi Nagaoka, Akira Tamai, Takashi Taniguchi, Hideshi Hojo

Statutory auditors: Sigeru Masuko, Yasumasa Iwagaki, Akihisa Watai

Article 34. (Name, Address of Incorporators and Number of Shares to be Subscribed)

The name and address of the incorporators and the number of shares to be subscribed by the incorporators shall be as follows;

Konami Corporation  
2-4-1, Marunouchi, Chiyoda-ku, Tokyo  
seventeen thousand and five hundred (17,500) common shares

Internet Initiative Japan Inc.  
1-105, Kanda Jinbo-cho, Chiyoda-ku, Tokyo  
seven thousand and five hundred (7,500) common shares

Article 35. (Application of Laws)

Matters not specifically provided for in these Articles of Incorporation shall be determined in conformity with the Commercial Code and other laws.

The incorporators hereto have caused these Articles of Incorporation to be duly executed and delivered as of the date written below by their duly authorized representatives for the purpose to establish Internet Revolution Inc.

Dated this 19th day of January, 2006.

Kagemasa Kozuki  
Representative Director  
Konami Corporation  
2-4-1, Marunouchi, Chiyoda-ku, Tokyo, Japan

Koichi Suzuki  
Representative Director  
INTERNET INITIATIVE JAPAN INC.  
1-105, Kanda Jinbo-cho, Chiyoda-ku, Tokyo, Japan

REGULATIONS OF THE BOARD OF DIRECTORS

CHAPTER 1. GENERAL PROVISIONS

Article 1. (Objects of These Regulations)

Matters concerning the Board of Directors of the Company, unless otherwise provided for by law or the Articles of Incorporation of the Company, shall be governed by these Regulations of the Board of Directors.

Article 2. (Organization and Authority)

1. The Board of Directors shall be organized by all directors and decide on important matters concerning execution of business of the Company.
2. Statutory auditors must attend meetings of the Board of Directors and must give their opinions thereat when it is deemed necessary.

Article 3. (Presence by persons other than Directors and Statutory Auditors)

Any persons other than directors and statutory auditors may attend meetings of the Board of Directors and be requested for their opinions or explanation when the chairman deems it necessary.

Article 4. (Meetings)

1. Meetings shall be held once a month; provided, however, that meetings may be adjourned with a prior notice.
2. In addition to the preceding paragraph, extraordinary meetings may be convened whenever necessary.

Article 5. (Place of Meetings)

The place of meeting of the Board of Directors shall be head office; provided that meetings of the Board of Directors may be convened at other place or over teleconference system when necessary.

CHAPTER 2. CONVOCATION

Article 6. (Convocators)

A meeting of the Board of Directors shall be convened by the Chairman or the President. In the event the Chairman and the President is prevented from so doing, another director shall convene the meeting in the order previously determined by a resolution of the Board of Directors.

Article 7. (Procedure of Convening)

1. A notice of convening a meeting of the Board of Directors shall be dispatched to each director and statutory auditor at least three (3) days prior to the date of the meeting; provided, however, that the notice period may be shortened in the case of emergency.
2. A notice of convening a meeting of the Board of Directors shall be in written and include the time and date and the place of the meeting and the agenda. In case that attendance over

teleconference system is permitted, such notice shall include such permission and the place to attend at over teleconference system.

3. With an oral notice, a meeting of the Board of Directors may be held, in the case of emergency, without such a notice as in the preceding paragraph. In that case, the agenda of a meeting is not required to be included in such a notice.

#### CHAPTER 3. PROCEEDINGS

##### Article 8. (Chairman)

At meetings of the Board of Directors, the President of the Company shall act as chairman. In the event that the President is prevented from so doing, another director shall act as chairman in the order previously determined by a resolution of the Board of Directors.

##### Article 9. (Matters Requiring Resolution)

The matters which shall require approval of the Board of Directors shall be in accordance with the Schedule 1 and Schedule 2.

##### Article 10. (Resolution)

1. A majority of all directors present at the meeting shall constitute a quorum. A resolution by the Board of Directors for the matters requiring resolution regarding the matters set forth in Schedule 1 shall be made by the unanimous vote of the directors present at the meeting of the Board of Directors and a resolution by the Board of Directors for the matters requiring resolution regarding the matters set forth in Schedule 2 shall be made by a majority vote of the directors present at the meeting of the Board of Directors.
2. Any director who has any special interest with respect to the agenda of a meeting of the Board of Directors in the preceding paragraph may not exercise his voting rights (in the matter). In this case, such director shall not be counted in the number of directors present set forth in the preceding paragraph.

##### Article 11. (Minutes)

The proceedings and the results of the meetings of the Board of Directors shall be stated or recorded in the Minutes, and shall be signed and sealed by the directors and the statutory auditors present at any such meeting.

##### Appendix

##### Article 12. (Effective Date)

These Regulations shall take effective as from February 1, 2006.

Standards for Matters Requiring Resolution

Important matters concerning execution of business of the Company and disposition of important assets of the Company(not less than one thousand million (1,000,000,000) Yen per one case thereof);

- (1) Changes of principal objects of the business of the Company;
- (2) Withdraw from the business as a whole or principal business of the Company or assignment of the business of the Company as a whole or an important part thereof;
- (3) Dissolution of the Company; and
- (4) Amendment to the standards for matters requiring resolution at a meeting of the Board of Directors and the number of voting rights relating to such standards in these Regulations.

Standards for Matters Requiring Resolution

- (1) Matters relating to meetings of shareholders;
  - Convocation of meetings of shareholders and decisions of items on the agenda of meetings of shareholders (not including standards for matters requiring resolution set forth in Schedule 1);
- (2) Matters relating to directors;
  - Elections and dismissals of Representative Directors and decisions of joint representatives;
  - Elections and dismissals of directors with special titles and executive officers with specific titles;
  - Approvals of transactions between directors and the Company;
  - Approvals of competing business transactions by directors;
  - Determinations of orders among the directors and orders relating to directors' acting on behalf of other directors;
- (3) Matters relating to accounting;
  - Approval of financial statements and exhibits;
  - Payment of interim dividends;
- (4) Matters relating to shares;
  - Issuances of new shares;
  - Issuances of stock acquisition rights;
  - Cancellation of stock acquisition rights;
  - Issuances of bonds with stock acquisition rights;
  - Issuances of bonds;
  - Capitalization of legal reserves;
  - Stock split and increase of the total number of shares to be issued by the Company;
- (5) Matters relating to organizations and personnel;
  - Establishments, changes and abolitions of branch offices;
  - Elections and dismissals of managers;
  - Establishments, changes and abolitions of organizations, important divisions;
  - Establishments, mergers or dissolutions of subsidiaries or affiliate companies;

- Elections and dismissals of executive officers and general managers;
- (6) Matters relating to execution of important business;
- Decisions and changes of medium/long term plans and short term management plans (operation plans);
  - Decisions of plans of advances to new business;
  - Acquisition of important assets (not less than one hundred million (100,000,000) Yen per one case thereof);
  - A large amount of borrowings and guaranty for debts (not less than one hundred million (100,000,000) Yen per one case thereof);
  - Establishment of lease and security of important assets of the Company (not less than one hundred million (100,000,000) Yen per one case thereof);
  - dispositions of important assets of the Company, commencements or terminations of transactions and conclusions of contracts (not less than one thousand million (1,000,000,000) Yen per one case thereof);
  - Important capital/business cooperations or cancellations thereof;
  - Establishments of important internal rules;
- (7) Other matters;
- Approval of important matters of subsidiaries;
  - Filing of important litigation (in case that the amount of such financial impact shall be not less than one hundred million (100,000,000) yen per case thereof);
  - Other matters which are recognized as necessary than each of the preceding sections.

(English Translation)

Agreement on Limited Liability

Internet Initiative Japan, Inc. ("IIJ") and [name of outside director / outside statutory auditor], an outside director of IIJ, (the "Director") / an outside statutory auditor of IIJ, (the "Auditor") agree as follows in respect of limited liability for damages stipulated in Article 423 paragraph 1 of the Corporation Law of Japan of the Director/the Auditor to the company pursuant to the provision of Article 427 paragraph 1 of the Corporation Law of Japan.

Article 1. (Maximum Amount of Limited Liability)

If, after the execution hereof, the Director/the Auditor conducts any of the acts stipulated in Article 423 paragraph 1 of the Corporation Law of Japan as an outside director/an outside statutory auditor of IIJ and causes IIJ to sustain any damages as a result of such act, the Director/the Auditor shall, save for acts conducted by himself/herself with any willful misconduct or gross negligence, bear the limited liability for such damages amounting to 10 million yen or the aggregate of the amounts set forth in Article 425 paragraph 1 of the Corporation Law of Japan, whichever is higher.

Article 2. (Expiration of Agreement on Limited Liability)

This Agreement shall expire at any time in the future if the Director /the Auditor becomes a director, an executive officer, or an employee entitled to execute the business of IIJ or a subsidiary thereof.

Article 3. (In case of Reelection)

This Agreement shall apply to the acts which the Director/the Auditor conducts until he/she retires from the position of director of IIJ; provided, however, if upon expiration of the term of office as a director/a statutory auditor, the Director/the Auditor is reelected as a director of IIJ and assumes the position, this Agreement shall remain effective with respect to the acts conducted by such director/auditor after the reelection. The same shall apply thereafter.

Article 4. (Deposit of Certificate of Stock Acquisition Rights)

If in case the Director/the Auditor possesses the certificate of stock acquisition right issued concerning the rights set forth in Article 288 paragraph 1 of the Corporation Law of Japan (including the certificate of stock acquisition rights issued concerning the rights set forth in Article 280-19 paragraph 1 of the Commercial Code of Japan which is granted pursuant to the resolution set forth in Article 280-21 paragraph 1 of the Commercial Code of Japan ) IIJ notifies the Director/the Auditor that the Director/the Auditor has caused IIJ to sustain damages by conducting the acts set forth in Article 423 paragraph 1 of the Corporation Law of Japan, the Director/the Auditor shall promptly deliver the certificate of stock acquisition rights to the care and custody of IIJ.

Article 5. (Disclosure of Agreement on Limited Liability)

IIJ may disclose the existence and contents of this Agreement to a third party if such disclosure is required by provisions of applicable laws or regulations.

Article 6. (Jurisdiction by Agreement)

Any incident or dispute arising out of or in relation to this Agreement shall be subject to the exclusive jurisdiction of the Tokyo District Court as the court of first instance.

IN WITNESS WHEREOF, this Agreement is executed in duplicate, and with their seals and signatures affixed, each party retains one original, respectively.

June 28, 2006

IIJ: Internet Initiative Japan, Inc.  
1-105, Kanda Jinbo-cho, Chiyoda-ku, Tokyo,  
Japan

Koichi Suzuki  
Representative Director

Director: [name of outside director/auditor]

Internet Initiative Japan Inc., Code of Conduct

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## I. PURPOSE OF THIS CODE

The following information constitutes IIJ's corporate Code of Conduct (this "Code"), which applies to all IIJ directors, officers and employees.

The Board of Directors has adopted this Code to:

- (1) promote honest and ethical conduct, including fair dealing and the ethical handling of actual or applicable conflicts of interest;
- (2) promote full, fair, accurate, timely and understandable disclosure;
- (3) promote compliance with applicable laws, rules and regulations;
- (4) ensure the protection of IIJ's legitimate business interest, including corporate opportunities, assets and confidential information;
- (5) deter wrongdoing; and
- (6) encourage the prompt reporting of any illegal or unethical behaviors.

All directors, officers and employees of IIJ are expected to be familiar with this Code and to adhere to those principles and procedures set forth in this Code that apply to them.

From time to time, IIJ may waive some provisions of this Code. Any waiver of this Code for officers or directors of IIJ may be made only by the Board of Directors, after consulting with the Board of Statutory Auditors, and must be disclosed as required by the United States Securities and Exchange Commission ("SEC") or the Nasdaq Stock Market ("Nasdaq") rules. Any waiver for other employees may be made only by the Chief Executive Officer ("CEO") or, if with respect to any material situation, by the Board of Directors.

The CEO may delegate his authority in this Code to an officer who is in charge of internal controls. Such delegation shall be authorized only by the Board of Directors.

IIJ shall take all action to ensure that this Code is applied to all directors, officers and employees of IIJ's subsidiaries; except that, if such application to any director, officer or employee of a subsidiary of IIJ conflicts with laws of the relevant jurisdiction, IIJ shall modify the application of this Code, with respect to such subsidiary, to avoid such conflict, but only to the extent that such modification is not inconsistent with the United States federal securities laws and regulations, the regulations of Nasdaq and the applicable laws and regulation of Japan. IIJ shall also take action to apply this Code to the directors, officers and employees of its affiliates.

## II. COMPLIANCE WITH APPLICABLE LAW

IIJ is committed to conducting its business in strict compliance with all applicable governmental laws, rules and regulations, including but not limited to laws, rules and regulations related to securities, labor, employment and workplace safety matters. Directors, officers and employees are expected at all times to conduct their activities on behalf of IIJ in accordance with all applicable laws and regulations as well as internal company rules and this Code. In addition to the laws of Japan, as a Nasdaq listed company, IIJ is subject to regulations of the SEC and Nasdaq and required to comply with United States federal securities laws and regulations.

### III. REPORTING AND ACCOUNTABILITY

The CEO is responsible for applying this Code promptly and in a consistent manner to specific situations in which questions are presented to the CEO and has the authority to interpret this Code in any particular situation for any employee; except that, in case of any material situation involving any employee, such responsibility and authority shall be assumed by the Board of Directors and, in case of any situations involving any officer or director, such responsibility and authority shall be assumed by the Board of Statutory Auditors. Any director, officer or employee who becomes aware of any past, existing or potential violation of this Code is required to notify the CEO promptly. Failure to do so is itself a violation of this Code. In case of any situation with respect to which the CEO does not have the responsibility or authority described above, the CEO shall promptly and in a consistent manner notify the Board of Directors or the Board of Statutory Auditors, as the case may be. Failure to do so is itself a violation of this Code.

A director, officer or employee who is unsure if a situation violates this Code should discuss the situation with the CEO promptly and in a consistent manner to prevent possible misunderstandings and embarrassment at a later date.

Each director, officer or employee is expected to do as follows; however, notwithstanding the foregoing, he or she may make confidential and anonymous submissions in accordance with the procedure established by the Board of Statutory Auditors:

- (1) Notify the CEO promptly of any past, existing or potential violation of this Code. Each director, officer or employee may notify the CEO through his or her supervisor.
- (2) Not retaliate against any other director, officer or employee for reports of potential violations that are made in good faith and protect its identities to the extent consistent with law and this Code.

The CEO shall promptly take all action he considers appropriate to investigate any potential or existing violation by an employee reported to him; except that, in case of any material potential or existing violation by any employee, such action shall be taken by the Board of Directors and, in case of any potential or existing violation by an officer or director, such action shall be taken by the Board of Statutory Auditors. If a violation has occurred, IIJ will promptly take such disciplinary or preventive action as it deems appropriate after consultation with (i) the CEO, in the case of any non-material violation by an employee, (ii) the Board of Directors, in the case of any material violation by an employee, or (iii) the Board of Statutory Auditors, in the case of any violation by an officer or director.

### IV. FAIR DEALING

It is the policy of IIJ to comply with applicable antitrust, competition and fair trade laws and regulations of each country and region where IIJ conducts its businesses. Directors, officers and employees are required to deal fairly with IIJ's financial institutions, customers, suppliers, vendors, competitors, agents and other entities, to base their business relationships on lawful, efficient and fair practices and to use only ethical practices when dealing with actual or potential counterparties, including financial institutions, customers, suppliers, vendors, competitors, agents and other parties. It is prohibited to give and accept anything of value from any current or potential counterparties, including financial institutions, suppliers or vendors as inducement for or in return for business or preferential treatment and to take advantage of any financial institution, customer, supplier, competitor or other entity through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair business practices.

## V. CONFLICT OF INTEREST

Business decisions and activities must be based on the best interests of IIJ and must not be motivated by, or appear to be motivated by, personal considerations or relationships. Any director, officer and employee should avoid any action which may involve, or appears to involve, a conflict of interest with IIJ. Relationships with actual or potential suppliers, contractors, customers or competitors must not affect, or appear to affect, your independent and sound judgment on behalf of IIJ. Directors, officers and employees are required to disclose to the CEO any situation that may be, or appears to be, a conflict of interest.

In particular, clear conflict of interest situations involving directors, officers and other employees who occupy supervisory positions or who have discretionary authority in dealing with any third party specified below may include the following:

- (1) any significant ownership interest in any supplier or customer;
- (2) any consulting or employment relationship with any customer, supplier or competitor;
- (3) any outside business activity that detracts from an individual's ability to devote appropriate time and attention to his or her responsibilities with IIJ;
- (4) the receipt of non-nominal gifts or excess entertainment from any company with which IIJ has current or prospective business dealings;
- (5) being in the position of supervising, reviewing or having any influence on the job evaluation, pay or benefit of any immediate family member; and
- (6) selling anything to IIJ or buying anything from IIJ, except on the same terms and conditions as comparable directors, officers or employees are permitted to so purchase or sell.

Such situations, if material, should always be discussed with the CEO.

## VI. DEALING WITH GOVERNMENT OFFICIALS

It is strictly prohibited to, directly or indirectly, promise, offer or make payment in money or anything of value to government officials for the purpose of, or that appears to be for the purpose of, seeking favorable business treatment or improperly affecting business or government decisions. In many countries gifts or payments to government officials are specifically prohibited by law. Any director, officer, or employee involved in sales or other transactions with government officials should ensure that such transactions comply with all applicable laws and regulations and avoid even the appearance of impropriety.

## VII. CONFIDENTIAL INFORMATION

IIJ will protect its own confidential and proprietary information as well as the information that financial institutions, customers, suppliers, competitors or their employees entrust to IIJ. Directors, officers and employees are required to maintain the confidentiality of all confidential and proprietary information and not to disclose or distribute any confidential or proprietary information except when authorized by the company. Directors, officers and employees are also required to use such information only for the purpose permitted by the company in connection with their duties at IIJ. Even within IIJ, directors, officers and employees shall only disclose confidential or proprietary information to those employees who have business-related "need-to-know".

## VIII. COMPANY'S ASSETS

Directors, officers and employees have a responsibility to protect the IIJ assets entrusted to them from loss, damage, misuse or theft. Such assets include both tangible and intangible assets, including IIJ's name, logo, brand, trademark, service marks, copyrights, patents, trade secrets, inventions, products, know-how, marketing and financial plans, databases, records and other intellectual property and may only be used for business purposes and other purposes approved by the Board of Directors.

#### IX. CORPORATE OPPORTUNITIES

Directors, officers and employees owe a duty to IIJ to advance IIJ's business interests. Directors, officers and employees are prohibited from taking for themselves or directing to a third party a business opportunity that is discovered through the use of corporate property, information or position, unless IIJ has already been offered the opportunity and determined not to pursue it. More generally, directors, officers and employees are prohibited from using corporate property, information or position for personal gain and from competing with IIJ.

Sometimes the line between personal and IIJ benefits is difficult to draw, and sometimes there are both personal and IIJ benefits in certain activities. Directors, officers and employees who intend to make use of IIJ property or services in a manner not solely for the benefit of IIJ should consult beforehand with the CEO.

#### X. INSIDE INFORMATION AND SECURITIES TRADING

It is illegal to use insider information when buying, selling or trading stocks or other securities, including not only the Company securities but also the securities of other companies about which directors, officers or employees have "material non-public information" as a result of business activities. "Material non-public information" is any non-public information which can be expected to affect the judgement of reasonable investors as to whether or not to buy, sell, or hold the securities in question. It includes financial performance including earnings, dividend plans, significant litigation exposure due to actual or threatened litigation, news of a pending or proposed acquisition or merger, corporate partnerships, acquisitions or strategic alliances, the disposition of assets, new equity or debt offerings, changes in senior management or any other significant activities. Directors, officers and employees must handle "material non-public information" just like other IIJ's proprietary information and must not disclose "material non-public information" unless authorized by IIJ. Any director, officer or employee who is uncertain about the legal rules involving a purchase or sale of any IIJ securities or any securities in companies that he or she is familiar with by virtue of his or her work for IIJ, should consult with the CEO or any person designated by CEO before making any such purchase or sale.

#### XI. MEDIA RELATIONS AND PUBLIC INQUIRIES

IIJ takes seriously its legal and business obligations to communicate accurately with the news media, regulatory agencies and other entities. Inappropriate comment to such entities may be damaging. To ensure professional and consistent handling of communication with any such entities, requests from the news media, press agents and other mass media should be forwarded to IIJ's investor relations section and the request from regulatory agencies and other governmental authority should be forwarded to IIJ's legal section.

#### XII. FINANCIAL REPORTING AND ACCURACY OF COMPANY RECORDS

IIJ is required by law and exchange regulations to make full, accurate, timely and understandable disclosure in the reports and documents that IIJ files with, or submits to the SEC, Nasdaq and other regulatory entities and in all other public communication it makes. All records, recordation and reporting, maintenance of information, including but not limited to business transactions, books and other financial records, must be accurate, complete and timely and must be a fair representation of facts.

Each director, officer or employee involved in IIJ's disclosure process, including the CEO, the Chief Financial Officer and the Chief Accounting Officer, is required to be familiar with and comply with IIJ's disclosure controls and procedures and internal control over financial reporting, to the extent relevant to his or her area of responsibility, so that IIJ's public reports and documents filed with SEC or Nasdaq comply in all material respects with the applicable federal securities law and SEC and Nasdaq rules. In addition, each person having direct or supervisory authority regarding these SEC filing or IIJ's other public communications concerning its general business, results, financial condition and prospects, should, to the extent appropriate within his or her area of responsibility, consult with other Company officers and employees and take other appropriate steps regarding these disclosures with the goal of making full, fair, accurate, timely and understandable disclosure.

Each director, officer or employee who is involved in IIJ's disclosure process, including without limitation the Chief Financial Officer, must:

- (1) Familiarize himself or herself with the disclosure requirement applicable to IIJ as well as the business and financial operations of IIJ;
- (2) Not knowingly misrepresent, or cause others to misrepresent, facts about IIJ to others, whether within or outside IIJ, including to IIJ's independent auditors and governmental regulators; and
- (3) Properly review and critically analyze proposed disclosure for accuracy and Completeness.

### XIII. STAKEHOLDERS

IIJ has a corporate social responsibility against a wide range of stakeholder groups, including shareholders, IIJ's users, suppliers, employees and public users of the Internet. Therefore, all directors, officers and employees of IIJ are expected not only to fulfill accountability to shareholders but also to endeavor to obtain better understanding of such various stakeholder groups in consideration of the strong social influence of IIJ.

All directors, officers and employees of IIJ are expected to report to CEO in advance in case that its own business for IIJ may work to be the detriment of the interest of a particular stakeholder group.

## CERTIFICATIONS

I, Koichi Suzuki, certify that:

1. I have reviewed this annual report on Form 20-F of Internet Initiative Japan Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: July 11, 2006

INTERNET INITIATIVE JAPAN INC.

/s/ Koichi Suzuki

-----  
Name: Koichi Suzuki  
Title: President, Chief Executive Officer and  
Representative Director

## CERTIFICATIONS

I, Akihisa Watai, certify that:

1. I have reviewed this annual report on Form 20-F of Internet Initiative Japan Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: July 11, 2006

INTERNET INITIATIVE JAPAN INC.

/s/ Akihisa Watai

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 Name: Akihisa Watai  
 Title: Director, Chief Financial Officer and  
 Chief Accounting Officer

CERTIFICATIONS  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(SUBSECTIONS (a) AND (b) OF SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED  
STATES CODE)

Pursuant to 18 U.S.C. Section 1350, the undersigned officer of Internet Initiative Japan Inc. (the "Company") hereby certifies, to such officer's knowledge, that the Company's annual report on Form 20-F for the year ended March 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 11, 2006

INTERNET INITIATIVE JAPAN INC.

/s/ Koichi Suzuki

-----  
Name: Koichi Suzuki  
Title: President, Chief Executive Officer and  
Representative Director

CERTIFICATIONS  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(SUBSECTIONS (a) AND (b) OF SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED STATES CODE)

Pursuant to 18 U.S.C. Section 1350, the undersigned officer of Internet Initiative Japan Inc. (the "Company") hereby certifies, to such officer's knowledge, that the Company's annual report on Form 20-F for the year ended March 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 11, 2006

INTERNET INITIATIVE JAPAN INC.

/s/ Akihisa Watai

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Name: Akihisa Watai  
Title: Director, Chief Financial Officer and  
Chief Accounting Officer